

Advocate Asset Management, LLC

MARKET COMMENTARY

THIRD QUARTER 2008

It is difficult to write a commentary on the capital markets that contains valuable insights for investors. There is too much change occurring on a daily basis; any opinions and insights can quickly become irrelevant or outdated. We are acutely aware of the short shelf-life of these comments.

We have had housing crises in the past. We have experienced financial crises, credit crises and confidences crises before. What we have not had is all these crises converging simultaneously until now. We are in uncharted waters.

By now, investors have been inundated with facts, figures and opinions on this multi-faceted crisis. Some of the financial journals have made comparisons to past crises. Others have ventured to make forecasts of impending collateral damage. Politicians especially have honed the art of finger pointing — to avert attention from their own support for policies that exacerbated the situation.

The case studies on what happened and why it happened will be written years from now. Assigning blame at this point is not particularly constructive (although we are working on a separate article that seeks to explain how the world ended up in this situation). Thinking about what may happen going forward is critically helpful in mitigating future damage to our wealth and prosperity.

Outlook

Most investors, especially those in free-market oriented economies, did not expect government regulators to have acted so aggressively and broadly. The fact that governments have had to get involved to such a massive extent has been shocking to the capital markets. It confirms our worst impressions as to how vulnerable the free market system was and is, and how overextended our financial system was well before prices started to decline. The fact that such massive involvement has done little to loosen up the credit markets has been even more shocking. Is there a limit to how much money governments can fabricate?

In our previous quarterly commentary, we wrote that governments have few policy options to resolve this crisis. What we should have said is that there are few policy options of *sufficient* impact to resolve this crisis. Governments across the world have implemented various creative although somewhat blunt policies to increase liquidity and impart some sort of confidence in the financial market. The top leadership failed to develop and then stress test their policy options in response to different types of potential financial distress. The fact is, in the beginning, the government had no comprehensive plan for the crisis.

The speed at which policies have been announced has increased dramatically during the first week in October, in response to a radical change in awareness by the policy makers. There was a realization that this crisis impacts more than just the banking or real-estate segments of

Contents

Outlook

Our economic outlook

Client Portfolios

Details of client portfolios

Market Highlights

Brief overview of broad market performance

the global economy. The impact was on both leveraged and non-leveraged businesses and consumers, on both functional and non-functional entities. There was a growing realization that this crisis and any resolution was global in nature, not something that can be controlled through isolated actions by individual governments.

Whatever the government policies will be (and there will certainly be more in the coming months), they may not be of sufficient impact to fully resolve the current crisis. But we believe that they will be of sufficient impact to form the basis of a recovery in the future, although not the near future, in the real economy. For all practical purposes, the U.S. economy shrank during the most recent quarter, as consumers reduced spending. Industrial production fell and job losses increased further. We expect this sort of contraction to continue during the next several quarters. It would not be surprising if the economy contracted by one percent each of the next two quarters.

There is just no apparent and functional catalyst to promote consumer spending, which is the driver of most developed economies. This obviously has negative impact on corporate profits across many sectors and industries. Consistent with corporate announcements of difficulties for the next several quarters, companies are paring back capital expenditures and reviewing headcount. The negative feedback loop that we described in the previous commentary is having a substantial impact.

In what now seems like an eternity ago, we wrote the following in our fourth quarter 2007 commentary:

“Several clients have asked us over the past weeks about our biggest concern. In general terms, we think that a weakening of business and consumer confidence is the greatest risk. Confidence is expressed in a multitude of interconnected ways in the capital markets and in everyday life.”

We still maintain that confidence is the single issue that binds all the other issues in this crisis. Because of a lack of confidence, banks do not lend. Because of a lack of confidence, consumers do not spend. We do not know what policy actions will restore a sense of confidence to investors. We believe that a sense of normalcy will return eventually, but we just cannot yet foresee what the catalyst will be for this change.

Valuations are not as cheap as some have suggested. P/Es have been elevated for many years. They were even elevated toward the low point of the market decline caused by the bursting of the high-tech bubble. With an expectation of lower earnings, prices may have to adjust further so that P/Es reach lower valuations. As our primary focus is to preserve capital, we expect to wait patiently for evidence that the capital markets has returned to more sensible valuations before recommitting assets significantly.

It is difficult to determine whether this will happen during the next several weeks, months or years. It is likely that even with a return to more stable capital markets, the real economy (what some refer to as Main Street) will not necessarily prosper until the damage courses through the economic system. Consumers and businesses will not suddenly start spending. Gross domestic output will not suddenly surge ahead. Significant damage has been done and confidence needs to be rebuilt. We stipulate that it takes a far longer time to rebuild lost confidence than to destroy it in the first place.

What we do believe with great certainty is that the concept and desire to take on leverage and risk have changed dramatically. Firms that depend on leverage to generate returns during good times will not be able to leverage as highly in the future as they have in the recent past. We expect major Congressional hearings, finger pointing, and more comprehensive regulations, especially on the ability to leverage and create complex financial derivatives.

As we explain later in this letter, we have liquidated a large portion of equity exposure. This affords us an opportunity to take a broad view of the world and patiently look for compelling, long-term investment themes.

