First Quarter 2009

Investing in volatile times: lessons learned

This past year was the most challenging for investors since the Great Depression. The snowballing credit crisis led the S&P 500 to its lowest returns since 1937. In 2008, volatility measures reached all-time highs, and triple-digits moves in the Dow Jones Industrial Average were commonplace. Seven of the ten biggest point gains in the Dow occurred last year, while five of the ten largest point losses occurred. Uncertainty creates volatility, and the financial crisis has been marked by opaque investments and asset valuations on company balance sheets.

While it is impossible to sugar coat the investment climate of the past year, it is possible to identify lessons that investors can use going forward. At Cutler, we believe the lessons of 2008 validate our investment approach and can be useful in both bull and bear markets.

Lesson #1: Dividends matter

Dividends have historically been over 40% of the total return from equities and as prices of the S&P 500 companies fell 38.49% in 2008, total dividend declarations fell by only 2.3%. Finding companies with consistent and growing dividend policies, a central tenet of Cutler's investment philosophy, remains a prudent investment approach for today's equity markets. Few companies in the current economy have the cash to increase their dividends, but those that can are very well positioned going forward.

Lesson #2: The difference between investing and speculation

In the era of discount brokerages and CNBC, it is tempting to buy equities based on short-term influences. Purchasing a company in a "hot sector" or that seems oversold is a popular approach by frequent commentators. However, this past year demonstrated that purchasing a company on speculation can be a very risky proposition. Firm founder Ken Cutler believed that a dollar well-earned deserved a well-earned investment. Purchasing companies based on their fundamentals is a prudent investment approach, that benefits investors when investing is most challenging.

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"When you earn a dollar, it has gained your respect.
When you invest that dollar, the investment should reflect your respect."

- Ken Cutler

LESSONS LEARNED CONTINUED...

Lesson #3: It is difficult to time the market

Investors with long-term cash positions have done well in the past year. However, most investors with lots of cash sold after the market losses only to hold cash during the historic up days. As we mentioned above, some of the strongest days in the history of the Dow Jones Industrial Average occurred during October and November. Market timers often locked in their losses, only to miss these opportunities for a moderate recovery in their equity values.

Lesson #4: Diversification reduces risk

Our equity portfolios are balanced across sectors in order to provide exposure to a broad swath of US securities. While an investor may ask, "Why own any financials?" the alternative is an overexposure somewhere else. Diversification away from financials helped Cutler portfolio's during the past year, and there will be stress points in the future where diversification will have similar benefits. If you are concerned or have questions about how Cutler can further diversify your portfolio, please call us today.

A GLOBAL CREDIT CRISIS

A coordinated emergency rate cut by several central banks around the world in the 4th Quarter was an admission that the credit crisis was global in nature. Yet, the failure of drastic monetary policies and open market operations alone to instill confidence back into the markets has forced governments around the world to resort to Keynesian economics largely comprising fiscal stimulus packages and tax cuts. Optimism is still clearly lacking in the markets and participants continue to ignore fundamental investing.

In general, countries heavily reliant on short-term funding markets, U.S. dollar financing, or commodities experienced dramatic weakening of their currencies and equity markets in the quarter. This was especially the case for emerging markets. In Iceland, for example, the krona plummeted despite its banks being considered well-capitalized before the credit crisis began. The result was a nationalization of the country's banks. Hungary was also a casualty whose currency and equity markets plummeted. The country is heavily reliant on foreign funds for credit, forcing its central bank to actually increase rates in an attempt to raise capital. Ukraine is another example, and sought emergency aid from the International Monetary Fund. Some estimates are that half of all the money that went directly into emerging equity markets from 2003-2007 was withdrawn in 2008. A dilemma emerging countries are facing is how to attract foreign capital, which prefers higher rates, while stimulating the economy, which requires lower rates.

Currency trends saw a major shift in direction this past year. Except for the Japanese yen and Swiss franc, the U.S. dollar advanced against all developed and emerging market currencies. The worst performing developed currency against the dollar was the U.K. pound, depreciating 27.8% for the year. This was the result of the Bank of England reversing its very hawkish tone upon deteriorating economic data. As the dollar rallied, several banks around the globe were put on credit watch by Standard & Poors due to depleted foreign currency reserves.

We believe that the current economic crisis is a temporary shift in the normalized earnings environment. As the crisis eases, we anticipate companies with strong restructuring potential to achieve earnings commensurate with their potential. In this environment, value investors should be well rewarded for their patience.

