

No one needs us to tell them that 2008 was one of the worst years ever for stocks. For the year, the Dow was down 31.93%, the S&P 500 was down 37.00% and the Nasdaq was down 40.13%. In fact, 2008 was only exceeded in its awfulness by 2 prior years, making it the third worst year since 1900. There was really no place to hide. Even the best-performing sector, consumer staples, lost more than 15% and not a single industry posted positive returns.

The reasons for the bear market are well documented and can be summed up by the following: too many bubbles popped at the same time. The excesses of years past came to roost and a massive deleveraging took place. We are still feeling the effects. But this, as all tough times have, will pass. And with its passage will be sown the seeds of the next bull market. We know that for a certainty. Unfortunately, it's not the "if" but the "when" that is more difficult to forecast. As you might expect, we'll share some thoughts with you on that point later.

Let us reiterate. We are not calling for, or predicting, a market bottom or an immediate economic recovery. Things may well get worse before they get better. There is simply no way to predict, with any certainty, the short-term direction of the market or the economy. The challenges we face are numerous and daunting. Plain and simple -- we are in a recession, and a serious one at that. But, we have had many recessions before and we have emerged from them all, only to continue the inexorable march toward economic recovery and higher stock market levels. If history is a guide, it will be no different this time.

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The carnage in the market has led some to question the very foundation and viability of equity investing in the future. We believe, however, the death of equities has been greatly exaggerated. We will spend the bulk of this letter sharing with you some of the reasons for our guarded optimism about the stock market, particularly over the next few years. At no point should our audacity to point out the positives be construed as "calling a bottom." We would merely like to take this opportunity to present a side of the argument you may not hear in the media, which tends to delight in doom.

Historically, the market is far more resilient than it is currently being given credit. A study that examined the major crises that occurred between the end of World War II and 1990 found that the market was, on average, 25.8% higher one year after bottoming. Two years later, it was on average 37.5% higher. Morningstar conducted research of a more recent period that confirmed these results. It studied five major crises that occurred from 1987-2006 (the October 1987 stock market crash, the early-90's savings & loan crisis, the Long Term Capital Management fiasco, the bursting of the tech stock bubble in 2000, and the 9/11 terrorist attacks), and found that three years after those crises, the market was up an average of 37%. Each of those crises was touted, in its time, as the death of the market. But it wasn't. And this crisis will not be either.

GRAPPLING WITH OUR EMOTIONS

Reflecting on 2008 stirs a range of emotions, but perhaps none were stronger than hope and fear. Historically, these two emotions have helped create every bubble and panic on record, and they are notorious for causing investors to buy high and sell low. This happens because emotions distort our perception of risk, and when investors allow the direction of the market to influence their risk tolerance, trouble is almost sure to follow.

For example, let's take a look back at 2007. It is clear that at the time, prevailing attitudes toward risk were much different. Investors' appetite for risky hedge funds and private equity funds was insatiable. Experts were touting the endless benefits of "investing" (speculating) in commodities, real estate, and emerging markets.

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The free-wheeling culture of risk was in full swing, and the contagion of ignorance infected banks and other lending institutions. It seemed the only requirement to get a loan was a pulse.

In 2008, the credit bubble popped, and the effects were devastating. Investor attitudes underwent a radical transformation as excessive hope gave way to excessive fear. During the second half of last year, nearly every asset class across the globe declined in value as investors sold risk-bearing positions in favor of “safer” pastures. U.S. equities dipped 38% and yet still outperformed all but five of the major international markets. Once-heralded BRIC investments (Brazil, Russia, India & China) dropped by an average of 58%. Commodities such as oil and copper fell over 50%. In response to the drop in value of equities and commodities, investors sought “safer” alternatives such as cash, gold, and U.S. Treasuries. But as seen in the past, the popping of one bubble often lays the foundation for the next. For example, in 2001, when the tech bubble burst, the resulting low interest rates provided the foundation for the credit crisis. Now, in the wake of the credit bubble, fear is creating a bubble in the “safety” of longer-term U.S. Treasuries. When this bubble inevitably pops, investors may find that they inadvertently took an even greater risk -- missing an eventual stock market recovery.

IS THERE REALLY A TREASURY BUBBLE?

