

# HEADWATER INVESTMENT CONSULTING, INC.

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## Quarterly Review & Outlook

1<sup>st</sup> Quarter 2008

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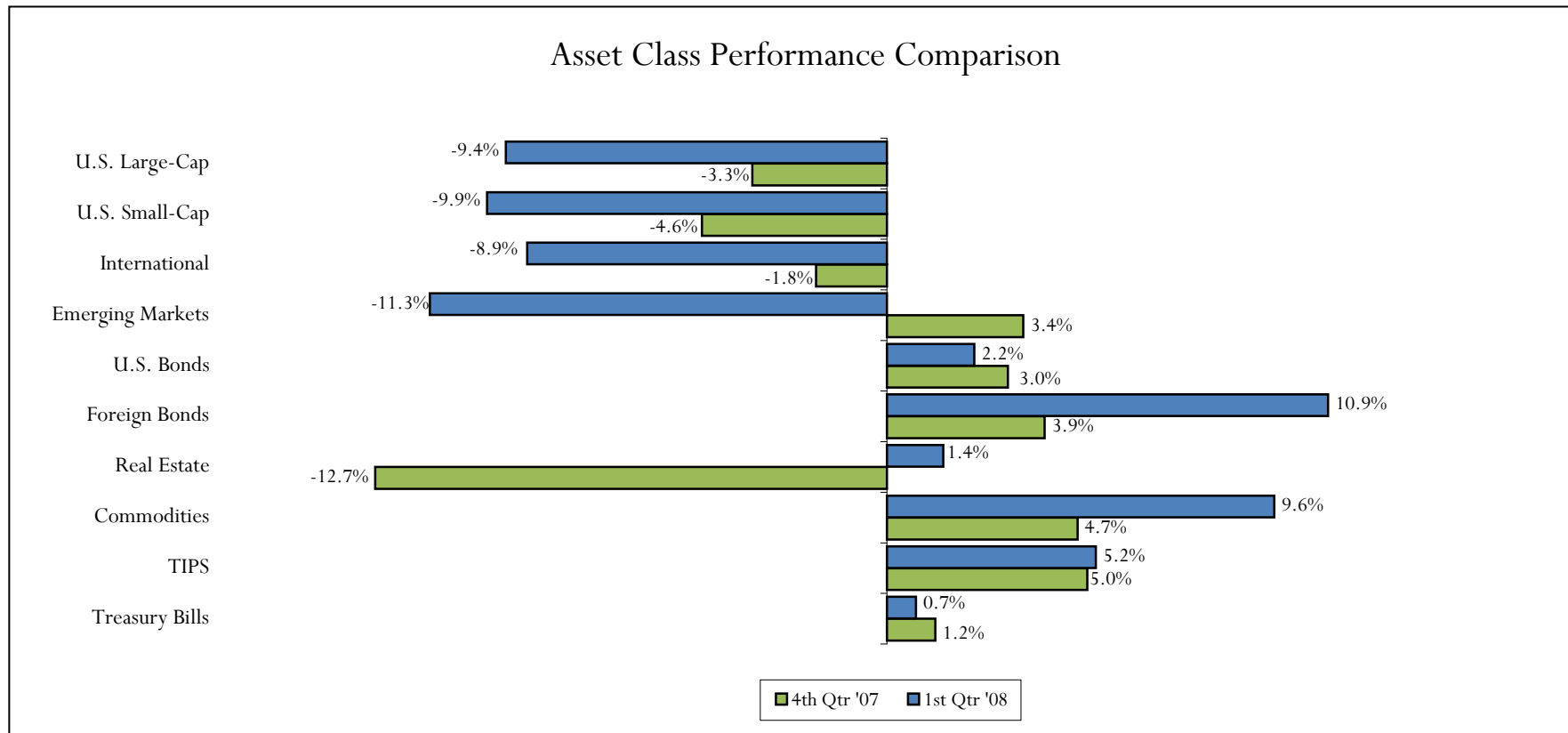
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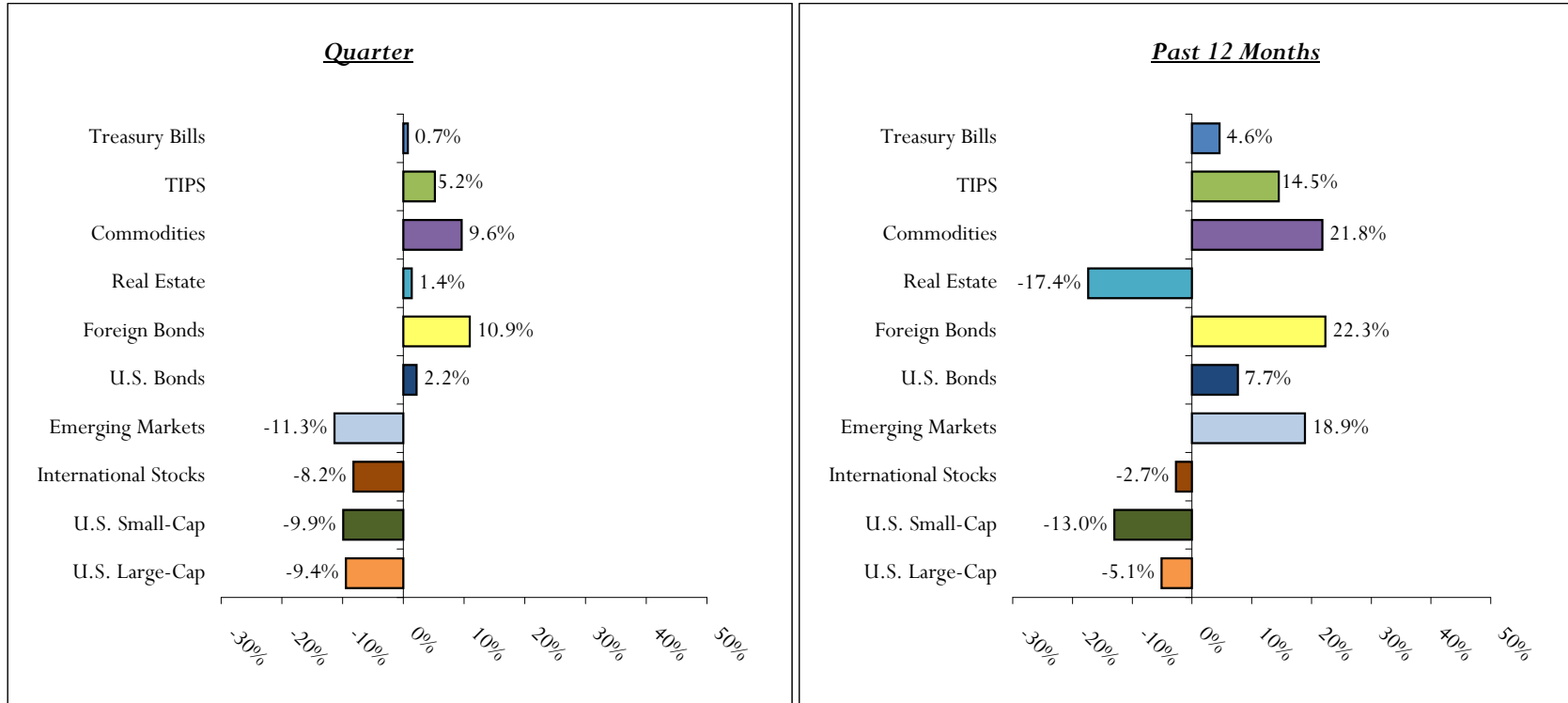
## MARKET UP-DATE

