

# HEADWATER INVESTMENT CONSULTING, INC.

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## Quarterly Review & Outlook

3<sup>rd</sup> Quarter 2008

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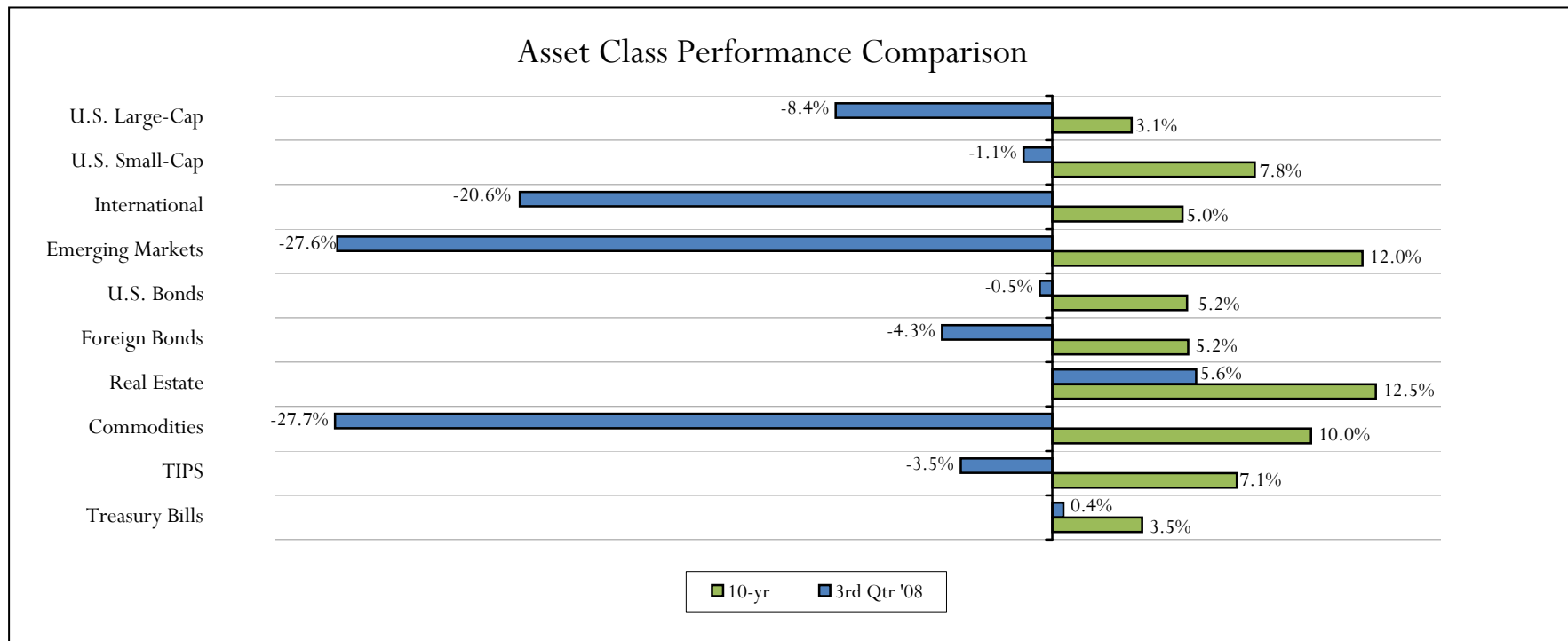
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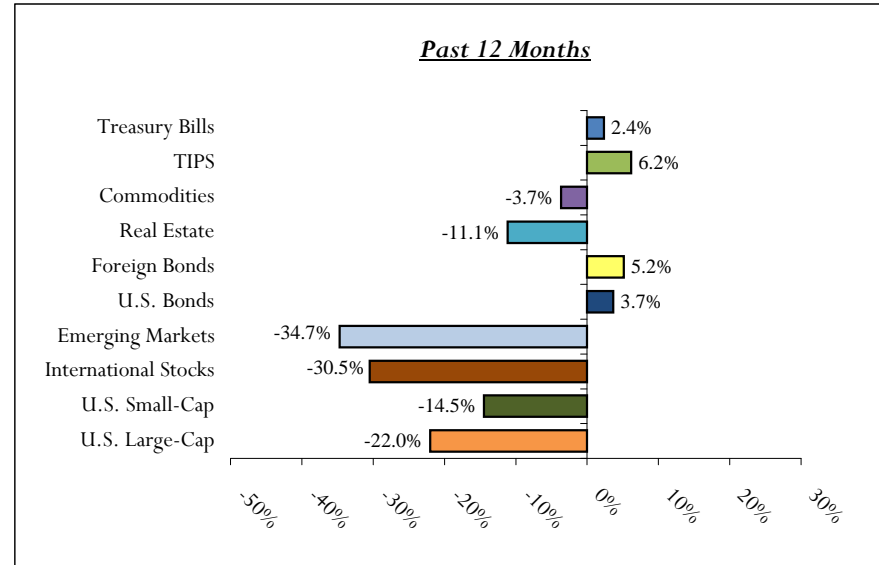
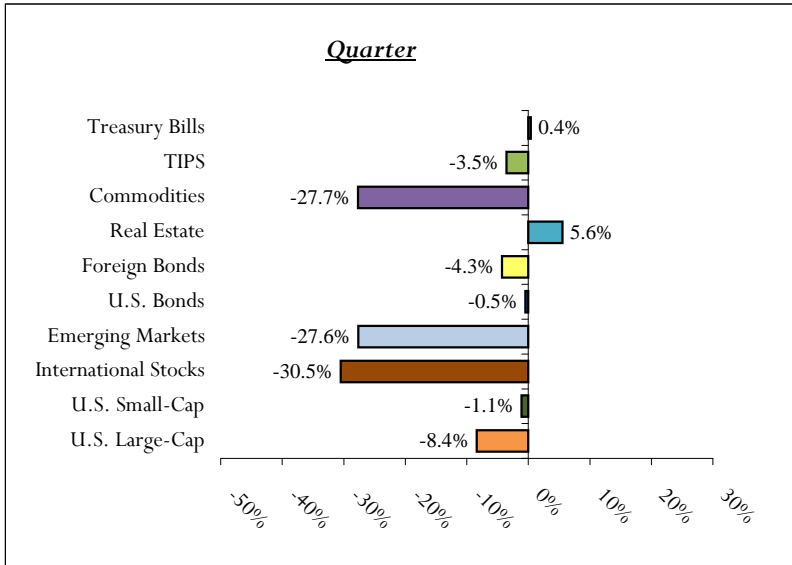
# MARKET UP-DATE