Because Treasuries carry a government guarantee, they are generally perceived to be the safest investment in the world. As fear escalated during 2008, investors moving from fixed income, commodities, equities, and alternative asset classes all converged in unison to the safe haven offered by Treasuries. The result was a historic increase in price as investors became more willing to accept increasingly low yields. While grounded in rational thought, this idea has been taken to the extreme as emotions have overpowered logic. The clearest example of this is the pricing on 3-month Treasury Bills. During three days in December, these securities actually traded at a 0.00% yield, meaning that investors received absolutely nothing other than their own money back. In fact, after trading costs, these bills traded at negative yields. This meant that people were actually paying the government to hold their money.

Prices on long-term Treasury bonds provide the clearest evidence of a “bubble” and are also symptomatic of intense fear. The Barclays Long Term Treasury Index surged an unheard of 24% in 2008 as buyers flocked to Treasuries. This gain caused today’s paltry yields on 10-year and 30-year Treasury Bonds. Both of these issues hit all-time lows in December, at 2.08% and 2.53%, respectively. To put this into historical perspective, prior to 2008, the 10-year had never traded below 3% and the 30-year had never traded below 4.25%.

In fact, the yield on the 10-year Treasury fell so low that it dropped below the dividend yield of the S&P 500 by a full percentage point by the end of 2008. This was the first time this happened since the 1950s and the implications are stunning. In short, this means that even if stock prices remain at today’s levels for the next ten years, the holder of the S&P 500 fund would still be better off just by collecting the dividends. Additionally, while stocks offer upside growth potential during this ten-year timeframe, a bond’s principal value will be continuously eroded by inflation. There is a common misconception that fixed income investors are better off than equity investors because they are “guaranteed” to get their money back at maturity, but they don’t, ever. At least not when you take inflation into account. Inflation often goes by unnoticed, but its power is easily demonstrated. For instance, if a bond with a \$1,000 face value is held for a ten-year period and inflation is 3%, the bond’s principal would be worth less than \$750 in real terms at maturity. In essence, an investor would lose 25% in purchasing power!

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Investors can also lose money on Treasuries (particularly longer-term bonds) due to interest rate risk, which occurs when interest rates change quickly. For every 1 percentage point increase in yield on a 10-year note, investors would lose approximately 7% in value if they sold the bond prior to maturity. Thus, if yields revert to their 10-year average of 4%-5%, an investor would experience a corresponding loss of 15%-20%. If rates rise, investors will be faced with an unpleasant choice -- either hold bonds with below-market yields until maturity or sell them at a steep loss.

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After considering inflation and interest rate risk, long-term Treasury bonds probably don't seem as safe, and for this reason, investors will eventually start demanding higher yields in return. This is why today's record low yields are unlikely to persist, and when this trend reverses, there will be massive selling as investors attempt to avoid being the "last one out." As investors shift into equities, the surge in demand will have the power to push stock prices up quickly. Usually when a financial bubble bursts, pain follows, but in this case, an end to the Treasury bubble will signal the beginning of a recovery for stocks and the rest of the economy.

WHAT WILL POP THE TREASURY BUBBLE?

To some extent, fear will dissipate naturally with the passage of time as long as there are no additional financial failures. More importantly, outside forces (such as inflation and the Fed) can make it increasingly unpalatable to hold Treasuries, and can instead encourage investors to hold risk-bearing assets such as municipal bonds, preferred stock, corporate bonds, commercial paper, stocks, and commodities.

Inflation is currently low, but with a massive fiscal stimulus estimated at \$825 billion set for 2009 and the continued injections from the \$700 billion in TARP funds, it seems almost inevitable that inflation will take hold. Plenty of fresh dollars will flood the system and lawmakers will be tempted to inflate their way out of the resulting debt. Because many investors are so preoccupied with the prospect of deflation, inflation concerns are being overlooked. Once inflation begins to pick up, it will be very difficult for investors to continue buying Treasuries. For instance, if the yield on a 2-year Treasury is 1% and inflation is a relatively mild 3%, the investor is really losing 2% in eroded purchasing power each year. If this occurs, Treasuries will no longer seem so "safe" after all.

