

INVESTING WITH DISCIPLINE

NEWSLETTER

DECEMBER 31, 2008

LESSONS OF 2008

By Brian Lawrence, CFA

Though 2008 is now behind us, the events of that year continue to reverberate strongly in our daily lives. The crash of our financial system has us mired in the worst recession since the 1970s and the daily news offers little hope. A savvy client asked me at the height of the turmoil, "What have you learned from the crisis?" I believe several important lessons were learned or reaffirmed in 2008. There are also silver linings amongst the wreckage and hope for the future.

The first lesson to be reaffirmed is: investing involves risks which are difficult to quantify. Most of the time the market rattles along and generally follows the broad ups and downs of the economy. However, events like terrorist attacks, oil embargoes, or incidents of corporate fraud can occur unexpectedly and often have an enormous impact on the markets and potentially the economy. Yet these events are nearly impossible to predict and it is even more difficult to gauge the scope of their impact. Thus, we need to realize that there are many unknowns outside of our control. Armed with this thought, we can move forward and easily justify owning safe bonds which can act as an anchor in any portfolio.

If understanding market risks is difficult, understanding your own risk tolerance can be equally as challenging. Over the past year we have each learned a lot about our individual ability to stomach risk. Now is probably a good time to ask yourself how 2008 made you feel. If you lost sleep and suffered extreme anxiety due to the market decline, it might make sense to adjust your long term investment targets to reflect a more conservative allocation. However, we do not advocate completely switching course in mid-stream. Investment plans are useless if you and I cannot follow them. We continue to be committed to the belief that even though our diversified portfolio approach does not work at every point in time, it does work exceedingly well through time.

Even though your risk tolerance can naturally change with time and circumstances, the media is a constant influencing force that can lead us astray from sound decision-making. Listening to the financial news media, especially television, does not make us better investors. The talking heads on TV sound extremely serious and knowledgeable, but the truth is they are entertainment. These financial commentators are selling news sound-byte-by-sound-byte as they try to predict the future. They are paid to make financial news exciting, not useful. For example, listen to how they report changes in the market during the trading day. They assert, "the market is rising", rather than, "the market rose." The difference is subtle yet important. The fact is you do not need to predict the future to have a successful investing experience. Information and awareness are great; just do not buy the hype. If we can manage to do this we will be able to make more rational investment decisions.

IMPORTANT TAX REMINDER

Our Management Fees are Tax-Deductible.

Consult your Tax Advisor for full details.

INDEX SCORE-CARD

QUARTERLY RETURNS

	3 RD	4 TH
US Large Cap:	-8.40%	-21.94%
US Small Cap:	-1.10%	-26.12%
International Stocks:	-20.60%	-19.95%
Emerging Markets:	-27.60%	-27.94%
US Bonds:	-0.50%	4.58%
Foreign Bonds:	-4.30%	8.80%
REITs:	5.60%	-38.80%
Commodities:	-27.70%	-30.04%
TIPS:	-3.50%	-3.48%
Treasury Bills:	0.40%	0.10%

3RD Quarter for the period ending
9/30/08

4TH Quarter for period ending
12/31/08

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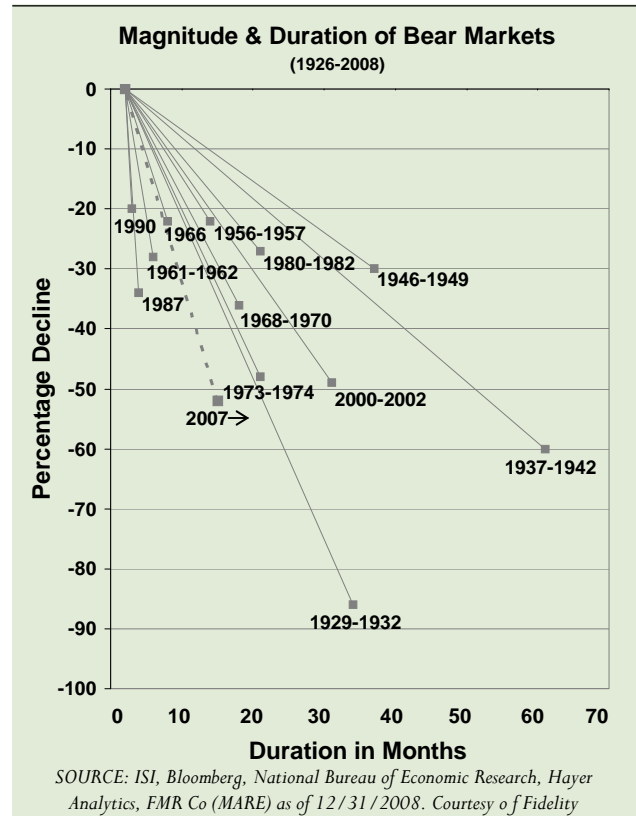
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LESSONS OF 2008: CONTINUED