The third quarter of 2008, and into October, saw a dramatic reversal of fortune for nearly all investment categories. U.S. Large Cap stocks lost nearly 20% while their international counterparts declined almost 30% through the end of September. Commodity prices plummeted as the world economy slowed. Gains made by REITs have were erased. Foreign bonds declined as investors fled to the only safe corner of the market, Treasuries, and as a result the U.S. dollar rallied.

The current environment was difficult for anyone to make money, from the smallest investor to the largest pension or hedge fund. Rather than become disheartened, we are sticking to our philosophy and investment plans.



# ASSET CLASS PERFORMANCE



**Index Performance as of: 9/30/2008**

	<b>YTD</b>	<b>1 Mo</b>	<b>3 Mo</b>	<b>1-yr</b>	<b>3-yr</b>	<b>5-yr</b>	<b>10-yr</b>
<b>U.S. Large-Cap</b>	-19.3%	-8.9%	-8.4%	-22.0%	0.2%	5.2%	3.1%
<b>U.S. Small-Cap</b>	-10.4%	-8.0%	-1.1%	-14.5%	1.8%	8.2%	7.8%
<b>International Stocks</b>	-29.3%	-14.5%	-30.5%	-30.5%	1.1%	9.7%	5.0%
<b>Emerging Markets</b>	-36.8%	-17.7%	-27.6%	-34.7%	6.0%	15.8%	12.0%
<b>U.S. Bonds</b>	0.6%	-1.3%	-0.5%	3.7%	4.2%	3.8%	5.2%
<b>Foreign Bonds</b>	1.2%	-1.7%	-4.3%	5.2%	5.5%	5.6%	5.2%
<b>Real Estate</b>	1.8%	-0.2%	5.6%	-11.1%	5.6%	13.5%	12.5%
<b>Commodities</b>	-8.0%	-11.5%	-27.7%	-3.7%	1.9%	10.2%	10.0%
<b>TIPS</b>	1.2%	-3.8%	-3.5%	6.2%	4.3%	5.2%	7.1%
<b>Treasury Bills</b>	1.4%	0.1%	0.4%	2.4%	4.1%	3.2%	3.5%

