



Mendham Capital Management, LLC

Independent Firm

January 14, 2009

FOURTH QUARTER 2008 NEWSLETTER

Nowhere to Run, Nowhere to Hide

The fourth quarter of 2008 was easily the worst three months of a year that saw unprecedented market volatility and negative returns across the board.

Review of Previous Quarters:

	<u>12/31/07</u>	<u>9/30/08</u>	<u>12/31/08</u>	<u>2008 YTD Change</u>
S&P 500	1468.36	1,164.74	903.25	(38.49%)
Dow	13,264.82	10,850.66	8,776.39	(33.84%)
NASDAQ Composite	2,652.28	2,292.98	1,577.03	(40.54%)
MSCI EAFE	2,253.357	1,553.149	1,237.420	(45.09%)
10-Year Treasury Note	4.03%	3.82%	2.25%	-178 basis points
3-Month T-Bill Rate	3.31%	.91%	.11%	-320 basis points
Price of Gold (COMEX)	833.20	\$877.40	878.20	+5.40%
Crude Oil (NYMEX)	95.92	\$102.09	39.22	(59.11%)

Inclusion of these indexes is for illustrative purposes only. Keep in mind that individuals cannot invest directly in any index, and index performance does not include transaction costs or other fees, which will affect actual investment performance. Individual investor's results will vary. Past performance does not guarantee future results.

- **Treasury Bills** are certificates reflecting short-term (under one year) obligations of the U.S. government.
- The **S&P 500** is an unmanaged index of 500 widely held stocks that's generally considered representative of the U.S. stock market.
- The **NASDAQ** composite is an unmanaged index of securities traded on the NASDAQ system.
- The **Dow Jones Industrial Average (DJIA)** commonly known as "the dow" is an index representing 30 stocks of companies maintained and reviewed by the editors of the Wall Street Journal.
- The **MSCI Europe, Australasia and Far East Index** is a market capitalization weighted selection of stocks from 21 developed nations excluding the US and Canada.

The markets finished the quarter up from the year's lows they set in mid-November, when the Dow twice finished under 8,000 – bottoming out at 7,552.29 on November 20 the lowest closing number in more than five years. Analysts found that the Dow had its third worst year in its 112-year history, having lost more only in 1907 (down 37.7%) and 1931 (down 52.7%).

Investors fled from equities, moving much of the proceeds to money market funds. As the year went on, dividend rates from money market funds dropped to less than 1.0% as the Federal Open Market Committee kept lowering the fed funds overnight lending rate. In December that rate was set between zero and 0.25%. With money market rates this low, it is clear that long-term investors will soon need to identify alternative solutions.

Not all the economic news was so dark. Light crude oil, selling at an all-time high of \$147.27 per barrel on July 11, closed the year at \$39.22, a drop of nearly 70% that translated to gasoline at the pump selling in the \$1.50 to \$1.75 per gallon range, welcome relief for motorists who had paid more than \$4 a gallon in mid-summer. This will help put more spending power back into the hands of consumers. The spectacular fall was the result of massive deleveraging and drastically curtailed gasoline demand not only in the United States, but in other developed and developing countries.

In October Congress passed a \$700 billion economic stabilization bill and the Treasury Department eventually began injecting money into the economy through banks and other firms. Congress balked at bailing out the Big Three automakers, but the Bush administration in mid-December agreed to make available \$17.4 billion of the economic stabilization funds as rescue loans in return for a series of concessions by unions and management. An especially positive development is the suspension of required minimum distributions from IRA's in 2009.

There was more to highlight the madness of this quarter. In early December, Bernard Madoff, who in the early 1990s served as non-executive chairman of the Nasdaq Stock Market, was accused of running a giant Ponzi scheme that bilked wealthy hedge fund investors (some of them very well known) out of an estimated \$50 billion. While the details are yet to emerge, the news did nothing to bolster investor confidence.

In the middle of it all, there was an election, from which Barack Obama emerged as President-elect. He wasted no time in reassuring both Wall Street and Main Street that he would place the economy as his highest priority, proposing a number of measures he hopes to have ready after he takes office on January 20.

“I can calculate the motions of heavenly bodies but not the madness of people” – Sir Isaac Newton.

The market action in Fourth Quarter 2008 can be characterized as an indiscriminate sell off of all securities with the exception of US Treasury obligations.

The panic of 2008 reflected the fear of systemic risk (the risk of collapse in the financial system) as opposed to the specific risk unique to any particular asset.

The volatility in the markets, from the perspective of a diversified portfolio, was an exceedingly low probability outcome, outside the normal bounds of expectations.

“History Doesn’t Repeat Itself, but It Often Rhymes”- Mark Twain

In the 83 calendar years from 1926-2008, the S&P 500 finished in positive territory 59 times (71% of the time).

There were only six years when the S&P was down 20% or more. Interestingly, only rarely did the market produce results close to its long-term average in a given year (a market return between 8-12% occurred in just five years, 6% of the time)

The most common result in a given year is a gain of 20% or more. This occurred in 31 years, which is over 37% of the time. It is not surprising that many of the strong up years followed a period of under performance in the market.

