

INVESTING WITH DISCIPLINE

NEWSLETTER

JUNE 30, 2009

PLUMBING OF THE ECONOMY: CAPITAL MARKETS

By Brian Lawrence, CFA

Last quarter we discussed banking and the crucial role it plays in our economy and everyday lives, connecting savers with businesses and individuals who need money. This quarter we extend the discussion of modern finance to include capital markets. These stock and bond markets benefit corporations, savers, and the economy at large.

Like banks, capital markets have been around for hundreds of years. The oldest stock exchange in the world is in Amsterdam, dating back to 1602. Trading in New York began soon after colonists arrived in the new world. Traders often congregated around the buttonwood tree on Wall Street, aptly named for the wall built by Dutch settlers to protect them from Native Americans. In 1792, a group of 24 stock brokers signed an agreement under the buttonwood tree that created what we know today as the New York Stock Exchange.

Such longevity is a testament to capital markets' usefulness. Since the time of the Buttonwood Agreement and formation of the NYSE, thousands of U.S. companies have used stock and bond markets to raise money for business expansion, acquisition of a rival firm, or other strategic activity. Capital markets are popular because they are efficient and flexible. For large companies, it is often less expensive to issue stock or bonds than take out a bank loan. In fact, very large companies may not be able to find a bank willing to lend the amounts they need. Having publicly traded stock and bonds gives a company a form of currency they can readily use in the future.

Markets of course have two sides – companies that issue stocks and bonds, and the buyers of those same securities. The buyers, or investors, also expect to benefit. The implicit expectation is that investments will over time yield a higher return than money placed elsewhere, for example, a bank savings

WIT & WISDOM

"The importance of money flows from it being a link between the present and the future."

John Maynard Keynes, (1883—1946)
British economist whose ideas have been a central influence on modern macroeconomics

INDEX SCORE-CARD

QUARTERLY RETURNS

	1 ST	2 ND
US Large Cap:	-11.01%	15.93%
US Small Cap:	-14.95%	20.69%
International Stocks:	-13.94%	25.43%
Emerging Markets:	0.52%	33.57%
US Bonds:	0.12%	1.78%
Foreign Bonds:	-5.74%	5.42%
REITs:	-33.92%	27.28%
Commodities:	-6.31%	11.67%
TIPS:	5.52%	0.66%
Treasury Bills:	0.05%	0.05%

1ST Quarter for period ending
3/31/09

2ND Quarter for the period ending
6/30/09

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PLUMBING OF THE ECONOMY: CAPITAL MARKETS (CONTINUED)



account. The higher risk assumed by investors accounts for the expectation of higher return.

The buyer of a stock effectively becomes a partial owner of the company. As an owner they participate in the success or failure of the business as the stock

price fluctuates. The logical expectation is that owners are rewarded out of profit if the company flourishes; conversely, owners can lose their entire investment if the company goes out of business.

Bond investors essentially enter into a contractual agreement with a company – the investor lends money and the company promises to pay interest and principal on certain dates. Bond investors do not benefit if the stock price rises. However, they are first in line and several steps ahead of stock owners in the worst case scenario, bankruptcy.

Thus capital markets are conduits for money flowing throughout the economy. They allow businesses in need of money to be matched with individuals and institutions (such as pension funds) who have excess money and want to invest it. Well-functioning markets allow viable businesses to raise money from a wide swath of investors, spreading out risk, and allowing them to access a huge pool of financial resources. At the same time, investors have the opportunity to apply their money to various kinds of investments with differing risk and return potential.

The economy as a whole benefits in many ways. Businesses with access to the capital markets can grow more easily and

create jobs. Individuals can invest for retirement. State pension funds can diversify their investments in an effort to meet long-term obligations. In addition, markets take on a “rationing” function, allocating capital to enterprises with promising ideas and prospects and away from outdated industries. In other words, business success, market prices, and investor decisions decide how capital is allocated through the marketplace. The matching and rationing of investor capital with business needs is a vital function in our global economy. Any marketplace, however, is not perfect. Whether it be for tulip bulbs, gold, stocks, or bonds, markets are subject to greed and fear, causing wild swings in valuation.

Despite recent turmoil, banking and capital markets remain effective mechanisms for savers to provide the people with ideas the money they need to move forward. Stocks and bonds continue to represent real ownership of assets or debt, while their prices transmit information about the health of the economy. As we have always advocated, capital markets must be viewed with the eye of a long-term investor and from the standpoint of a highly diversified portfolio.

WELCOME!

We would like to introduce Ginger Teller, the newest member to the Headwater Investments team.

Ginger earned her B.S. in Accounting from Linfield College in 1999. She has worked as a governmental auditor and a bookkeeper. Ginger will be helping C.B. with administrative tasks, including cashiering requests and check deposit notices, among other duties as an analytic assistant. Ginger is looking forward to meeting you. Stop by or call to say “Hello!”

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: Measured by the Barclays Capital Aggregate Bond Index, which takes into account corporate, government, mortgage and asset backed securities.

Foreign Bonds: Measured by the Barclays Capital Global Aggregate Bond Index. The fund is comprised of primarily investment grade bonds from around the world.

REITs: Measured by the FTSE NAREIT Composite Index which is a composite of Real Estate Investment Trusts traded on U.S. exchanges.

Commodities: Performance is represented by the Dow Jones UBS Commodity Index.

TIPS: Performance is represented by the Barclays Capital 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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