

Advocate Asset Management, LLC

MARKET COMMENTARY

SECOND QUARTER 2008

We recall the start of a theme song from a 1980's television sitcom, *The Facts of Life*. It began, "You take the good, you take the bad, you take it all, and there you have, the facts of life..." In other words, evaluate the situation calmly and rationally with all available information, as we do. Perhaps this is an appropriate tone to begin this commentary.

It is worthwhile to point that we do not envision a global economic collapse. With some time to work out the interim panic, we believe that the capital markets will regain their composure.

Outlook

The capital markets are in a negative feedback loop. Declining demand for housing causes housing prices to decline. Reduced housing wealth causes greater delinquencies and defaults, increasing economic distress. This increases pressure on finance companies. Consumer spending slows, causing work furloughs and plant closings. Higher unemployment encourages a slowing economy and capital market losses. This feedback loop appears particularly severe and promotes recessionary expectations.

We mentioned in our previous commentary that we believed that the U.S. was in a recession. We still believe this to be the case. According to the NBER, National Bureau of Economic Research, the entity in charge of calculating such things, their definition of a recession is as follows (from an October 2003 report).

A recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales. A recession begins just after the economy reaches a peak of activity and ends as the economy reaches its trough. Between trough and peak, the economy is in an expansion. Expansion is the normal state of the economy; most recessions are brief and they have been rare in recent decades.

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Notice that there is no mention of two consecutive quarters of negative economic growth, the popular conception of a recession (unfortunately also referenced by some members of Congress). If we examine the factors cited in this definition, the prognosis points towards a recession. There really is a significant decline in economic activity spread across the economy. What may have started in the financial services sector and real-estate has swept across many sectors now. Profits are mostly down and input costs are rising. Real income is down, unemployment is up, industrial production is down and wholesale-retail sales are mixed.

Other measures that we monitor that are not cited by NBER also appear weak. Consumer confidence numbers, as measured by the Conference Board, are at the lowest point since October 1992. Inflation expectations are at 7.7% for the next twelve months (the highest since August 1987),

rising sharply from the 6.8% expectations in March 2008. The mortgage market has essentially seized up for all but the most standard borrowers (who are paying higher rates than they should be). For those borrowers who invested less than 80% of home value to purchase their home, delinquencies have increased for the 26th consecutive month.

Conditions are particularly problematic for the huge bulge of baby boomers who are nearing retirement. Their two main sources of wealth, homes and retirements funds, are losing value, just as government-reported inflation is rising (and actual inflation rising even more). Of course, the past ten years may have just been an illusion of wealth. The fact is, capital markets never really adjusted for the system wide errant speculation of the 1990s. This current process of adjustment will try the patience of most investors.

Government policies have done little to help this, in spite of some valiant efforts. In truth, the U.S. government has few policy options. It is boxed in by both domestic and international pressures in a globally linked economy. The U.S. is squandering its leadership role in the world, a world that is increasingly shaped by a shared stage among several powers (the topic of a recent article by Fareed Zakaria in *Newsweek* magazine).

Some assets that have worked well in the past as a hedge against stressed equity markets, such as bonds, are not particularly attractive. The flight to quality into government bonds and inflationary expectations means that future performance is likely to be mediocre at best. In what is certainly an inflationary future, there are few credible options for the U.S. Federal Reserve. Inflationary expectations from consumers, corporations and traders (as measured by the spread between treasury inflation protected securities and conventional treasury notes) are rising. Although the Fed speaks about tightening in the near future as a mechanism to control inflation, it looks less likely that this will be their course of action. With the economy still weak the financial system still stressed, and unemployment rising, we have a hard time believing that the Fed will add to this mess by raising interest rates in the near term (although there is spirited debate about this within the Fed).

Some assets that investors believe work well as a hedge against inflation are not particularly attractive either. Commodities in general, and gold in particular, are high-profile assets (we would argue that gold is not a true commodity) that are cited as inflation hedges. However, gold has a very poor history of actually hedging inflation. The very recent upward price movement has been highly correlated with the physical quantity of gold that has been purchased by exchange-traded-funds that specialize in this asset. Perhaps it is best to think of gold as a fear hedge, certainly warranted during the past several quarters. We continue to ask ourselves, how much of this fear is already reflected in gold prices? Price corrections in commodities and gold in particular are vicious. We do not want to own this asset when fear subsidies and rational thought returns.

The future always seems scariest at the bottom of a cycle. We have no intention of calling a bottom to this cycle, but we do think that a great deal of fear and paranoia have been priced into the capital markets. We restate a belief from the previous commentary that investment approaches that have worked during past stressful market periods may not be sufficient in this cycle.