Fixed Income Update

Navigating the bond market

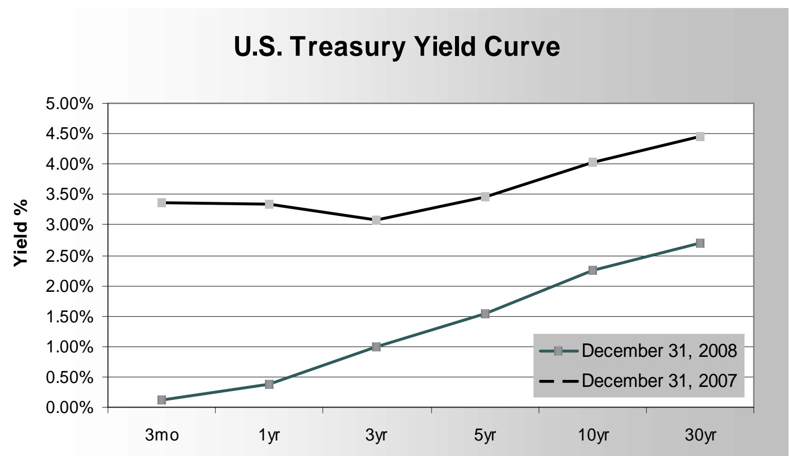
During the Fourth Quarter of 2008, the Barclays Aggregate Index, formerly the Lehman Aggregate Index, produced a total return of 4.59%. The Quarter witnessed a massive exodus of the CMBS and ABS sectors causing a negative return of -13.52% and -6.82% respectively. As investors continued to seek the safety of US Treasury securities, this sector once again outperformed all others by substantial amounts. The Treasury sector produced returns that were 2.65% greater than the next nearest return, which was Agencies. All other sectors did not fare as well.

Away from Treasuries (especially the 33.72% gain from the back end of the curve for long-end Treasuries) few sectors fared well in 2008. Few 'seers' got both the direction and especially the magnitude of the global economic correction right. As a result, the credit sectors that did not have any relationship to a Government Sponsor all had negative returns. The worst of the bunch was the CMBS sector with a 2008 return of -20.62%. On the heels of the CMBS sector was the ABS sector with a return of -12.72% and the Corporate sector ended down by -4.94%. The Treasury sector outperformed the Agency sector by 4.66% and the MBS sector by 5.4%. These relative returns are enormous considering that these two sectors, Agency and MBS, are created using Governments Sponsored.

General Outlook:

With interest rates across the yield spectrum at all time lows, it is difficult to make a case for even lower rates in the coming months. However, interest rates are also not likely to climb dramatically in the next quarter as the US and Global economic condition is not expected to improve very much. As a result, we continue to pursue a duration strategy that matches the duration of the index with a bias for a portfolio with lower durations versus the benchmark.

The yield curve flattened throughout the fourth quarter as demand in longer dated US Treasury maturities increased. With yields of all Treasuries inside of three years at below 1%, it is difficult to be excited with that sector of the yield curve. However, it is more difficult even contemplating increasing maturity risk or yield curve risk at these low interest rate levels. The best choice on the curve today is to be neutral to the term structure and await opportunities in the future. While we believe that 2009 will offer opportunities in the high grade corporate sector, we prefer waiting for greater clarity on how companies have survived the dramatic fourth quarter slowdown. Opportunities in the MBS and CMBS sectors will also be contemplated. Overweighting the AAA CMBS is based on valuation and a view that actual losses are unlikely even under extremely stressed economic scenarios.



Times of Change

A Hinge Pointe in History: Where do we go from here?

At President Obama's recent inauguration, the evangelical pastor Rick Warren, when giving the invocation said, "We sit at a hinge point in history." While he may have been referencing the historic nature of the President-elect, any investor watching had to agree. Clearly, 2008 was a seminal year in American history, and at Cutler, we watched in awe as such industry stalwarts fell by the wayside due to credit missteps. As the finance industry changes, one is forced to take a step back and ask, "What will the investment industry look like once this has passed?" From our vantage point, we believe the crisis has accelerated the momentum toward increased accountability, transparency, and independence.

Accountability

At Cutler, we take great pride in the accountability of our Portfolio Managers. We believe that holding investment professionals accountable for their decisions reduces risk. We also ensure that we "eat our own cooking" and invest alongside our clients; our employees are invested only in Cutler managed 401k products. However, over the past several years, many managers were being rewarded on performance bonuses providing huge incentives for outsized returns, while offering no punishment for outsized losses. The investment banking and hedge fund industries were built around this incentive structure, and that risk-seeking behavior has imploded in the current crisis. This has been ***a change for the better.***

Independence

Independent investment advisers have the strategic advantage of being "independent." They are not beholden to corporate incentives, either through pushing funds with large loads or being pulled down by missteps from above. The independent adviser business, with a simplified corporate structure and client-first mandate, is gaining momentum. We believe the investment business is once again a people business, also ***a change for the better.***

Transparency

Finally, the investment industry has been shifting toward increased transparency. Opaque fees and payment structures are no longer tolerable by investors or shareholders. Corporate salaries are being scrutinized at an increasing rate, and shareholder approval of pay packages is the likely outcome. Bernie Madoff has highlighted the importance of audits and layering investments in off-shore funds. Investors will demand a greater level of oversight in the future, once again, ***a change for the better.***

Cutler Quick Facts

Accountability

Cutler's interests are aligned with those of our clients. The professionals at Cutler have been investing alongside our clients since 1977 and take pride in the investment success of our longstanding clients and their families.

Independence

Cutler maintains a client centric approach to management. Independent investment management affords you excellent service and proven results.

Transparency

Cutler clients are fully informed regarding their portfolio holdings, fee arrangements, and performance results. Cutler is subject to statutory SEC examinations and engages an independent CPA to audit the firm. Cutler is not a custodian and does not take possession of client assets.

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