The first quarter of 2008 was marked by turmoil. As highlighted in the chart below, equities took a beating while fixed income, commodities and TIPS provided some counter-balance in the volatile markets. We expect uncertainty in the financial markets to persist throughout 2008.

The U.S. and global economies grew in Q1, albeit slowly. External factors, such as continued economic progress in China and other emerging markets, will play a role in our recovery. In our quarterly topic, we discuss some of the other hurdles our country must overcome before the economy will strengthen.



# ASSET CLASS PERFORMANCE



*Index Performance as of: 03/31/2008*

	<u>YTD</u>	<u>1 Mo</u>	<u>3 Mo</u>	<u>1-yr</u>	<u>3-yr</u>	<u>5-yr</u>	<u>10-yr</u>
<i>U.S. Large-Cap</i>	-9.4%	-0.4%	-9.4%	-5.1%	5.9%	11.3%	3.5%
<i>U.S. Small-Cap</i>	-9.9%	0.4%	-9.9%	-13.0%	5.1%	14.9%	5.0%
<i>International Stocks</i>	-8.9%	-1.1%	-8.2%	-2.7%	13.3%	21.4%	6.2%
<i>Emerging Markets</i>	-11.3%	-5.4%	-11.3%	18.9%	26.3%	32.3%	9.7%
<i>U.S. Bonds</i>	2.2%	0.3%	2.2%	7.7%	5.5%	4.6%	6.0%
<i>Foreign Bonds</i>	10.9%	3.8%	10.9%	22.3%	7.4%	9.0%	7.4%
<i>Real Estate</i>	1.4%	6.2%	1.4%	-17.4%	11.7%	18.3%	10.7%
<i>Commodities</i>	9.6%	-6.3%	9.6%	21.8%	12.1%	15.7%	10.4%
<i>TIPS</i>	5.2%	-0.1%	5.2%	14.5%	6.8%	6.8%	8.0%
<i>Treasury Bills</i>	0.7%	0.2%	0.7%	4.6%	4.7%	3.4%	3.9%

## QUARTERLY TOPIC: "IN-DEBT-GESTION"

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fallout from stalled credit markets continues to ripple through our economy and sets the stage for an interesting, if not difficult, 2008. What started as trouble in a small segment of the mortgage industry has quickly snowballed and exposed problems in other areas, weaknesses that had been slowly building but remained masked by extraordinarily easy access to money/credit. The situation prompts a number of thoughts and observations.

The world is suffering from a case of "in-debt-gestion" following a global binge on all types of debt, the most unsavory being related to sub-prime mortgages. Low interest rates and declining lending standards made debt available for virtually anyone who wanted it. Want to buy a house for \$0 down, with bad credit, and no documentation of income? No problem! This kind of faulty thinking and gross misjudgment of risk has percolated through the economy in the last 3-5 years. As a result, many Americans have a savings rate very near zero and less than 50% equity in their homes for the first time in history. Mortgage debt, credit card debt, auto debt, corporate buy-out debt – these took years to build up and our case of "in-debt-gestion" will not go away overnight.

To a large degree the accumulation of debt was made easy by financial innovation and the misjudgment of risk. Banks were willing to lend on looser terms because they were not going to be responsible for collecting the debt payments. Financial engineers

devised a way for commercial banks and mortgage companies to sell loans to investment banks—they package the loans together, get them stamped with a AAA rating by a credit agency, and sell interests in this mortgage backed security to hedge funds, banks, municipalities, and anyone else who was interested. The actual owners of risk became so far removed from the underlying investment they had difficulty evaluating its quality.

Banks did not have an incentive to worry about the risky loans they were making, as long as they could turn around and sell the loans to someone else. However, when sub-prime home buyers began to default, banks and other mortgage lenders could no longer sell the toxic loans they were making. That's when the wheels really came off the cart. Mortgage backed securities by this point had been spread far and wide. As they defaulted at higher than expected rates, their AAA credit ratings became meaningless and determining who owned them difficult. For those reasons, trading of the bonds locked up. Banks and brokerages began hoarding money to cover rising defaults. Off balance sheet investment vehicles, à la Enron, were exposed and lead to further capital hoarding and write-offs for bad loans. These trends are still in play and confidence in the financial system is severely shaken.

The system is not broken; however, there is no quick fix. The federal government is providing some economic stimulus and extra money for financial institutions, but the true healing of our system will take time. Banks need to replenish the capital reserves that back their loans.

Foreign investors have contributed billions of dollars in this regard. Consumers need to rebuild savings and pay off debt. A small tax rebate is nice, but only secure jobs will truly facilitate this change.

As the market and people are drawing lessons from our current situation, we need to remember that financial innovation can be great. It has given us the mutual fund concept, online banking, and exchange traded funds. Furthermore, economic crisis is a regular occurrence. In fact, financial history is littered with examples, from speculation over tulip bulbs to internet stocks. Financial crises and speculation are inherent risks to an open market system.

