

# Third Quarter 2008 Investment Summary

## Trinity Wealth Advisors

### Values and Performance as of 9/30/08

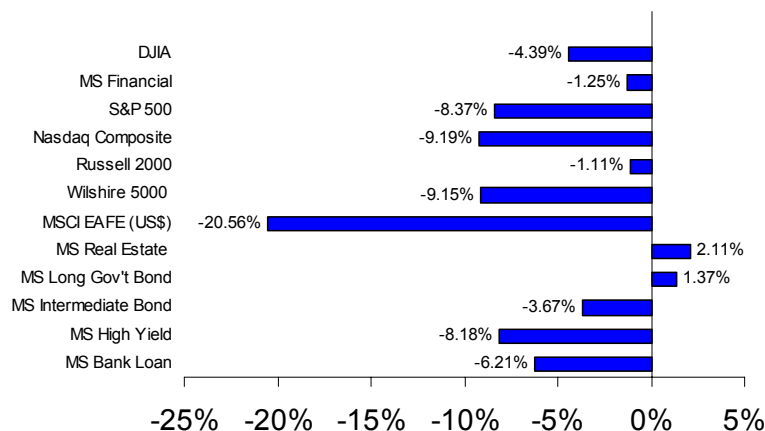
#### Market Update

Economics may be the dismal science, but the third-quarter of 2008 has been one of high economic drama. The ongoing financial crisis that claimed investment bank Bear Stearns in the first quarter of 2008, and that has upset markets all year, accelerated to force Lehman Brothers into bankruptcy, put mortgage lenders Fannie Mae and Freddie Mac into U.S. government conservatorship, force distressed insurance behemoth AIG to take an \$85 billion cash infusion from the government, and led eventually to the passing of a \$700 billion rescue plan by Congress. Additionally, Bank of America purchased Merrill Lynch, while the last two remaining large, independent investment banks, Morgan Stanley and Goldman Sachs, elected effectively to become regulated commercial banks with the result being that they won't be able to operate with as much leverage as they did previously.

As the credit crisis grew, the markets reacted with increasing volatility and negative results. The U.S. broad markets declined 8-10% for the quarter and have declined 22-24% over the past 12 months. Surprisingly, smaller stocks fared better during the quarter and were down only 1% during the quarter which is unusual during a period such as this. Not surprisingly, financial stocks have shown some of the highest volatility over the past year, but did fare better during the quarter (down 1% overall) as the U.S. government made some progress with the crisis. As a result of the improved financial sector's performance, the Dow was down 4.4% for the quarter. The financial crisis began to spread to overseas markets and the stock market impact was more severe. International markets fell approximately 20% during the quarter and have declined 30% over the past year. Some of the decline was due to the dollar increasing more than 8% against the Euro suddenly during the last two weeks of September, but Europe and Japan's economy began to show signs of recession as well. Real estate stocks were one of the few equity sectors that showed a positive return for the quarter, increasing 2%.

The dislocations in the credit markets impacted bond markets as well. Government bonds grew by 1-2% during the quarter as a flight to safety ensued. During the end of September, major adjustments to risk spreads began that caused interest rates to widen and prices to drop for most categories of corporate bonds. As a result corporate bonds declined 3-8% during the quarter.

#### 3rd Qtr 2008 Market Returns



Sources: Frank Russell Company, Standard & Poors, Wilshire Associates, Morningstar, Lipper, Wall Street Journal  
Past performance is no guarantee of future results

## The Credit Crisis

Recent weeks have rattled financial markets around the globe and have shaken investors deeply. During the turmoil, Congress passed a \$700 billion bailout bill aimed at restoring confidence in the financial system. The stock market has grabbed the headlines, but it is the reeling credit markets that will get the most government attention in its bailout efforts. As the credit markets tighten, the economic impact can be felt in many areas. Some of the ill effects are already noticeable. Auto financing is less available, which is one reason car sales have dropped sharply. Approvals for home mortgages have gotten much tougher, and credit-card interest rates have increased.

