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January 6, 2009

Dear Investor,

2008 was a very momentous year. As some truly unique events unfolded, we felt compelled to keep our clients informed so as to be well-equipped to deal with turbulent economic times. We feel the time is right to once again provide you with a substantive update on financial market conditions. In this letter we also review 2008 governmental policy actions, general economic conditions, and provide a few forward-looking comments.

By any measure, 2008 was a very trying year for investors. Equity markets were no exception. During 2008 the Dow Jones Industrial Average fell 33.8%. The S&P 500 and NASDAQ indices fell 38.5% and 40.5%, respectively. Sector-wise for the year, financial stocks were the poorest performing domestic sector (-55.3%) while consumer staples were the best performing domestic sector (-15.4%). In terms of equity style and level of capitalization, Mid-Cap Growth stocks performed the poorest (-44.3%) while Small-Cap Value stocks performed the best (-28.9%). Foreign Large-Cap stocks performed poorly, averaging returns between -42% on the value end and -47% on the growth end.

Fixed-Income markets provided some relief for investors in certain circumstances. For 2008, U.S. Treasuries returned 13.7% while Mortgage-Backed Securities (MBS) returned 8.3%. In contrast, Treasury Inflation-Protected Securities (TIPS), Municipal Bonds, and Corporate Bonds delivered returns of -2.4%, -2.5%, and -4.9%, respectively. Emerging Market Debt (EMD) and High Yield Bonds experienced the worst returns at -14.7% and -26.2%, respectively.

The year 2008 saw the federal funds rate drop from 4.25% to a target range of 0-0.25% and the yield on the six-month Treasury bill fell from 3.49% to 0.27%. Also, the U.S. median existing home price fell from \$208,800 to \$181,300 and oil dropped from \$95.98 to \$44.40 a barrel. In addition to poor performance in financial markets, general economic conditions deteriorated during 2008. The unemployment rate went up from 4.7% to 6.7% while the threat of inflation subsided and in some cases has turned into a concern about deflation. Third quarter growth in Real GDP was estimated to be -0.5%. On December 1, 2008, the National Bureau of Economic Research announced to the public that the U.S. economy had been in recession since December of 2007.

The events of 2008 that resulted in the outcomes outlined above are worth reviewing. Concerns over subprime lending, which first surfaced during the summer of 2007, translated into a full-blown crisis by the beginning of 2008. At the same time, equities began to erode from their high values achieved during the previous October. Also, oil prices continued to climb and contributed to higher food prices and rising general inflation. The U.S. government responded with a stimulus package in the form of tax rebates. Later, in March, Pension Consultants, Inc. was out front in recognizing one of the negative out-workings of subprime lending and the securitization process that can lead to toxic mortgage-backed securities (MBS). The developments in fixed income markets prompted us to more explicitly outline the problems and mounting risks and communicate this to our clients. Letters in January and March informed our clients about subprime lending problems and risks posed to Stable Value Funds and other guaranteed accounts that often lack the same level of transparency as SEC-registered open-end mutual funds. Later in the year, our concerns with these and other fixed-income instruments were substantiated. Also in March 2008, the government provided credit guarantees to J.P. Morgan, facilitating its buyout of Bear Stearns. Not long after that the U.S. Treasury placed Fannie Mae and Freddie Mac in conservatorship. At this point, most of America was alarmed but not shaken. A few institutions had encountered trouble, the government stepped in, and markets continue to function smoothly.

The smooth operation of financial markets came to a grinding halt in September when the Treasury Department refused to provide

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guarantees or otherwise bail out Lehman Brothers. The complete collapse of Lehman Brothers had far-reaching effects, especially on the commercial paper market. Once this short-term business-oriented debt market was disrupted, the government was forced to become much more deeply involved in the crisis. The U.S. Treasury opened a temporary guarantee program for money market funds and along with Congress, created the Troubled Asset Relief Program (TARP). Treasury and other government entities directly and indirectly involved themselves in facilitating mergers and acquisitions in the insurance and investment banking industries. Letters sent to our clients in September and October were designed to provide updates on these far-reaching developments.

Subsequently, TARP monies have been used to provide relief to AIG, Citigroup, Bank of America, and other financial firms. Beginning in September and continuing to today, government intervention has taken on a much wider scope in an effort to prevent financial system collapse and stave off a potentially virulent recession. Much has been done and continues to be done to address the facets of our economy that have been left seriously weakened by the credit crisis. So far these efforts have been successful. However, for many the most indelible effect of the past six months has been the loss of value in equity investments. Many people are now faced with tough economic prospects due to their retirement account balances falling substantially. This, combined with very little or no home equity credit lines available, has forced many households to cut back drastically on spending. This spending is sorely missed and provides the impetus and rationale for increased government spending.

As if our economy has not been through enough, we still face additional downside to our economic situation. Home foreclosures are expected to continue at elevated levels, in part due to additional mortgage defaults. These default concerns are focused on so-called "Alt-A" loans, adjustable-rate mortgages (ARMs), and leveraged loans, which are different from subprime loans. Along with these continuing credit market problems, the general economy has entered a recession. Finally, revelations have come to light about the alleged Ponzi scheme fraud perpetrated by Bernard Madoff. This scandal has not only hurt those who lost their investments but has contributed to a lack of trust and confidence that our markets can ill-afford at this time. Our economy is definitely being put through the paces by all these challenging circumstances.

In general, we are starting the New Year in a low interest-rate, low inflation-rate environment with a great deal of opportunity and uncertainty in marketplaces and among market participants. Our economy has been battered but is not broken. Our financial system is being made over and has not collapsed. Reform is already in the making and in some cases, in place and meeting with success. We have the attitude of watchful optimism. We have this attitude because even though weakened, our public and private sectors are taking active steps to recover. We feel very much the same as we did a few months ago. The government continues to take appropriate steps in assisting credit markets and general economy as they mend. This process is not perfect due to its political nature and it takes time. Despite this, we are already seeing some improvement in equity performance. On the fixed-income front, we continue to watch for more signs of a thaw in the still largely frozen credit markets.

Generally speaking, many believe economic recovery from the recession will not start until the latter half of 2009. Until then, we can expect some worsening economic news before conditions improve. Unemployment in particular can be expected to rise and remain high throughout 2009. Deflation for some may be a bigger problem than the specter of inflation. To be sure, the current economic landscape is deserving of everyone's attention. We will remain alert and maintain a watchful eye on future developments. Do not hesitate to contact us with questions or concerns. We are mindful of our duty to serve and are ready to assist you in any way we can.

Sincerely,
Steven T. Petty, Ph.D.
Senior Research Analyst

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