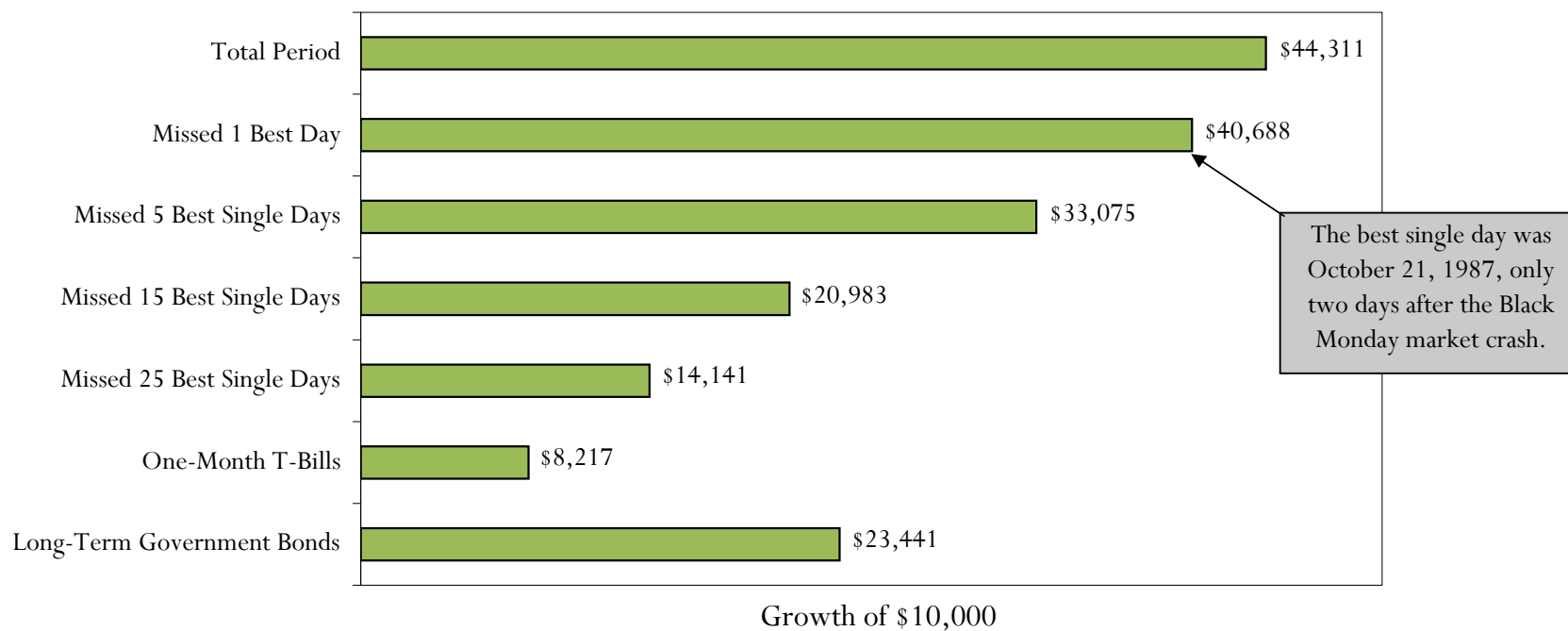
The economy will continue to ebb and flow. Although it could take awhile for the economy to get back to the growth rate we expect, we have confidence that it will grow again. The U.S. is a dynamic and innovative country and economy. The best way to move forward is to look at the decision making from the recent speculative era and try to avoid future mistakes. The current situation is a startling demonstration of risk being misunderstood or ignored. Even boring bonds have risk. That's why we diversify.

Regards,  
Brian J Lawrence, CFA

# THE RISK OF MARKET TIMING

## Performance of the S&P 500 Index

January 1970 - December 2005 (9,122 Total Days)