One of the beneficial effects of a protracted market decline is that it presents unusual investment opportunities. Periods of sub-par performance mean that valuations return to reasonable levels, enabling smart investors to capture real opportunities for long-term gains. We are now on the hunt to find reasonable re-entry points to begin to buy value.

Client Portfolios

During the quarter, there was little change in overall portfolio themes, although we did re-balance sector allocations slightly. We liquidated the full position in the Telecommunications sector, and invested some of the proceeds in early July in the Oil & Gas Equipment Services sector. As we suggested in a previous commentary, the lack of price support in the Telecommunications sector was a concern, so we decided that the capital markets were not rewarding long-term growth at this point in time.

Most clients are still invested at about half of their equity neutral policy, with a large allocation to cash. We own strong economic sectors. On the domestic equity side, the major exposures are in Oil & Gas Equipment Services, Technology, Utilities, Global Healthcare. To a lesser extent, many clients also have exposure to Energy and Basic Materials. We are concerned about the weakness in the Technology sector, a major reversal during the past few months. This is earnings season, so we are evaluating technology earnings to determine if they are still line with our expectations.

On the international equity side, most clients still have exposure to Germany. This investment has not performed well this year, although it is still about 30% above cost for many clients. Industrial output for Germany in May fell 2.6% from April, and inventories of finished goods are rising. The statistics in the Euro-zone in general are not very positive, although the trajectory is similar to the U.S. In May, industrial production fell 1.9% from the previous month, the biggest drop in 16 years. Year over year production dropped 0.6%, the most in three years. Basically, the same story as in the U.S., only with a strong currency. We continue to monitor global industrializing economies for an opportunity to invest.

We have had hedged positions in many client portfolios at various times during the past several quarters. The bulk of these hedges were in domestic small-cap equities, although there was also a bit in financials. We do not have a hedge investment now, primarily because we cannot ascertain the absolute level of pessimism already priced into the capital markets. While we still feel that opportunistic hedges are possible and we examine them daily, they add large volatility to the portfolio, something that we try to minimize.

In the previous commentary, we mentioned that there has not been the capitulation that would mark the bottom in equity prices. We still believe this to be the case, although it is evident (at least to us) that certain sectors are trading with extremely low expectations of solvency.

For example, in spite of some questionable business practices by financial institutions (which we have commented on at length in the past), we believe that most of these institutions will outlast this crisis. We do not know which institutions will survive and which will fail, which is the benefit of our investment strategy focusing on sectors, not individual companies. There is already such a great deal of pessimism and diminished expectations priced into these banks. When the financial services sector begins a turnaround (which could simply manifest itself as less pessimism), we expect the broader capital markets to follow. Of course, the specific timing is always imprecise.

Although we monitor the capital markets for investment opportunities, we do not feel that there is a particular need to commit available cash to investments. This is the flexibility that our investment strategy affords. In uncertain times, this is particularly useful.

Market Highlights

Although it started with a strong April, the second quarter ended with a whimper. Fear and paranoia were predominant, and this has continued into the third quarter.

The S&P 500 was down 2.7% for the quarter, adding to the first quarter loss of 9.4%. Although April and May were strong months, the index fell 8.4% in June alone. Once again, there was a large variance in individual sector performance. The usual suspects were down. Financials were down 19%, adding to the almost 15% loss in the first quarter. Industrials were down about 11%, adding to the almost 5% loss in the first quarter. Only four sectors displayed any strength for the quarter: Energy (up 17%), Materials (up almost 4%), Technology (up over 2%), and Utilities (up 7%). U.S. real-estate, as measured by the Dow Jones Equity REIT Index, was down 4.9% for the quarter, dropping almost 10.9% in June alone.

Outside the United States, developed Europe was down 5.8%, adding to the 9.2% loss in the first quarter. Japan was actually up 2.4%, after an 8.6% loss in the first quarter. It is difficult to explain any structural reason for Japan's gain, other than a search for deep discounts in a country that has been in an economic malaise for some time now. Pacific ex-Japan was slightly positive for the quarter, but this was after a 13.7% loss in the first quarter. Emerging markets were down 1.6%, after an 11.3% loss in the first quarter.