Winston Churchill once said, “If you are going through Hell, keep going.” Right now our financial markets are making a heated and uncertain journey through unknown territory. As they struggle to function normally, we are faced each morning with dire headlines and predictions. Perspective is very difficult to have in the midst of a crisis. But that is exactly what is needed – perspective. This, along with a healthy dose of patience and a return to basic investing principals, will help investors “keep going.”

First, how did we get here? At the most basic level, financial companies and individuals borrowed too much and had too little in reserve for a rainy day. When air began to leak out of the housing market bubble and unrealistic expectations that home prices always go up rapidly proved false, all parties were caught off guard. There are many nuances to this story. However, the bottom line is this – prosperity bred complacency.

Complacency has been washed away and replaced by austerity and extreme conservatism. Banks are in the process of reducing their leverage (debt) and rebuilding that boring rainy day fund (capital reserves). Consumers nationally are starting to reduce their spending and refocus on paying down debt and saving

more. This shift occurs in every downturn, but the process is painful and is causing the financial system to freeze. The Feds are attacking the problem on various fronts to ensure basic lending, the lifeblood of our economy, keeps flowing while a more solid foundation is laid for our economy’s future.

In the meantime, investors in all markets (stocks, bonds, foreign, and domestic) are participating in an unpleasant journey through bear market territory. The danger of veering off course could not be greater, nor the consequences more severe. Let’s revisit some investment basics to help stay focused.

First of all, trying to time the markets is a losing proposition. There are reams of data to demonstrate that even seasoned pros have great difficulty buying & selling frequently to outperform a simple buy & hold approach. In fact, more fail at the task than mere chance suggests. To avoid market timing and the emotions prevalent during market declines, it is crucial to have (and follow) a written investment plan. We have one for each client. The discipline it imposes means we are buying stocks in market troughs, not at market tops.

Second, cost still matters. Low mutual fund expenses keep more money in your portfolio. Those savings are crucial when returns are scarce, and when the market

recovers the savings compound in your favor.

Next, diversification reduces risk and helps capture return. The collapse of Lehman, Bear Stearns, and Enron lead to complete loss for their shareholders. Yet mutual funds who owned those stocks were hardly affected. At the portfolio level, diversifying across many asset types allows us to capture returns without the need to forecast which market will be the next top performer.

Finally, everything has a cycle. Our economy and the markets will eventually find equilibrium and then recover. For long-term investors, potential returns today are much better than they were just a year ago. Bond yields are higher, stock valuations are lower.

