

January 14th, 2009

Here is our newsletter for the 4th Quarter of 2008.

2008 In Review

In our newsletter one year ago we indicated “the possibility of rough times ahead” with “corporate profit growth falling or perhaps even turning negative”. As it turns out 2008 was the worst year for the stock markets since 1937. Our equity benchmark was down 39.3% for the year. Foreign equities fell more than the U.S. markets with the developed markets falling 44% and the emerging markets falling 53%. Alternative asset classes REITs and commodities fared no better with losses of 37% and 36% respectively. The majority of these losses occurred during the market crash in late September and early October.

As is always the case when the equity markets crash, the bond markets performed better with the total bond market indexes posting a 5% gain. However, all the gain in the composite came from government bonds posting an 18% gain with all other sectors in the bond market suffering losses. High-Yield corporate bonds lost 26%.

Our Portfolios

All of our portfolios lost less than 30% for the year. Our Equity-Tilted composite lost 23.6% vs. a loss for the benchmark of 28.1%. Losses were minimized primarily by reducing our equity positions and holding cash. One way to evaluate a loss is to determine how large a gain will be required to recoup your loss. For an investor who lost 40% in 2008, he will have to have a 67% gain to recoup his losses. For most of our clients with a loss of around 25%, they will need a 33% gain to recoup their losses.

In actuality, none of our clients has lost anything in the bear market. Our retired clients who are withdrawing from their portfolios funded their withdrawals last year with cash raised in late 2007 before the bear market started.

Outlook for 2009

Clearly we are in the midst of a severe recession that could continue through all of 2009. Corporate earnings could continue to fall and not recover for some time. Recall the chart of the S&P 500 Reported Earnings we presented in our newsletter one year ago. A year ago corporate earnings were well above the long-term trend: over the last year they have fallen so fast they are now well below the long-term trend. Earnings will come back but it's anyone's guess when this will happen. A consensus among economists we respect seems to be building about the recession being long and with a slow recovery afterward. The root cause of our problems is the increase in household debt over the last twenty years to

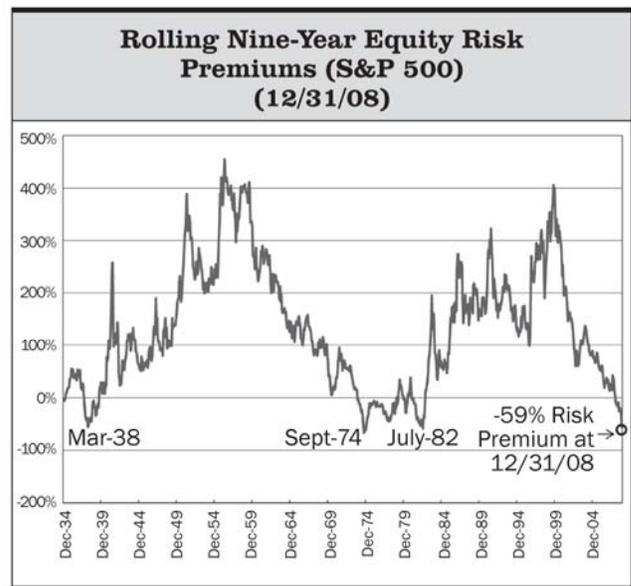
unsustainable levels. Add the high leverage built into the investment banks and the only way out is a deleveraging process that will take years to correct.

The good news is everyone knows the economy is terrible and stock and corporate bond prices reflect at least some of the bad news. Pessimism and fear are rampant. Usually investing during these times has been fruitful for those who go against the herd. So what expectations are reflected in asset prices? All we know for sure is what prices are today and how those prices compare from an historical perspective. Here are a couple of analysis we find useful.

Trailing Risk Premiums

An analysis done by Advisors Intelligence compares stock market returns to the returns for a risk-free asset. They date this secular bear market at about nine years ago and compare the S&P 500 returns to three-month Treasury Bills over the last nine years using month-end returns going back to the Great Depression.