An old saying advises "don't fight the Fed," and right now the Fed is armed and dangerous. With a slew of new programs, the Fed has unprecedented power to influence Treasury prices. With two key announcements at its December 16th meeting, the Fed has already shown it is willing to pop the Treasury bubble in order to drive investors back to other assets. Their first step was to lower the Fed Funds target to a record low range of 0.00-0.25%. In addition, they announced that they would begin buying long-term Treasuries. The net result is that yields on all Treasuries from 3 months to 30 years sunk even lower, making them less attractive to hold. Clearly, the Fed is sending a strong signal that it does not want investors in Treasuries. But why not?

When investors buy Treasuries, they are lending money to the government. But right now, consumers and companies are in desperate need of these loans. Without credit, consumers cannot make large purchases such as cars and homes. Businesses need credit to fund working capital, replace maturing debt, or invest in new projects. Credit is the lifeblood of our economy, and the Fed knows that in order to restore the economy to full health, it must do whatever it can to convince investors to lend money (buy bonds) or contribute equity (buy stocks) to individuals and corporations. By forcing Treasuries to historically low yields, the Fed is essentially saying, "Thank you, but we don't want your money."

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Besides its attempts to reinvigorate the economy, the Fed is also taking steps to ensure we avoid deflation. In this fight, the Fed is actively trying to "reflate" the economy, which means increasing the money supply. It accomplishes this by purchasing Treasuries, taking bonds out of circulation and injecting money in their place. Just as before, if inflation accelerates beyond the yields offered by Treasuries, investors will be forced to seek more attractive returns elsewhere that can keep pace with inflation.

Putting all the pieces together, here's what we see: current demand for Treasuries is artificially high because of fearful investors and the Fed's intervention. In the future, supply must increase to fund the fiscal stimulus package and other bailout-related expenses. Like any other product, falling demand coupled with rising supply means prices must come down, and when they do, the bubble will burst.

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DEALING WITH INFLATION

The trillions of dollars of stimulus that the government has (and it seems, will continue) to pump into the economy in an effort to stave off the evils of economic cycles, will most likely have an inflationary impact down the road. To think otherwise seems naïve.

There is a popular misconception that gold is a better inflation hedge than stocks. This is quite simply not true. In point of fact, stocks are the only asset class that has significantly outpaced inflation. The reason for this is simple. Stock investors reap the benefits of the increasing revenue that comes as a result of economic growth. There is no such benefit to the holders of gold, bonds, bills or real estate.

In his famous book, "Stocks for the Long Run," famed investor Jeremy Siegel analyzed the long term performance of stocks, bonds, T-bills, and gold. To conduct his experiment, he assumed an investor put \$1 into each of the following assets for 200 years starting in 1801. Here is what each \$1 investment would have grown to through the end of 2008:

The same holds true if we examine a more recent period. Since World War II, after taking into account inflation, stocks have returned 3,500%, while long-term Treasuries have returned 190%, short-term Treasuries 46%, real estate 103% and gold a mere 42%. It is quite clear that equities, contrary to popular belief, are by far the best inflation hedge over the long run.

WHAT ABOUT GOLD?

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During 2008 some panic-stricken investors chose to flee to the "safety" of gold. It's hard to believe gold could be considered a "safe" investment when the U.S. is no longer on the Gold Standard. Is it reasonable for this shiny yellow metal to be more highly valued than other scarce metals which have greater industrial use? The price of almost every other commodity has fallen 30%-50% in response to weakened demand and the prospect of global recession. Can gold buck this trend indefinitely? Gold does provide an inflation hedge, but then again all commodities rise during inflationary periods -- this is the very definition of inflation.

As a long-term investment, gold has an abysmal track record because unlike other investments, it does not grow and it does not provide cash flow to the investor. This is likely why gold trades for roughly the same price as it did at its peak in 1980, while the S&P 500 is 1800% higher even after a tumultuous 2008. Gold has a shaky history in terms of safety as well, fluctuating wildly from \$300/oz to \$1000/oz during this period. These trends have held true for longer periods as well.

While gold has kept pace with inflation, keep in mind that stock returns have outpaced inflation over every 20-year period in history. While gold may beat the stock market in short intervals, it has proven to be far less reliable and an inferior asset class in the long run.

THE REAL RISK -- MISSING THE RECOVERY

Investors who have fled to the illusory "safety" offered by Treasuries and gold are also engaging in a very risky trading strategy -- market timing. It may be tempting to do in turbulent times, but is incredibly difficult and carries steep consequences. The penalty for missing just a few days can be quite significant. This study, from AIM Investment Group, examined annualized returns from 1996-2006 and illustrates the impact of missing some of the market's best days.