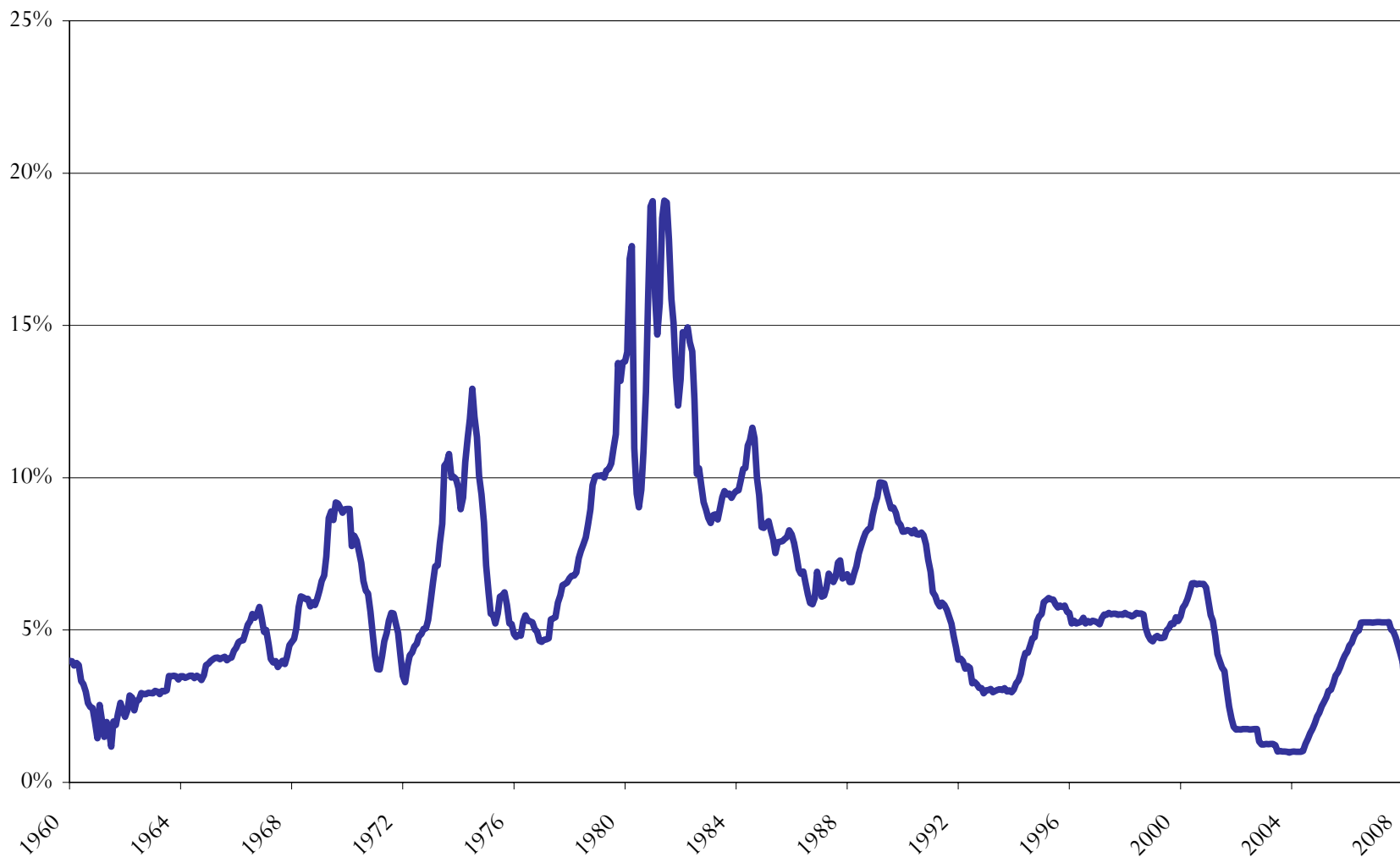


- \* The best one-month return, October 1974, happened immediately after the worst one-year period.
- \* The occurrence of strong positive returns has been especially unpredictable. Investors attempting to wait out an apparent downturn ran a high risk of missing these best periods.

	<u>Total Period</u>	<u>Missed 1 Best Day</u>	<u>Missed 5 Best Single Days</u>	<u>Missed 15 Best Single Days</u>	<u>Missed 25 Best Single Days</u>	<u>One-Month T-Bills</u>	<u>Long-Term Gov't Bonds</u>
Annualized Compound Return	11.1%	10.8%	10.2%	8.8%	7.6%	6.0%	9.2%
% Differential to Total Period	0.0%	-0.3%	-0.9%	-2.3%	-3.5%	-5.1%	-2.0%