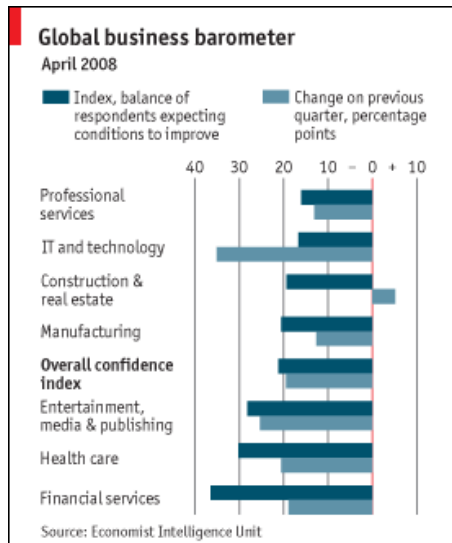
Domestic bonds, as measured by the Lehman Aggregate Bond Index, were down 1% for the quarter, returning just over 1% for the year. Municipal bonds were up 0.6%, making them flat for what has turned out to be a very volatile year for them. Inflation-protected bonds were down 0.3% for the quarter, returning about 4.9% for the year.

In U.S. dollar terms, quarterly bond performance across Europe was down 2.9%, returning about 5.7% for the year. Asia-Pacific was down 6.7%, returning about 4.7% for the year. Inflation-protected bonds in the United Kingdom were up 1.2% for the quarter, returning 4.9% for the year. In Germany, these same bonds were down 1.6% for the quarter, returning 11.9% for the year. In Japan, these bonds were down 5.1% (perhaps due to a rotation into equities), but still returning about 6.3% for the year.

Few sectors in the U.S. were immune to weakness (the same story, with different numbers, is told across the world). For May, the most recent period available, commercial construction spending on hotels and office buildings was slightly positive, offsetting reduced spending on shopping centers. We do not expect this marginal strength to continue, as banks continue to tighten lending standards and collateral requirements. Residential construction dropped 1.6%, the 25th decline in the past 26 months. The slow sales of existing homes and increasing foreclosures have increased residential inventories. U.S. residential foreclosure filings rose 53% in June year-over-year.

The U.S. Federal Reserve and Treasury Department were again the focus of attention this quarter. Capital markets do not like uncertainty, so any ambiguity in government policy is punished. This is evident as the financial sector continues to be severely punished on bad *and* good news. Financial companies have been prolific in making statements about how their capital levels are sufficient to meet their needs and are well within government standards. Unfortunately, the capital depends too much on debt and too little equity. A well-functioning company should not need to state that it is functioning, although this increased transparency is one important factor to ultimately resolving the financial mess.

We believe that the fear of ambiguous government policy is adding to this mess, although there is some progress along this front. On July 13, the Treasury Department announced a plan to allow the large mortgage firms, Fannie Mae and Freddie Mac, to borrow from the Federal Reserve, as well as allow a government equity investment in these institutions. This is important, as these entities are involved in about 45% of the entire \$12 trillion domestic mortgage market. The consistent message across government agencies is that they will support these companies as shareholder-owned entities. We think that this is a positive sign and should, *over time*, help to resolve this current mortgage crisis. There is passionate disagreement on whether such policies are beneficial. There is truth in comments made by an ex-Federal Reserve governor that if these were private institutions, they would be insolvent. However, they are not truly private institutions, and that makes all the difference. Does this expose the government to additional risk and more inflationary concerns? Yes, there is some additional risk with any such policy, but the tradeoff between risk and short-term benefit seems to be positive in our opinion. Of course, the capital markets disagree, and continue to punish Fannie and Freddie. For now, the pessimists are winning.



We end this letter with a chart that we have cited in previous letters. In the April 17, 2008 edition of *The Economist* magazine, this chart summarized a quarterly survey of more than 1000 executives conducted by the Economist Intelligence Unit of the magazine. It measures the balance of executives who think business will improve over those who expect it to worsen. Although all the sectors are negative, the change from the previous quarter in two particular sectors is interesting. There is a positive change from the real-estate industry, perhaps reflecting that at least there is some floor to the devastation in construction. There is a continued negative change in the financial services industry, perhaps reflecting that the worst is not over yet. Given that this was an April 2008 survey, this barometer has reflected the brutal reality of the capital markets in May, June and July quite well. According to the survey firm, North America is most pessimistic across all industries, and the BRIC countries (Brazil, Russia, India and China) are least pessimistic.

Concluding Thoughts

It is normal to feel anxiety in times like these. In time, the fear will diminish. In time, the paranoia will fade. For now, as we mentioned in the beginning of this commentary, we evaluate the situation with calm and reason. Our timing will certainly be off in the short-term, but we will use this opportunity to invest in sectors that have taken undue punishment, and hedge with sectors that have yet to see more punishment. Our role is to try to make sure that our clients have sufficient capital when normal times return to meet their goals.

We thank you for your support and confidence in Advocate. We recognize that our clients have given us an important responsibility to manage their assets. We take this charge very seriously. Please contact us at 312-578-8300 or via email if you have any questions or would like to discuss our outlook in detail.

July 15, 2008