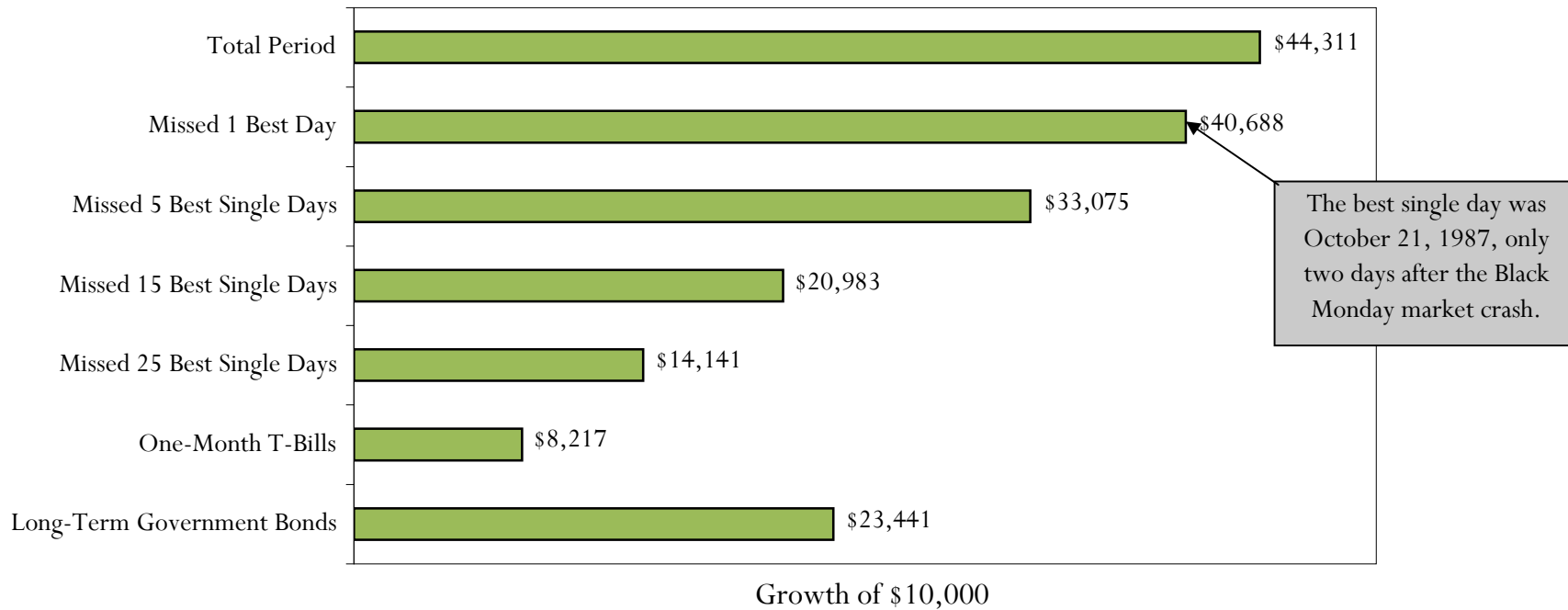
We are quite likely in for more of a tumultuous journey. Time is needed to heal the wounds to our global economy. However, patient and calm investors who “keep going” will be rewarded.