The banking system is going through a consolidation. In addition to the household sector overextending itself with home mortgages, our banking system overextended itself. It grew its balance sheet faster than its revenues grew, and now it has to shrink back. That's a painful process. It's really almost an unnatural act for a banking system to shrink. It cuts off credit to the economy. This consolidation could significantly reduce the number of institutions that will ultimately survive through mergers and attrition. For example, Canada has only a few banks; the U.S. has 8,000. There is excess capacity in the financial industry which will need to be consolidated. This consolidation will be necessary for the industry to stabilize and allow their returns on equity to grow.

A big part of the government bailout effort is aimed at restoring confidence in the credit markets by creating a "buyer of last resort," especially for the toxic credit derivatives that have heavily damaged the financial sector. By getting these troubled assets off of the companies' balance sheets, banks would become more appealing as business partners and as investments. Perhaps the closest parallel to today's proposed bailout effort was the Resolution Trust Corp., or RTC, that was created in the late 1980s to clean up the mess caused by the collapse and government takeover of over 700 Savings and Loan associations. The RTC was left with some \$500 billion of assets to dispose of ranging from conventional home mortgages and construction loans to raw land, half-finished real estate developments, office buildings and the like. The assets that the Treasury will end up with this time around will be far easier to manage. RTC at its peak had 10,000 employees. It's estimated that this effort could function with just a tenth of that number.

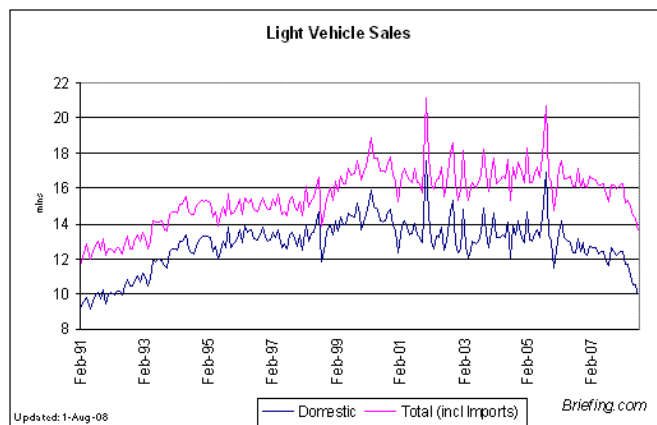
In addition to the consolidation problems, there has also become a trust problem between the financial institutions themselves. Nobody knows which firms may go under, causing lenders to be reluctant to lend. So the solutions have had to become more coordinated and comprehensive among the U.S. government (Federal Reserve, U.S. Treasury, FDIC and the SEC), as well as with the European Union. The U.S. has moved aggressively to respond to the scope of the problems. The European Union, which has the E.U. Central Bank and fifteen separate Treasuries to coordinate, is starting to grasp the magnitude of the situation as well. It is anticipated that the U.S. and E.U. will begin to coordinate some of their actions such as reducing interest rates over the next few weeks.

It is anticipated that the U.S. and European Governments will ultimately become the clearinghouse to get the lending institutions to operate functionally again. An example of this is with the corporate commercial paper market. The Fed said it would purchase three-month unsecured and asset-backed commercial paper directly from issuers, an unusual foray into unsecured lending. Traditionally, when the Fed lends to banks and other financial institutions, the loans are secured by collateral. In this case, the Fed will collect up-front fees paid by issuers. The same kind of support is expected to occur between interbank lending to support what used to be normal transfers between banks.