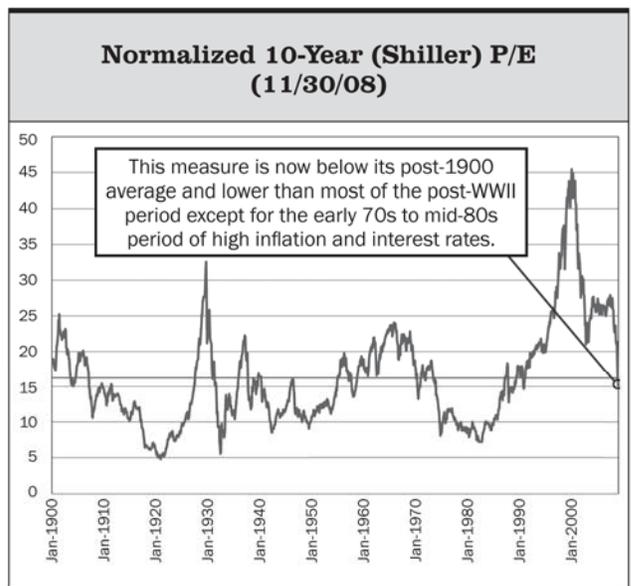
The results show that by underperforming T-bills over the last nine years by 59%, the risk premium is presently one of the worst on record, matching the worst nine years during the Great Depression. Looking forward the long-term returns were quite good following similarly horrible nine-year periods.



The risk premium is the difference between the stock market return and the "risk-free" return available from the average three-month T-bill yield over the period.

Valuation Evidence: Shiller P/E

There are many ways to assess current valuations with earnings multiples being one of the more popular. Unfortunately the E in the equation going forward is anyone's guess. Robert Shiller with Yale calculates his P/E based on an average of the last 10 years' earnings in order to smooth out short-term volatility and also inflation-adjusts the earnings and stock price levels. The current Shiller P/E is 15 times normalized earnings. This is lower than most of the post-WWII Period except for the early 1970s thru mid-1980 when inflation and interest rates were much higher than today. P/E's could always go lower and stay low for years, but this



The Shiller P/E adjusts stock prices and earnings for inflation. It is also a normalized P/E that is based on average earnings over the trailing 10 years in order to smooth out earnings volatility. Given the extreme level of earnings volatility over the past 10 years we find this method appealing.

level of P/E has generally been a good long-term entry point into the stock market.

So where does all of this leave us? We have been decreasing our high cash positions over the last three months and have been slowly moving back into stocks and bonds.

Our largest new position is in high-yield bonds. We began buying high-yield bonds (a.k.a. “junk bonds”) in lieu of equities in mid-October. We have added to them after the first of the year and now have about a 17% allocation in most of our portfolios. The market and we believe the severe recession will result in extremely high default rates for junk bonds, possibly reaching the highest levels since the 1930s. We also believe the average recovery from the defaulted bonds will be historically low (recovery refers to the value ultimately recovered by bond holders after a default). Nevertheless, our analysis tells us that the probability of capturing average annual returns into the teens over the next few years is very high. This is possible because of the vicious sell-off in this market in the fourth quarter of 2008, partly driven by forced selling from hedge funds and others. The sell-off has left the high-yield market priced at a yield-to-maturity of over 20%, an all time high, with an average price of around 60 (compared to a par value of 100).

Advisors Intelligence has modeled out the returns assuming various default rates and interest-rate scenarios over the next five years. Their most negative scenario assumes a cumulative default rate over five years of 50% (more extreme than the 1930s) with a recovery of 25% of par (the historical average recovery is around 40%). We don't know of any experts who are forecasting more severe assumptions. Investors in a diversified high-yield portfolio will capture a very high return on the bonds that don't default as holders get paid par value for their bonds at maturity. For those bonds that do default, the loss will amount to the investor's cost basis (e.g., the average price for bonds in the high-yield index is currently around 60) less the recovery value (the 25% we forecast on average) and less the interest earned prior to the default. Many of the bonds that will default are likely already selling below 60. Working through the math, even in the 50% cumulative default scenario, the five-year average annual return works out to about 13% (as of 12/31/08). This represents a great opportunity and we are using these bonds as an equity surrogate, buying junk bonds to fund some of our equity exposure with less risk than equities.