Regards,  
Brian Lawrence

# THE RISK OF MARKET TIMING

## Performance of the S&P 500 Index

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

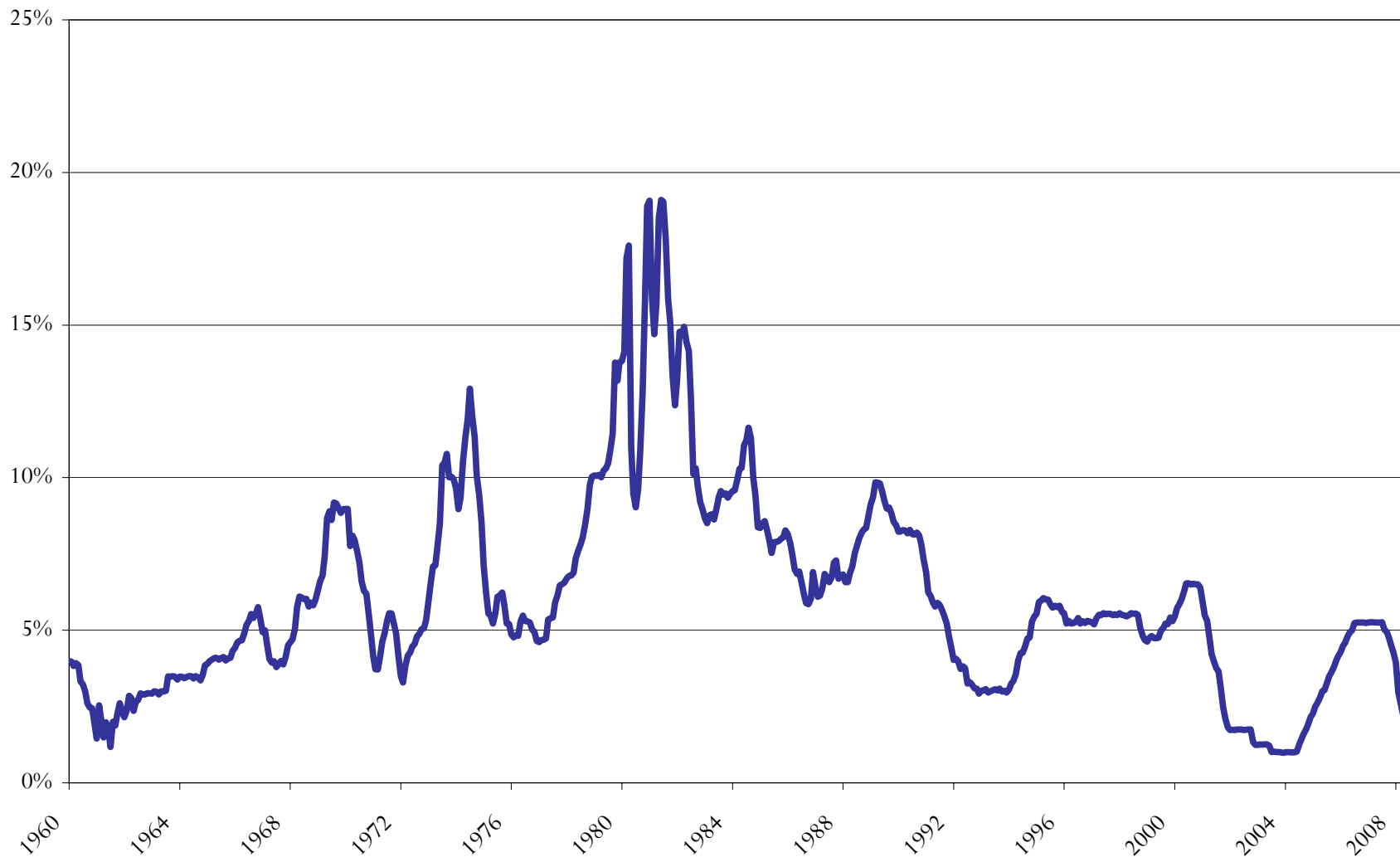


- \* The best one-month return, October 1974, happened immediately after the worst one-year period.
- \* The occurrence of strong positive returns has been especially unpredictable. Investors attempting to wait out an apparent downturn ran a high risk of missing these best periods.