Another lesson of 2008 is that history repeats itself. The last 200 years are ripe with examples of recession, depression, speculation, and credit/capital bubbles. Some of these periods look eerily familiar. For example, the depression of 1837 – 1843 followed the panic of 1837, resulting in a failure of the banking system. This followed years of rapid investment growth and real estate speculation. Sound familiar? Or how about the depression of 1893-1899, caused by speculative investment (railroads) and the collapse of local real estate markets in the central and western U.S.? The question becomes not if, but when will the next crisis occur. Likewise, recovery is a matter of timing. As mentioned above, we are in a deep and difficult recession. We have been here before many times throughout the history of our country and have survived each time. While we cannot predict the timing of how this cycle plays out, an examination of some facts can help us understand how recovery might occur.

Over the past 25 years the U.S. became an increasing indebted society that saved less and less. These trends were unsustainable and are now in reverse. The likely result is slower economic growth over the next decade than we had in the 1990s. The economy has not stopped, and in fact there is activity waiting to happen once credit markets return to normal. There is a base level of spending that needs to occur to meet our daily needs. While individuals are likely to re-evaluate whether needs are actually wants, people are still spending money. A trend to save more income than in the past will slow consumer spending and slow economic growth. Massive government debt also risks crowding out private investment and further slowing our growth rate trend. So how does a recovery happen? The economy will eventually find equilibrium. Once the financial sector stabilizes, the additional dollars we save as individuals will be available to be lent out by banks, funding economic expansion through the creation of new businesses, business expansion, and infrastructure spending. Instead of consumer-driven growth, we may



have more investment-driven growth. In other words, rather than investment in houses and toys that sit in the driveway, investment will focus on new jobs, means to communicate, roads, technology, and other things that create real, long-term economic growth and efficiency. Any turn-around, though, will very likely be preceded by more bad news. Unemployment and other measures of the economy will get worse before they get better and we must brace ourselves to receive this data.

All investors can learn several important lessons from the experiences of 2008: strive to understand market risk and accept that risk is part of investing; know your own limits to accepting risk and develop an investment plan that you can live with through all environments; ignore the media hype; and finally, be assured that history will repeat itself and we need to be ready. We look forward to this new year with patience and perseverance as we move through this difficult time and lay the groundwork for better times ahead.

WIT & WISDOM

"Harmony seldom makes a headline."

Silas Bent (1882-1945)

American journalist, author, and lecturer

Index Definitions

- US Large Cap:** A U.S. large company stock index measured by the S&P 500. A group of 500 of the most widely traded stocks in the U.S., as chosen by Standard & Poor's.
- US Small Cap:** Measured by the Russell 2000. The index is comprised of the smallest 2000 stocks in the Russell 3000 Market Index.
- International Stock:** An international stock index measured by the MSCI EAFE. It is comprised of stocks from developed markets in Europe, Australia, Asia, and the Far East.
- Emerging Markets:** An international stock index that tracks non-developed markets throughout the world. It is measured by the MSCI Emerging Markets Index.
- US Bonds:** A measure of the Total U.S. Bond Market by the Lehman Aggregate Bond Index. It takes into account corporate, government, mortgage and asset backed securities.
- Foreign Bonds:** Measured by the Citi World Gov't Bond Index. The fund is comprised of primarily investment grade bonds from around the world.
- REITs:** Measured by the FTSE NAREIT Index which is a composite of Real Estate Investment Trusts traded on U.S. exchanges.
- Commodities:** Performance is represented by the PIMCO Commodity Real Return Strategy Fund, which uses the DJ AIG Commodity Index as a benchmark.
- TIPS:** Performance is represented by the Lehman Brothers US Treasury Inflation Protected Securities Index. TIPS are government bonds that have adjustable coupon payments based on the rate of inflation (as measured by the CPI).
- Treasury Bills:** Short-term government issued securities with maturities less than 90 days. Because they are government issued, T-Bills are free from default risk.

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