## FEDERAL FUNDS RATE: JANUARY 1960 - DECEMBER 2007

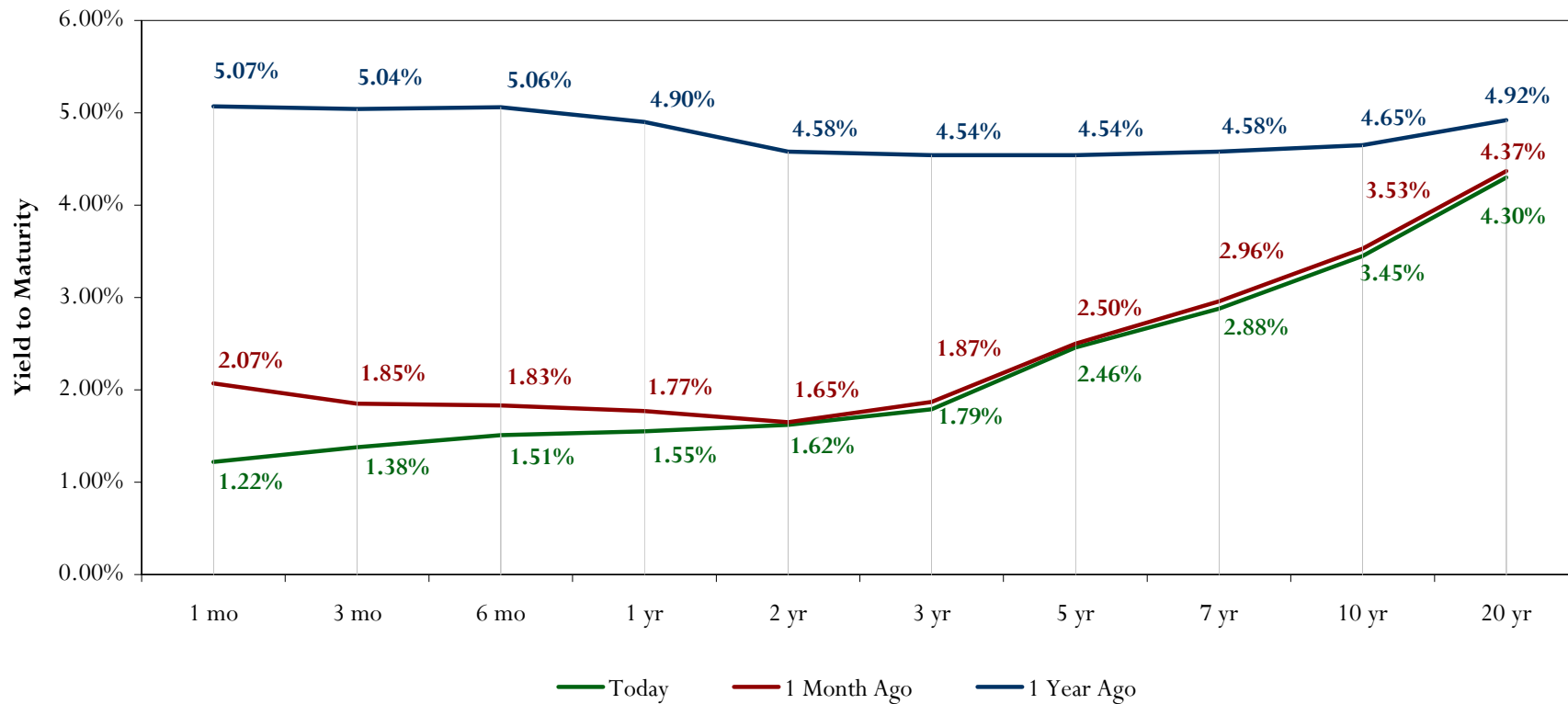
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The Federal Funds Rate is the interest rate on overnight loans between banks as set by the Federal Reserve. Also, the Federal Funds Rate serves as a benchmark for interest rates that banks charge to businesses and individuals.