	Total Period	Missed 1 Best Day	Missed 5 Best Single Days	Missed 15 Best Single Days	Missed 25 Best Single Days	One-Month T-Bills	Long-Term Gov't Bonds
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 - SEPTEMBER 2008

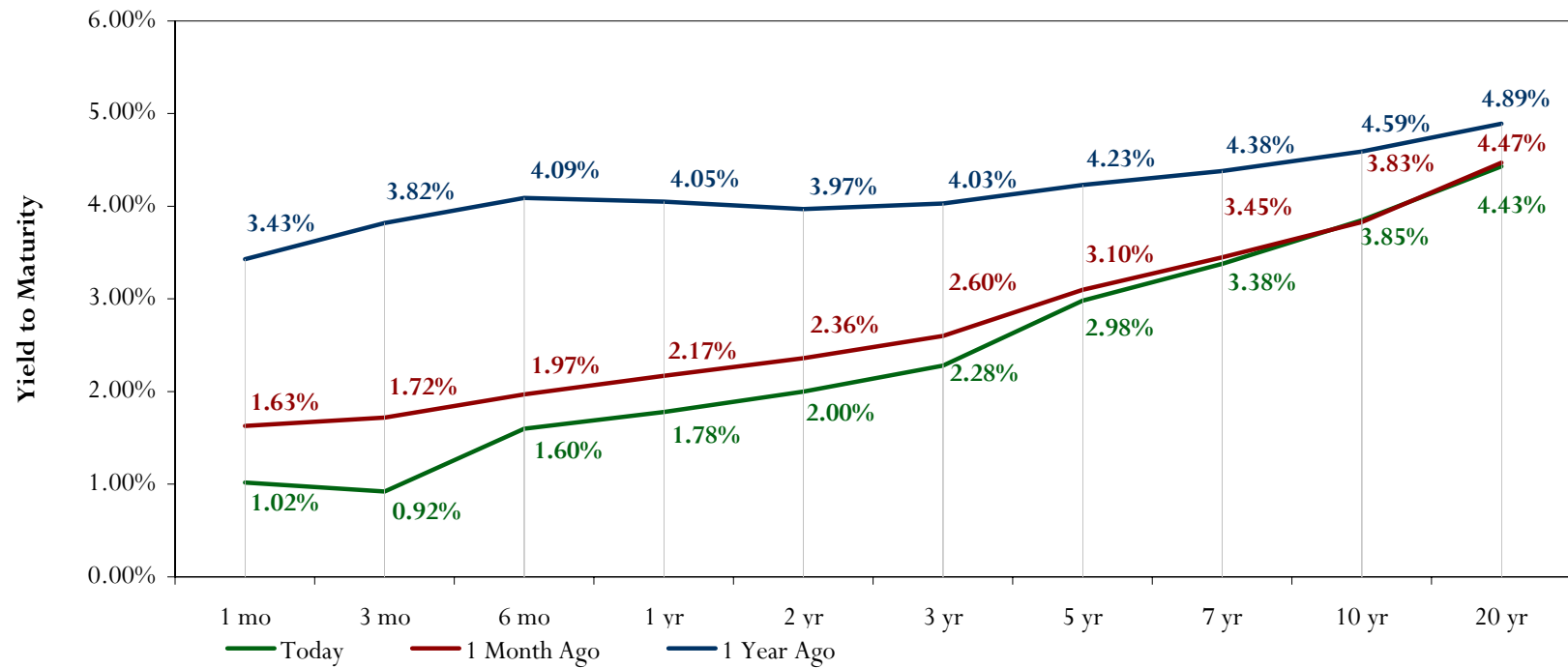
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The Federal Funds Rate is the interest rate on overnight loans between banks as set by the Federal Reserve. Also, the Federal Funds Rate serves as a benchmark for interest rates that banks charge to businesses and individuals.