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Period of Investment	Total Return	Growth of \$10,000
Fully Invested	8.33%	\$22,252
Miss 10 Best Days	3.32%	\$13,864
Miss 20 Best Days	-0.46%	\$9,548
Miss 30 Best Days	-3.71%	\$6,846
Miss 60 Best Days	-10.98%	\$3,125

Source: AIM Investment Group

Because today's market is characterized by extreme volatility, the penalty is likely to be even steeper. In 2008, we had 18 days where the daily move on the S&P 500 was greater than 5%. From 1956-2007, we only had 17 such days in that entire 51-year span. In addition, the average daily point range for the Dow between September 1, 2008 and December 31, 2008 was 421 points. In the recovery from a volatile market such as this, investors will almost surely miss some of the market's best days while waiting for the "all clear" sign.

One of the primary dangers of market timing is the rapidity with which stock market rallies can occur. Those sitting on the sidelines waiting for an "all-clear sign" that the bear market has ended are often left with a pocket full of regret. There is no shortage of evidence to support this notion. For example, in the first 40 days of a new bull market, stocks usually regain a third of what they lost during the previous bear market. Likewise, 47% of bull market gains usually come in the first 12 months of the upturn.

The last two bear markets that rival the current one in magnitude and severity serve as examples of this phenomenon: 1973-1974 and 2000-2003. The bear market of 1973-74 ended in October of 1974. After two months of gyrations, the S&P 500 started moving up in December, and in less than two months, had gained back 20% of its value. By May of 1975, just seven months or so after what turned out to be the bottom, it was up 40%. The bear market that began in 2000 shares similar characteristics. After similar gyrations through late 2002 and early 2003, the market began rallying in March of 2003. By June, it had risen about 20%, and by the end of the year, it was up almost 40% from the lows. In all, the market rose almost 40% in ten months.

Those aren't the only two bear markets that have shifted into bull markets swiftly. In fact, following the last nine bear market bottoms, the S&P 500 was up an average of 14.7% after three months, 21.6% after six months and 35.3% after a year. We think the lesson here is clear. If you wait for the sound of the bulls, you may often find yourself trampled!

While market timers and Treasury investors think they are reducing their risk, they are likely only hurting themselves in the long run. In reality, it's highly risky to be out of the stock market right now based on historical patterns. Consider this: since 1900, there have been 10 previous occasions in which the Dow fell by more than 20%. In the year following these down years, the market rallied by an average of 25% and staged double digit returns 8 of the 10 times. There's still quite a bit of fear in the market, but facts like this give us hope for 2009.

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VALUATIONS

Valuations are also supportive of some measured optimism. Even after taking into account the massive write-downs of the assets of financial companies, and some unfortunate companies of the non-financial variety, price-to-book values are the lowest in years. For example, just three years ago, only nine companies in the S&P 500 were trading at prices below their book values. Today, almost a third of them are.

Using earnings estimates for 2009, the price-to-earnings ratio for the S&P 500 is somewhere between 10x and 15x, depending on how pessimistic the estimator of the earnings happens to be. At either end of that range, the market is, at worst, reasonably priced. It is worth noting that the price to earnings ratio has averaged 12 at the end of previous bear markets. Even if we use one of the most conservative valuation measures, the price/10-year-average-earnings ratio, stocks are now cheaper than they've been in over twenty years.

SO HAVE WE HIT THE BOTTOM YET?

It is worth noting that the market is a leading, not lagging, indicator that discounts future value, and as such, the market usually recovers long before the economy does. In fact, the market performed better during the recessions of 1980, 1981-82, 1990-91, and 2001 than it did in the six months leading up to them. In fact, with the exception of 2001, stock market returns were actually positive during those recessions, and then went on to generate significant returns over the following year. Simply stated, a full economic revival is by no means a necessary precursor for the stock market to rally.

Bottoms represent the most extreme swings in stock prices and are often the most painful to endure. It is helpful to know if a bottoming process is underway because there may be a strong temptation to stray from one's investment principles. Stock market losses over the entire duration of a recession are often far less than those experienced at the bottom of the market during the recession. For example, in the 21 recessions since 1900, the average total decline from the beginning to the end of a recession is just -7.6%. But, the maximum decline at the bottom averaged 3 times as much, at -24.2%.