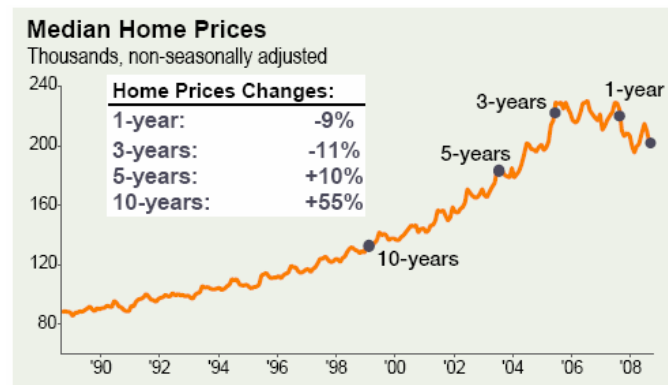
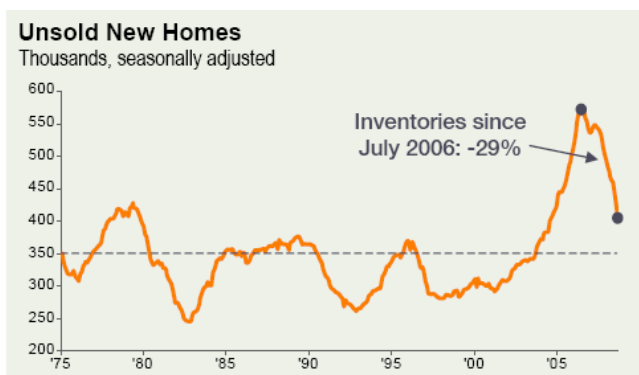
The equity markets hate uncertainty and this crisis has been full of surprises. Add to that the impact of a slower economy due to the financial dislocations and we've seen much higher market volatility and highly emotional markets. As a result, the Treasury Department is under pressure to show meaningful results from its authority to buy \$700 billion of distressed assets. The Treasury is expected to begin buying assets near the end of October through the use of auctions. The core of the Treasury's plan is to conduct auctions as quickly as possible to purchase the distressed mortgage securities from financial institutions in an orderly fashion. The Treasury is expected to hire experienced asset managers quickly to begin to facilitate the transition.

## The Economy

After escaping a downturn for much of the year, the economy is showing signs of contraction under the weight of the credit crisis and past increases in energy prices. The U.S. economy slid further toward a recession last month as companies shed workers at the fastest pace in more than five years, a bleak sign for household spending. Automobile sales also declined sharply, which is evidence that the crisis in financial markets is making it tougher for U.S. households to obtain credit.



Home sales and prices continue to fall in August, even though inventories of unsold homes managed to shrink. While second quarter GDP was still positive, the Commerce Department revised the growth from 3.3% to 2.8%, with softer numbers from consumer spending, net exports and inventories. The U.S. economy slowed to a crawl in the third quarter and is limping, at best, into the final quarter of the year. While a bailout package would help reliquefy the U.S. monetary base and kick-start lending, this turnaround will take time.



For much of 2008, commodity prices behaved as if growth in China and other emerging markets would compensate for the housing and financial crisis in the U.S. A year ago, the global economy was expanding by roughly 5% per year, with the emerging markets posting growth in the 8-10% range. Now, the message from the markets is that the slowdown is spreading worldwide. Safe-haven currencies, the dollar and the yen, increased in early October as several economists revised forecasts for a global recession in 2009. The landscape looks radically different today, as Japan is on the verge of a recession. The Eurozone has also shown significant declines, with many of its nations (Ireland, Spain and Germany, among others) also on the brink of recession. In China and India, the rising cost of energy, food and lately, capital, have all conspired to slow growth.

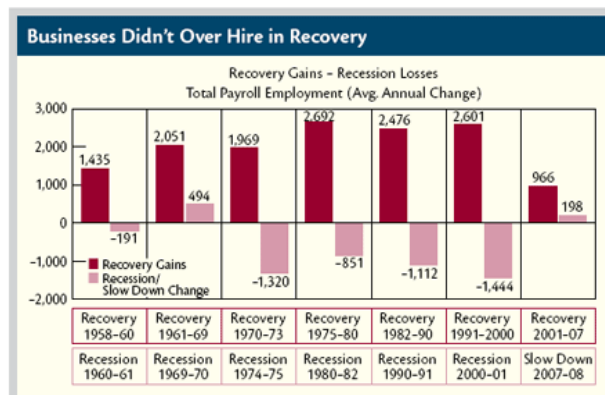
### Some Encouraging News and Perspective

If there's one bright spot in a bad economy, it's that gasoline prices have fallen, and they're expected to drop even further. As the global economy falters, demand for oil has dropped. And since the price of oil, which makes up about half of the cost of a gallon of gas, is down 40 percent from its high in July, analysts see more relief ahead at the pump. Expectations are moving towards \$3.00 gas prices in the near future.