Once we see evidence of normalcy, one macro theme that is compelling is in global infrastructure. Much like the massive infrastructure programs after the Great Depression in the early 20th century and the current Chinese development policies, the U.S. government will need to promote employment and spending on a national scale through infrastructure programs. First, it is evident that our infrastructure is crumbling and repairs have been delayed for far too long. Second, and perhaps more important, is that the psychological barrier to enormous deficit spending has been broken with recent rescue and stimulus policies. It is as if a dam broke and the dollars are flooding downstream.

Water and sewage treatment infrastructures need to be upgraded. Bridges need to be repaired or replaced. Transportation systems need to be enhanced for planes, trains and autos. Technological infrastructure, such as internet communications, are outdated in the U.S. by global standards. These will need to be upgraded as well. Although this problem is acute in the United States, similar issues exist across the developed world. The World Bank estimates that over \$50 trillion will need to be spent during the next two decades on global infrastructure. We intend to commit assets to various infrastructure sectors at the appropriate time.

Another macro theme is healthcare. Given our risk-averse posture, the sole equity exposure across most client portfolios remains the global healthcare sector. On a purely demographic level, the global population is aging. This will require increased per-capita spending on healthcare services, pharmaceuticals and devices. Although there are some questionable social aspects of how healthcare is allocated, this is still a very profitable sector that has access to immense internal cash flows (and, therefore, less need for external capital, an important advantage in any credit crisis). The key risks for healthcare are regulatory changes, patent protection and managing legal risks.

Regulatory changes are difficult to predict. Politics is perhaps the one area that is even less rational than the current capital markets. Nevertheless, there is a risk that the social aspects of healthcare access will become so perverted that politicians will be forced to impose a more equitable distribution of access and costs — what some pundits call socialism. This will certainly have negative profit consequences for the sector, although the generic drug manufacturers may stand to benefit from this. Of course, patent protection is also essential for generic drug manufacturers. Importantly, profitable patents for billions of dollars of drugs are set to expire within the next several years. There will need to be an improvement in the drug pipeline for global pharmaceutical companies to maintain their profit margins via patent-protected drugs.

One of the beneficial effects of a protracted market decline is that it may present unusual investment opportunities. Many money managers will likely profess that there are attractive buying opportunities now. True, periods of sub-par performance mean that valuations return to reasonable levels, enabling smart investors to capture real opportunities for long-term gains.

Although we consider ourselves to be smart investors, given that we are cautiously waiting for evidence that the current crisis has stabilized, we may end up missing the first portion of any sustained rebound rally. This does not make us less smart; we are just less prone to take risk given our capital preservation strategy.

There are times when it is profitable to be early in recommitting assets. There are times when it is best to be late. The case for being early is that markets can spike upward suddenly after a sell-off and those who are late miss out on a good portion of the potential gains. At the other extreme, being too early can mean suffering through the final painful sell-off that often comes near the end of a bear market. We would rather be late during this cycle.

Client Portfolios

This was an unusually active quarter in terms of transaction activity. However, these are unusual times, with a years worth of price movements occurring in a single day. Consequently, we felt that it was necessary to increase our portfolio turnover in order to protect client assets.

In mid-June, we increased our exposure to the Oil/Gas Equipment and Services sector. At the time, we believed that the disconnect between oil demand and production would promote a greater emphasis on oil and gas exploration utilizing increasingly more expensive technology. What we did not contemplate is the sudden collapse in the capital markets which crushed the price of oil (to be fair, 'crushed' is a relative term, as oil moving from \$150 a barrel to \$90 is still high by historical standards). We liquidated this sector during early October in light of the enormous turmoil in the capital markets.

In late June, we sold off the full position in Telecommunications. The lack of price support in the Telecommunications sector was a concern. We decided that the capital markets were not rewarding long-term growth at this point in time.

We sold our full position in Germany during early September. Our initial case for investing in Germany was based on a growing manufacturing output, demand in Asia for Germany's expertise in machinery, and a weakening U.S. currency. However, it became evident that a high exposure to financial services (a major part of its market capitalization) and lowered manufacturing output in Germany, coupled with a relatively strong U.S. dollar, did not support our investment case in the short-term.

The full position in Basic Materials was sold during early September. The case for strong global demand for basic materials deteriorated quickly as economies were thrown into risk of recession. We felt that it was more prudent to liquidate and wait for a more rational re-entry point.

We committed additional capital to Utilities in mid-September by effectively doubling client exposure to this sector. We felt that the transparency of balance sheets for these companies was compelling in light of the uncertainty of risk across other sectors such as finance and industrials. We felt that the high dividend yields would cushion capital losses. We did not envision the extent of the collapse of the corporate bond market. This collapse in bond prices adversely impacted utilities as this sector is a large issuer of corporate debt. We liquidated this sector during early October in light of the enormous turmoil in the capital markets.

In early October, we liquidated the full positions in Technology. As we wrote in the previous commentary, we were concerned about the weakness in the Technology sector. It became apparent that even this sector was not immune from investor fear, as stock prices completely disconnected from actual earnings and projected earnings.