According to Fidelity Investments, the average return one year after the market trough of the 12 historical bear markets from 1926-2007, was a gain of 46%.

In the typical recovery, after a market decline such as we have just experienced, it can take several years to reach new market highs. We have often experienced a sizable rally, followed by a partial retracement of the advance, and then a couple of years characterized by less volatile results. However, remember past performance may not be indicative of future results.

“Our Number 1 prediction for 2009: Economic Disaster AND a Soaring Stock Market” – The Oxford Club investment newsletter, January 1, 2009 edition.

Most economists expect the US Economy to contract in 2009. At the same time, there are many market strategists anticipating positive, albeit volatile, results from stocks this year. How can this be?

A bullish outcome does not necessarily hinge on economic optimism. Stocks can rise just from a lifting of our worst fears. In times like this, markets almost always discount a worse future than is likely. This leaves the market open to positive surprise.

It is important to recognize that stocks are a leading indicator. Stocks tend to anticipate the future and historically start rising four months ahead of GDP turning positive.

Low interest rates make it less expensive to borrow and low oil prices have put more money in our pockets. Federal spending will provide a major stimulus and the actions thus far of President-elect Obama have instilled a sense of public confidence and optimism for the future.

No one can say for sure whether stocks will rise in 2009. There is a consensus that we should expect continued volatility. Regardless of the outcome in 2009, it is fair to say that great values are now available to long-term investors.

“I’ve been buying American stocks...A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, fear is now widespread, gripping even seasoned investors” – Warren Buffet, October 17, 2008.

Many strategists believe that the flight from equities is over done with prices down sharply in every sector. The value proposition, after the indiscriminate sell off of 2008, has become compelling.

The fundamentals of sound companies should begin to matter, once again providing opportunity for savvy investors.

Diversification should also matter once again, as market participants focus not on the risks to the system as a whole, but rather on the specific risk unique to each asset.

Historically, the market has turned suddenly and dramatically. This suggests that long-term investors, who have moved funds out of the market, will need to develop a strategy for returning to a more normal investment allocation to avoid missing a rally. Prices are likely to be much higher long before the all-clear has sounded.

“Even professional money managers are hiding in short-term Treasuries that yield next to nothing. A time will come when earning zero interest starts getting old” – Kopin Tan, Barron’s, January 5, 2009.

Among the reasons to consider stocks now is the minimal return available from low risk alternatives.

There is a record amount of cash on the sidelines which is earning next to nothing. If confidence is restored to the point that investors return to the market, this cash is the fuel that could ignite a significant market rally.

We wish to point out that 2008 market action has created a significant investment opportunity in bonds as well as stocks. We find numerous examples of both corporate and municipal investment grade credits that have been marked down in price. Investors have the ability to lock in attractive yields and enjoy price appreciation as values gravitate back towards par.

Risks on the Horizon

We are all acutely aware of the myriad of economic challenges we face in the year ahead.

In the short run, we must face the risk of deflation as a result of the sharp contraction in economic activity. The negative effects of deflation are best illustrated by the decade long period of economic stagnation experienced in Japan.

In the longer term, we face the risk of inflation. Historically, whenever the Fed has accelerated the flow of money and reserves, a rise in inflation has always followed.

The Fed has made clear it understands these risks and that, when the opportunity presents itself, it will alter policy and remove excess liquidity from the system. We must hope the Fed can be nimble enough to navigate this challenging environment.

Lessons from the Downturn

Investing is part art and part science. There are always variables and unknowns which are beyond our control. In 2008, it was possible to follow all the guidelines of proper investing, own a diversified portfolio of high quality securities, and still see your asset value marked down by one third or more!

This sort of outcome was highly improbable, but the results show it was within the realm of possibility.

Successful investing takes time, patience and flexibility. Based on our experience last year, we are adding a couple of arrows to our quiver which will prove helpful in future periods of downside volatility. As always, our focus will be on high quality securities well positioned to weather the storm. Both strategies fit nicely within the framework of our philosophy of asset allocation.

The first is that we will seek to allocate a portion of a client portfolio, where appropriate, to individual securities such as exchange traded funds (ETF's). These investments possess some qualities that make them a nice complement to the mutual funds that comprise the lion's share of our client portfolios.

ETF's trade throughout the day which is a key difference versus mutual funds, which are priced once a day, when the fund's net asset value is calculated after the market closes. This is an attractive quality, given the sort of volatility we have seen possible even in the context of one business day.

Another characteristic of ETF's is the opportunity to take advantage of a trading technique called a stop order. In this example, a stop order would instruct the sale of a position once the stop price has been hit. In this way an investor can seek to limit potential losses by instructing a sale if a security drops to a specific price. In a more positive scenario, a stop order can be used to protect gains in a position that has moved up. You should be aware that the price when the order is actually executed may be different than the stop price, especially if the market is moving quickly.