The U.S. Government has shown the willingness and ability to step in quickly and to take action to correct the financial crisis. So far, the solutions the government has thrown at the system haven't restored confidence. But progress is being made and the government has shown the ability to adjust to the scope of the problems. There are still more cards to play if the situation becomes more strained and it appears we are on the right course toward solving this problem.

It is also not ridiculous to believe that the government's investment in these securities could actually make a profit over time, or certainly not lose anywhere near what the market fears. According to Barron's recent analysis of the plan, the Treasury Department could fare well in the bailout and could actually turn a profit over the years ahead. For one thing, the mortgages and mortgage securities that the government will be buying back from commercial and investment banks, credit unions, insurance companies and others aren't as toxic or wide-spread as commonly assumed. The Treasury's purchases should not only help free up credit markets but boost the prices of securities that are backed by home loans. Bill Gross of Pimco is even more optimistic than Barron's. He believes the U.S. Treasury could end up earning a yield of 7-8% on the purchases, and could sell the assets at a higher value when the market improves.

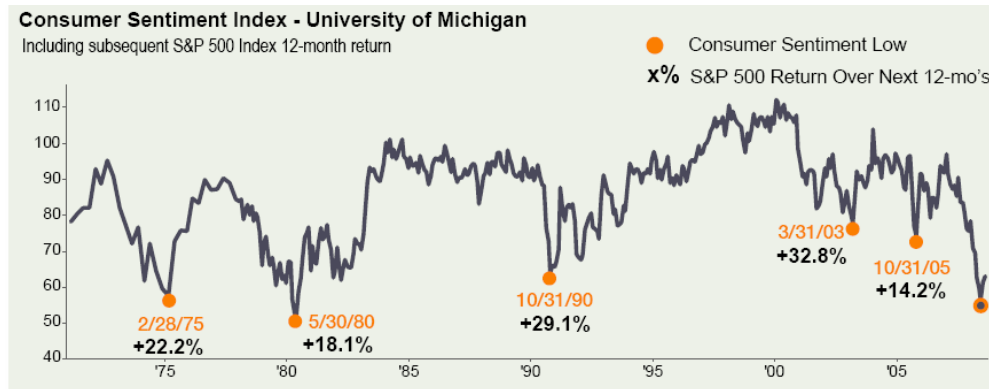
As the U.S. economy appears to be entering into a slowdown or a recession, outside of the financial sector businesses are generally in good shape to handle this cycle. Business balance sheets look stronger than in past recessions and companies didn't over hire during the last few years. Assuming the financial sector gets on track in 2009, it appears this slowdown could be relatively mild.



Source of chart data: U.S. Census Bureau, 5/31/08.

Summary:

The recent market adjustments have been extremely emotional over the past weeks which often is typical of market bottoms. With a global slowdown approaching and a credit crisis still in transition, we would expect market volatility to remain high throughout the rest of this year. In a highly emotionally-charged, fear-driven market it is hard to make prediction on short term directions. Historically, when consumer sentiment is extremely weak that has been a signal that the market has hit a bottom with a strong probability of recovery over the next twelve months. The chart below shows five previous times that consumer sentiment has shown these tendencies with strong positive results realized over the next year.



It is encouraging to see many healthy institutions, like Berkshire Hathaway (Warren Buffet), taking a long-term perspective and buying and or investing in companies they consider to be cheap. However we do realize these are extraordinary times and it is possible that with this credit crisis, the downside to this market could be longer and more difficult than expected. As a result we believe it is important to review the mix of investment managers and their strategies to be comfortable that they match with your objectives.

Jim Evens  
Investment Director