Because market bottoms are a process rather than a moment in time, they are nearly impossible to pinpoint. However, we can turn to history as a guide to see where we are today and when we might expect this process to occur. In the 11 major recessions since 1900, the average recession length has been 19 months and the bottom typically occurs 65% into the downturn. There has only been one recession which lasted longer than 24 months and that was the Great Depression. Therefore, if we estimate that the current recession ends up lasting between 19-24 months, and its official start date is December 2007 (as recently announced by the National Bureau of Economic Research), then this would imply a bottom occurring sometime between November 2008 and March 2009. This isn't to indicate that a bottom will necessarily occur between these dates. Rather, we are just trying to note where a bottom may occur if this recession follows historical patterns.

As the saying goes, "it is always darkest before the dawn," and there is no doubt these are dark times. But, looking back at the past 100 years helps put today's recession in perspective. It also serves as a reminder that bottoms happen long before the first signs of economic improvement. As a result, market timers will almost surely be left behind while participating in what appears to be a Treasury bubble. We don't claim to know when the recession will end or when the market might bottom, but we can confidently say that staying the course is the best way to avoid missing the eventual recovery.

As the panic has spread through our markets, one of the results is the accumulation of massive amounts of cash on the sidelines. The total amount of cash, bank deposits, and money market funds now totals almost \$9 trillion. This money, which is earning interest at a rate roughly equivalent to hiding it under the proverbial mattress, now equals roughly 75% of the market value of all U.S. stocks combined. In fact, we have not seen a level of cash this high in nearly twenty years. But individuals are not alone in this panic. American corporations are also hoarding cash. As of the end of the third quarter of 2008, non-financial U.S. companies had close to \$1 trillion in cash on their balance sheets. We don't know exactly when this money will be reallocated into equities -- only that it certainly will. And when it does, it will not take much to push stocks higher.

OUR INVESTMENT STRATEGY

While our quantitative models combine both value and growth measures, they have a bias towards value. We have chosen this bias as a result of numerous academic studies, over various time frames, which have consistently confirmed that value oriented strategies outperform growth strategies over time. However, over shorter time frames, there are periods where growth outperforms value. The last three years have been such a period, with growth stocks outperforming by around 2% per year on average. In 2008, growth stocks outperformed their value counterparts by over 4%. The outperformance of growth was due in large part to weakness in the financial sector, to which the value indices have greater exposure. We have not been immune from this influence.

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Thankfully, mean reversion works in both directions, and the dominance of growth-biased strategies tends to be short-lived. Over the last 50 or so years, when growth has outperformed value for two consecutive years, value has outperformed growth by an average of 17% over the subsequent 7 years.

Value stocks are also frequently superior in the periods following economic downturns. A study by the research group Value Expectations found that following the bottoms of the three most recent historically significant market downturns (1987, 1990 and 2000), value stocks outperformed growth stocks in each case, and by significant margins. For example, value stocks beat growth stocks by an average of 10% over the six-month periods (22% vs. 12%) and by 22% (50% vs. 28%) over the one-year periods following these market bottoms.

At any given time, investors must weigh the pros and cons of investing in equities. The cons are obvious: the often considerable volatility and the risk of significant loss. However, in the fullness of time, long-term investors have been unquestionably and resoundingly rewarded for suffering temporary losses with permanent gains. It is our resolute belief that successful long-term investing is not built on market-timing, or buying a stock at its low and selling it at its high. No one can reliably and repeatedly do that. No one.

We believe that the market as a whole is attractively valued, but there are individual issues that are especially compelling. One of the reasons we think we will fare well coming out of this downturn is that our stock-selection process is driven by a focus on fundamentals. While many investors are hesitant to invest in stocks after periods of turmoil, our strategy focuses solely on the facts -- earnings, sales, debt, and other fundamentals -- to help identify those stocks that are truly undervalued in the marketplace. While others allow emotion to get the best of them and pass on the good deals available after precipitous downturns, our strategy is designed to identify fundamentally sound companies being mispriced by investors. We continue to believe that our success over the coming years will be built on the consistent application of the same objective, fundamentally-based, value-biased philosophy that has enabled us to generate outperformance over the long term.

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