In early September, we committed capital to the S&P 500 Buywrite strategy. This strategy seeks to profit from market volatility in a sideways equity market. This investment performs well during most market segments of sideways and rising capital markets, and had performed well historically during declining markets. However, it performed in line with the broad capital markets during these recent intense sell-offs — which is to say, it performed poorly. We liquidated this sector in early October in light of the enormous turmoil in the capital markets.

In mid-September, we committed additional capital to Healthcare. Demographics favor investing in the services utilized by an aging population (in the US, Western Europe and Japan). This is the sole remaining equity exposure that we hold across most client portfolios. This is the one sector which we feel has the greatest access to internal cash flow (e.g. less need for outside capital). Although conventional wisdom suggests that a Democratic administration in this fall's election would prompt reduced profit margins, we feel that this has already been priced into this sector.

Throughout the third quarter, we have opportunistically purchased and sold various 'short' exposures in several sectors that we felt would be weak — Industrials, Real Estate and Financials. These were all profitable trades. In the short-term, we expect to take advantage of market volatility through additional commitments on the short side of the market. This would necessarily mean increased portfolio turnover, but we think that the risk-reward tradeoff is worth the tax consequences for our taxable investors.

We had limited exposure to corporate bonds in some client portfolios. It became apparent to us that even high-quality corporate bonds were going to be sold off massively to either generate cash for other commitments or because of the general fear in the capital markets of other surprises in credit defaults. In late September, we liquidated these investments and committed the capital to either cash reserves or U.S. Treasuries. Our commitment to fixed-income is mostly in short-term (one- to three-year duration) U.S. Treasuries, although some portfolios also have small commitments to long-term U.S. Treasuries and inflation-protected U.S. Treasuries ("TIPS").

We will continue to monitor the sectors we sold for possible re-investment in the future. Many of these sectors are major components of our infrastructure theme.

We have been pushing ourselves hard to generate investment ideas for the next several quarters. 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 at this time. Currently, client equity exposures remain very low, in the single digits. Cash reserves remain very high. This is the flexibility that our investment strategy affords. In uncertain times, this is particularly useful in preserving client assets.

Market Highlights

Fear and paranoia dominated the capital markets. We truly believed that massive government commitments to rescue banks would promote a more positive response in the capital markets. The U.S. Federal Reserve and Treasury Department were again the focus of attention this quarter. Perhaps the Bush administration did *too* compelling a job convincing investors how broken the real economy really is. We expect a broad array of firms and municipalities to lobby the federal government for low-interest loans or capital infusions.

We cannot recall spending so much time researching cash options during the past several weeks as we had in the past several years. When even the security of cash equivalents is at

risk, there is demonstrable fear in the capital markets. Of course, this is consistent with the seize-up in the credit markets. Given our high cash-reserves position (on average, about 90% of portfolio assets), we have invested cash in higher-quality money-market funds.

During the third quarter, the Dow Jones Wilshire 5000 was down about 8.7%, bringing year-to-date performance to down 18.7% through the end of the quarter. Most investors would have been content with this performance if they knew what was coming in October. Through October 10th alone, the Wilshire 5000 was down about 23% for the month, bringing year-to-date performance down to almost 38%. No sector has been immune from the carnage.

Outside the U.S., performance was even more dreadful. Developed Europe was down about 21% for the quarter, dragging down year-to-date performance to almost minus 33% through the end of the quarter. MSCI EAFE, which is a broader measure of 21 developed markets in Europe, Australia, Asia and the Far East, returned very similar poor performance for the quarter and year-to-date period. As with the U.S. markets, most investors would have been less irritated with this lousy level of performance if they knew what was coming in October. MSCI EAFE was down about 22% in October alone (through October 10th).

With the exception of U.S. Treasuries, bonds across the quality and duration spectrum were also adversely impacted by the crisis, although not to the extent of equities. The Lehman Aggregate Bond Index was down 0.5% for the quarter, bring year-to-date performance to a positive 0.6%. However, October has been difficult as investors sold off non-government bonds in favor of Treasuries.

To get a sense of the loss in the lower-quality segment of the bond market, the Lehman Corporate High Yield Index was down almost 9% for the third quarter, bringing year-to-date performance to a negative 10%. Through October 10th, *month-to-date* performance for high-yield bonds was negative 14%. So, the Lehman High Yield Index was down 24% year-to-date through October 10th.

It is senseless to write more about the third quarter, when October has already been such a distressing month. What is true today about the capital markets may become irrelevant by tomorrow. What were historically multi-quarter market cycles have been compressed into daily market price changes.

Concluding Thoughts

We continue to evaluate the capital markets with reason and discipline, although with more tension than in previous quarters. This has been an especially stressful several weeks for our clients. We understand and feel this viscerally as we invest in the same strategies as our clients. Our role is to try to make sure that our clients have sufficient capital when normal times return to meet their goals.

We have been speaking with clients frequently in October to explain our strategy. Please contact us at 312-578-8300 or via email if you have any questions or would like to discuss our outlook in detail.

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.

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