# TREASURY YIELD CURVES

	<u>1 mo</u>	<u>3 mo</u>	<u>6 mo</u>	<u>1 yr</u>	<u>2 yr</u>	<u>3 yr</u>	<u>5 yr</u>	<u>7 yr</u>	<u>10 yr</u>	<u>20 yr</u>
<i>March 31, 2008</i>	1.22%	1.38%	1.51%	1.55%	1.62%	1.79%	2.46%	2.88%	3.45%	4.30%
<i>February 29, 2008</i>	2.07%	1.85%	1.83%	1.77%	1.65%	1.87%	2.50%	2.96%	3.53%	4.37%
<i>March 30, 2007</i>	5.07%	5.04%	5.06%	4.90%	4.58%	4.54%	4.54%	4.58%	4.65%	4.92%



Treasury debt (bills, notes, and bonds) are issued by the US Treasury and are considered the safest investment security. The yield to maturity at each time interval represents what an investor would earn if a treasury debt was purchased with a corresponding maturity period. The shape of the yield curve changes over time, representing investors' views on prospective economic growth, inflation, and risk tolerance.

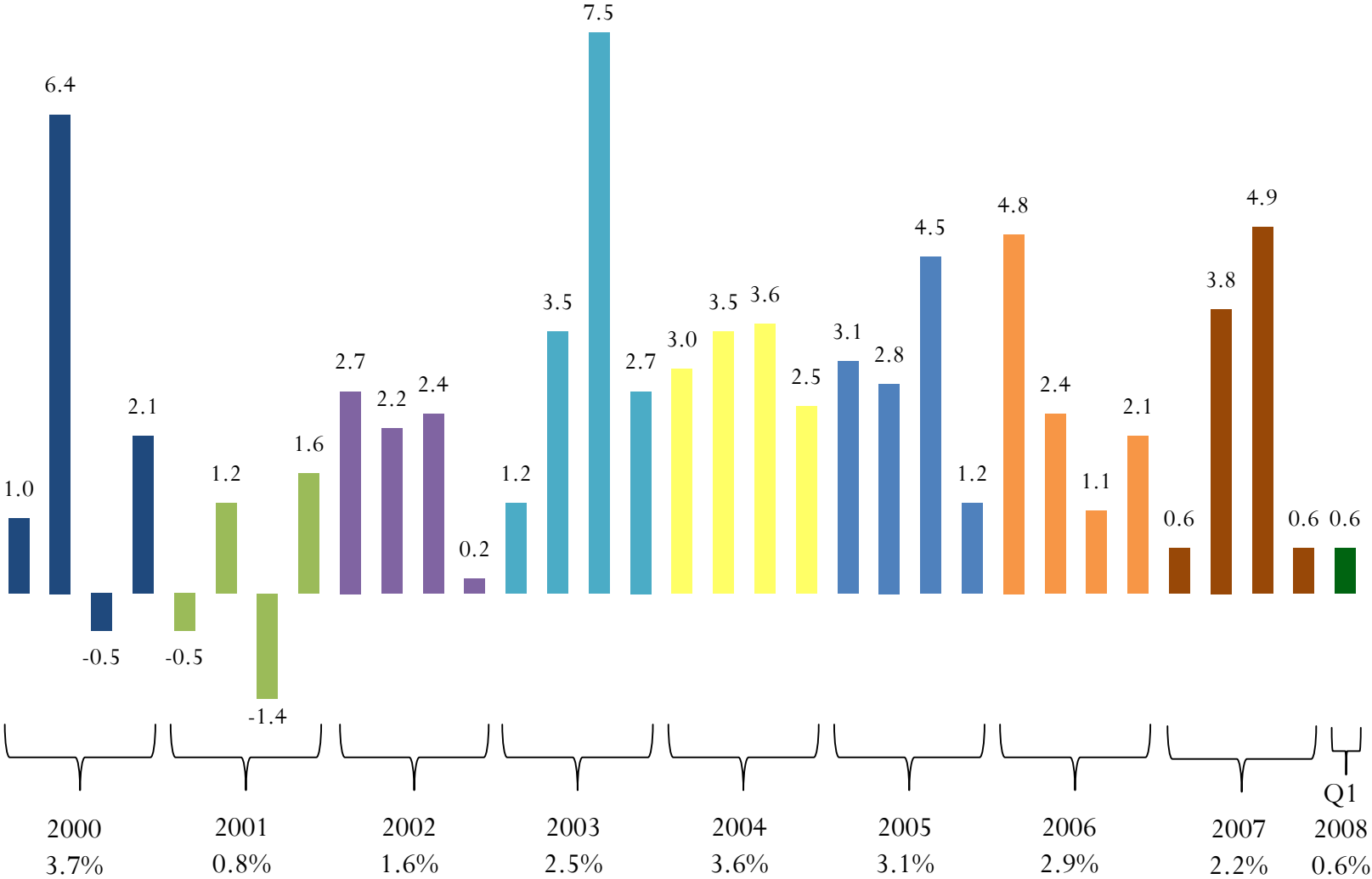
## CAPITAL MARKET HISTORY: OVER 10 YEARS OF RETURNS BY ASSET CLASS

These are Annual Returns

<u>Year</u>	<u>Inflation</u>	<u>Money Market</u>	<u>Large Co. Stocks</u>	<u>Small Co. Stocks</u>	<u>International Stocks</u>	<u>Emerging Markets</u>	<u>Total Bond Market</u>	<u>Foreign Bonds</u>	<u>TIPS</u>	<u>REIT</u>	<u>Home Prices</u>
3/31/2008	4.0	0.7	-9.4	-9.9	-8.9	-11.3	2.2	10.9	5.2	1.4	-3.9 <sup>1</sup>
2007	3.8	5.2	5.5	-1.6	11.2	36.5	7.0	11.5	11.6	-15.7	-9.1
2006	2.6	5.1	15.8	18.4	26.3	29.2	4.3	6.9	0.4	36.1	0.7
2005	3.4	3.3	4.9	4.6	13.5	30.3	2.4	-9.2	2.8	14.0	15.5
2004	3.3	1.4	10.9	18.3	20.3	22.5	4.3	12.1	8.5	3.1	16.2
2003	1.9	1.1	28.7	47.3	38.6	51.6	4.1	18.5	8.4	36.1	11.4
2002	2.4	1.7	-22.1	-20.5	-15.9	-8.0	10.3	22.0	16.6	3.6	12.2
2001	1.6	3.7	-11.9	2.5	-21.4	-4.7	8.4	-3.5	7.9	12.4	7.9
2000	3.4	6.3	-9.1	-3.0	-14.2	-31.9	11.6	-2.6	13.2	31.0	14.1
1999	2.7	4.9	21.0	21.3	27.0	64.1	-0.8	-5.1	2.4	-2.6	10.8
1998	1.6	5.0	28.6	-2.6	19.9	-27.7	8.7	17.8	4.0	-17.0	9.1
1997	1.7	5.3	33.4	22.4	1.8	-14.0	9.7	-4.3	---	19.7	5.4