## 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>September 30, 2008</i>	1.02%	0.92%	1.60%	1.78%	2.00%	2.28%	2.98%	3.38%	3.85%	4.43%
<i>August 29, 2008</i>	1.63%	1.72%	1.97%	2.17%	2.36%	2.60%	3.10%	3.45%	3.83%	4.47%
<i>September 28, 2007</i>	3.43%	3.82%	4.09%	4.05%	3.97%	4.03%	4.23%	4.38%	4.59%	4.89%



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.

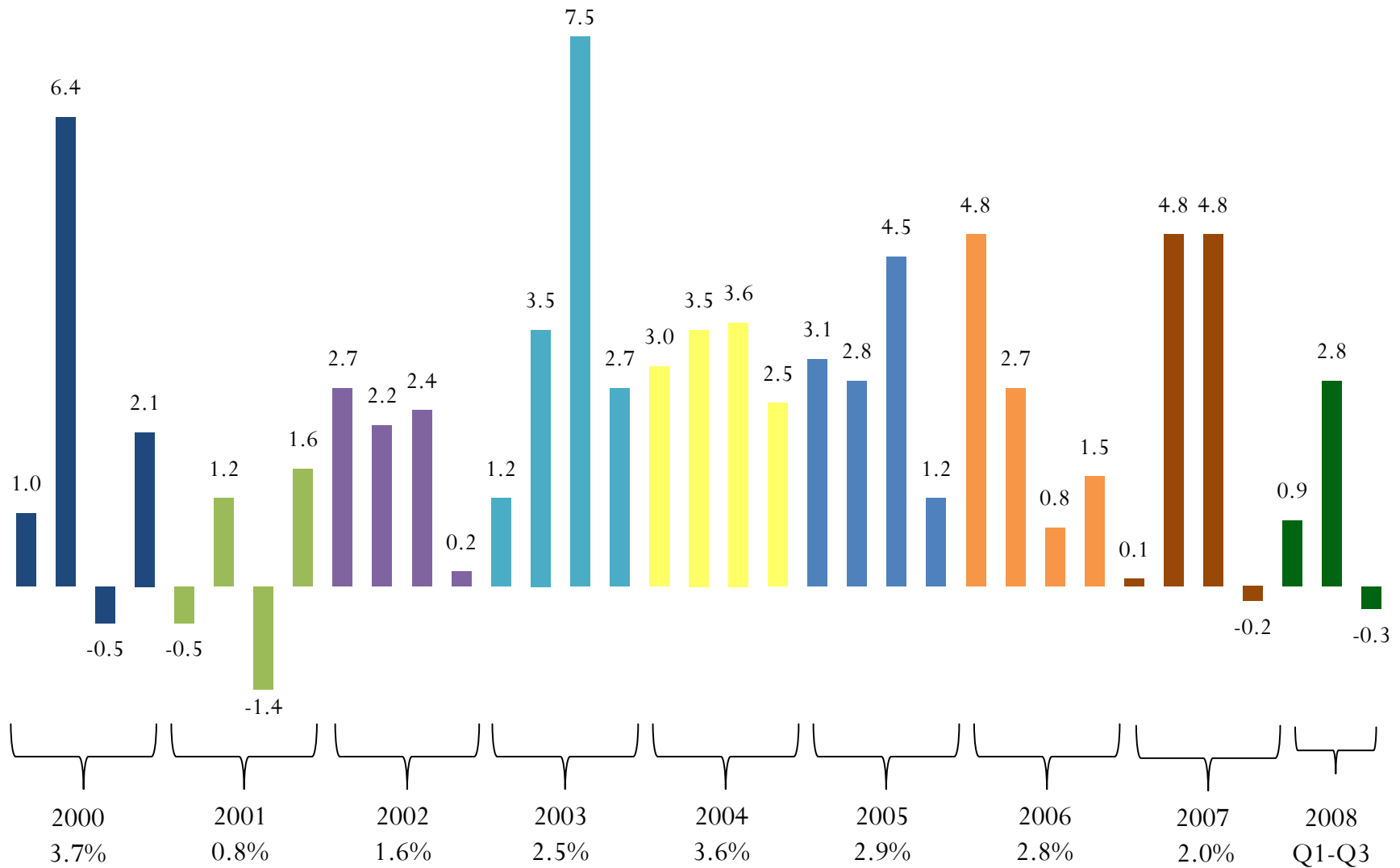
# CAPITAL MARKET HISTORY: OVER 10 YEARS OF RETURNS BY ASSET CLASS

Year	Inflation	Money Market	Large Co. Stocks	Small Co. Stocks	Int'l Stocks	Emerging Markets	US Bond Market	Foreign Bonds	TIPS	REIT	Home Prices <sup>1</sup>	Commodities
9/30/2008	3.4	1.4	-19.3	-10.4	-29.3	-36.8	0.6	1.2	1.2	1.8	-15.3	-8.0
2007	4.1	4.8	5.5	-1.6	11.2	36.5	7.0	11.5	11.6	-17.6	-9.1	16.2
2006	2.6	5.1	15.8	18.4	26.3	29.2	4.3	6.9	0.4	36.1	0.7	2.1
2005	3.4	3.3	4.9	4.6	13.5	30.3	2.4	-9.2	2.8	14.0	15.5	21.4
2004	3.3	1.4	10.9	18.3	20.3	22.5	4.3	12.1	8.5	3.1	16.2	9.2
2003	1.9	1.1	28.7	47.3	38.6	51.6	4.1	18.5	8.4	36.1	11.4	24.0
2002	2.4	1.7	-22.1	-20.5	-15.9	-8.0	10.3	22.0	16.6	3.6	12.2	26.0
2001	1.6	3.7	-11.9	2.5	-21.4	-4.7	8.4	-3.5	7.9	12.4	7.9	-19.5
2000	3.4	6.3	-9.1	-3.0	-14.2	-31.9	11.6	-2.6	13.2	31.0	14.1	31.8
1999	2.7	4.9	21.0	21.3	27.0	64.1	-0.8	-5.1	2.4	-2.6	10.8	24.4
1998	1.6	5.0	28.6	-2.6	19.9	-27.7	8.7	17.8	4.0	-17.0	9.1	-27.0
1997	1.7	5.3	33.4	22.4	1.8	-14.0	9.7	-4.3	---	19.7	5.4	-3.4
1996	3.4	5.3	23.0	16.5	6.1	-3.9	3.6	4.1	---	37.0	1.9	23.2
1995	2.5	5.8	37.6	28.5	11.2	-6.9	18.5	19.6	---	12.2	-0.4	15.2
1994	2.6	4.5	1.3	-1.8	7.8	-8.7	-2.9	6.0	---	2.7	1.7	16.6
Average	2.7	4.1	12.0	10.7	9.4	9.2	6.4	6.7	7.6	12.2	7.0	11.4
Risk	0.8	1.7	18.1	17.1	17.4	29.6	5.4	10.5	5.2	18.3	7.3	17.5

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

These are Annual Returns

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



Gross Domestic Product (GDP) is the 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.