This is not a strategy which calls for frequent trading, but rather is a disciplined approach to managing risk, appropriate for a portion of a portfolio, designed to take the emotion out of investing. It is a strategy which can cushion portfolio results in a volatile market.

The addition of Bob to our team has made it possible for us to embrace this strategy. His two decade career as an equity trader at a Wall Street specialist firm make him uniquely qualified to implement this approach.

We should explain that an ETF is similar to a mutual fund in that it pools the money of many investors and purchases a group of securities. They are attractive in that they combine the diversification of mutual funds with the trading flexibility of stocks.

ETF shareholders should be aware that the general level of stock or bond prices may decline, thus affecting the value of an exchange-traded fund. Although exchange-traded funds are designed to provide investment results that generally correspond to the price and yield performance of their respective underlying indexes, the funds may not be able to exactly replicate the performance of the indexes because of fund expenses and other factors.

Investors should consider the investment objectives, risks, charges and expenses of ETFs before investing. This and other important information about ETFs are contained in the prospectus, which can be obtained from your financial advisor and should be read carefully before investing.

The second concept we have embraced is a technique for investing in equities while protecting against the downside with guarantees on the future income potential of the portfolio. This technique is a relatively new development, available in the form of a variable annuity with a living benefit, generally referred to as a Guaranteed Minimum Withdrawal Benefit (GMWB).

When you add a GMWB to an annuity, the provider tracks a separate "income account" along side your regular account. The income account is guaranteed to grow at a rate of 5-6% per annum for at least ten years. When you are ready to draw from the account, it can be tapped to provide a guaranteed lifetime income of 5% of its value at age 65, for example. We are enthusiastic about this idea because it offers an investor the upside potential available from the market with a buffer against the downside. This is a hypothetical illustration and is not intended to reflect the actual performance of any particular security.

The benefits provided by variable annuities, and riders such as the GMWB, come with expenses that should be carefully evaluated before investing. This concept is not appropriate for everyone. A detailed, individualized discussion is required before you can conclude whether such a vehicle is right for you.

Investors should consider the investment objectives, risks, charges and expenses of variable annuities and their underlying funds. This and other important information about variable annuities are contained in the prospectus, which can be obtained from your financial adviser and should be read carefully before investing.

Annuities involve market risk and should be considered as long term investments. Withdrawals are subject to income taxes and may be subject to a penalty if withdrawn before age 59 ½. Withdrawals may also be subject to surrender charges.

There are fees and charges associated with variable annuities, including mortality and expense charges, administrative fees, and annual contract fees.

Guarantees are based upon the claims paying ability of the insurer.

It's Cool to be Calm

Being reminded to keep calm is not just therapeutic advice in this time of financial stress. Panic often causes us to think short-term when it is well known that smart investors think long-term. A psychological quirk called *recency* causes us to pay too much attention to the recent past when making decisions. After past market crashes, the market has most often gone on to produce healthy gains over the next year or two. It is often best to sit tight on a well diversified portfolio. Once again, please remember that past performance may not be indicative of future results. Keep in mind diversification does not assume a profit, nor protect against loss in a declining market.

Money and Trust

The unnerving events of 2008, exemplified by failures among major financial institutions, the revelation of financial scandal and the dramatic erosion of asset values have created a crisis in confidence and trust. Many lives have been negatively impacted as a consequence of these events.

Our guiding principle at MCM is to demonstrate the qualities that inspire trust. As a team we possess a firm moral compass and are committed to sound investment principles, integrity and stewardship in everything we do.

The five of us comprise an excellent team both in terms of investment professionals and investment support. We are always available to assist you and we look forward to working with you in the coming year.

Best wishes for a happy, healthy and more prosperous 2009!

Thank you for your continued trust and support.

Sincerely,



William F. Burke, Jr.
Registered Principal/Investment Consultant
Raymond James Financial Services, Inc.



Hilary L. Larkin
Investment Consultant
Raymond James Financial Services, Inc.



Robert J. Burke
Investment Consultant
Raymond James Financial Services, Inc.

WFB:mn

The information contained in this report does not purport to be a complete description of the securities, markets or developments referred to in this material. Any information is not a complete summary or statement of all available data necessary for making an investment decision and does not constitute a recommendation. Any opinions are those of William F. Burke, Hilary Larkin or Robert J. Burke and not necessarily those of RJFS or Raymond James. Expressions of opinion are as of this date and are subject to change without notice. This information is not intended as a solicitation or an offer to buy or sell any security referred to herein. Investments mentioned may not be suitable for all investors. Past performance may not be indicative of future results. You should discuss any tax or legal matters with the appropriate professional.

27 East Main Street, Mendham, New Jersey 07945 * Tel: 973-543-6670 * Fax: 973-543-6680
www.raymondjames.com/MendhamCapitalManagement

Securities and Investment Advisory Services offered through **Raymond James Financial Services, Inc.**
Member FINRA/SIPC