We also bought back into a commodity index fund at a 4% allocation. This fund was sold back in early July when the price was three times higher than its current price. This fund is a great diversifier and since the commodity positions are collateralized using TIPS (Treasury Inflation Protected Securities) it will offer a current historically high real yield on top of the commodity positions.

We were tempted late last year to initiate a position in the REIT (Real Estate Investment Trust) market. Valuations were looking very compelling. We decided to hold off primarily due to the high level of debt that is used in these investments. It will be very difficult for these firms to rollover their debt going forward and we expect vacancies to continue their climb up and earnings to deteriorate.

Going forward, we will likely increase our allocation to foreign securities, especially in the emerging markets. With prices in the emerging markets having dropped by more than half

over the last year, valuations are becoming more compelling and we expect economic growth to be better there than in the developing world. As the year progresses we will look for opportunities to increase the risk profile of our portfolios up to benchmark levels. The stock market will recover before the economy turns around and we will not know when the economy has turned around until it has already done so.

The Madoff Scandal

What Bernie Madoff got away with for so long is truly amazing. How do you assure you don't fall victim to a similar scam? Here are some tips.

1. Don't simply trust anyone based upon what they say, how they appear, who they know or what their resume looks like. Verify the information they give you by reviewing your portfolio statements and other independent information. Don't trust the SEC or anyone else to do this for you.
2. Don't hire an all-in-one shop. Madoff and his firm were the investment advisor, brokerage and custodian of all the assets under management. My firm is only the investment advisor. We use TD Ameritrade as the brokerage platform and custodian for all our accounts. We use them at arm's length, meaning there is no financial relationship between us. We don't pay them nor do they pay us any compensation as a result of us using their service.
3. Understand what you're investing in and who is managing those investments. The financial industry comes up with another vehicle to use almost daily. One can invest in private equity, hedge funds, separately managed accounts, united managed accounts, unit investment trusts, auction rate funds, CDOs, structured products, and on and on. Honestly I don't know what classification Madoff's fund fits into: all I know is it was not a mutual fund. We choose to use publically traded, liquid mutual funds and ETFs. Mutual funds are highly regulated and transparent vehicles that have been used for many years. I have a database system that can list all the top holdings inside the fund (in addition to them being listed in the quarterly reports) and there is complete analytical data on the performance, volatility, management and other characteristics of the funds at my fingertip.

How is the State of Your Household Debt?

Too much debt is at the heart of our nation's current financial problems. The Controller General of the U.S. David Walker has been on a campaign to educate the public and our leaders concerning the coming crisis at the federal level. A video presentation has been posted on my website at www.CompFinancial.com on the Documents page titled IOUSA. Currently the federal debt stands at \$8.7 Trillion which represents 64% of our annual GDP. This number is not very high by historical standards but where we are going is the problem if bold action is not taken. Using current projections in the growth of government spending primarily for Social Security, Medicare and Medicaid the present value of all future liabilities is estimated to be \$53 Trillion. That means for every man, women and child currently in this country, each one of them would have to put up \$173,000 to fund the future government spending on top of current taxes. I do not mean to paint too pessimistic a picture. There are plenty of solutions to get us out of this problem. Unfortunately the largest part of the

solution will be higher taxes in our futures. After 28 years of generally lower taxation the tide is likely to turn the other way.

So what can you do? The best thing for all of us to do is make sure our own house is in order. I have helped many clients analyze their debts and make specific recommendations to restructure, consolidate, reduce and pay down their debts to secure their financial picture. Mortgage rates have been falling lately and I expect, with the determination of the Federal Reserve, for mortgage rates to fall more soon. It's a great time to look at the options and put a plan of action together.

Thank you for your continued business and I will continue to work hard to earn it.

Sincerely,

Stan Johnson, CFP(R)
Comprehensive Financial, Inc.
Registered Investment Advisor