1996	3.4	5.3	23.0	16.5	6.1	-3.9	3.6	4.1	---	37.0	1.9
1995	2.5	5.8	37.6	28.5	11.2	-6.9	18.5	19.6	---	12.2	-0.4
1994	2.6	4.5	1.3	-1.8	7.8	-8.7	-2.9	6.0	---	2.7	1.7
Average	2.6	4.2	12.0	10.7	9.4	9.2	6.4	6.7	7.6	12.3	7.0
Risk	0.7	1.7	18.1	17.1	17.4	29.6	5.4	10.5	5.2	18.1	7.3

<sup>1</sup> Home Prices through February 2008

GROSS DOMESTIC PRODUCT: QUARTERLY AND ANNUAL PERCENTAGE CHANGES (2000 - 2008)



Gross Domestic Product (GDP) is output of goods and services produced in the United States. Quarterly estimates are expressed as seasonally adjusted annual rates.

## DISCLOSURES & DEFINITIONS

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\* Statistical data is gathered from Morningstar Principia and/or the fund manager's web site. All information contained in this document is compiled from sources believed to be reliable and current.

\* Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of a portfolio.

\* As with any investment, the holder of each fund is subject to various risk factors. These factors can be explained on a fund by fund basis.

\* The performance data shown represents past performance, which is not a guarantee of future results. Current performance may be lower or higher than the data cited.

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**Large-Cap Stocks** - A U.S. large company stock index measured by the S&P 500. It is made up of a group of 500 of the most widely traded stocks in the U.S., as chosen by Standard & Poor's.

**Small-Cap Stocks**- Measured by the Russell 2000 which is the dominant small-cap index in the U.S. The index is comprised of the smallest 2000 stocks in the Russell 3000 Market Index.

**International Stocks**- 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.

**U.S. 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.

**Real Estate** - 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.