INVESTMENT PERSPECTIVES
QUARTERLY UPDATE – JANUARY 1, 2009

BROWN ADVISORY

OUT WITH THE OLD…

It's probably safe to say that almost everyone in the investment world (not to mention the many who have departed it) is absolutely delighted that 2008 is now officially over. As investors are painfully aware, the year ranks among the worst ever in terms of the percentage decline in stocks, commodities, real estate, and various other asset classes. Virtually nothing worked.

Moreover, there's no consensus regarding the outlook, no agreement on how the nation and the world will get out of this mess. On the one hand are the pessimists who believe that the current recession will morph into a deep and lasting depression, while on the other are the more optimistic observers, who think the economy may be bottoming soon. The unusually wide gap between these views means that the level of uncertainty in the markets is extraordinarily high. When people feel like they really don't know what the future holds, their perception of risk rises, and, with it, the risk premium attached to various securities and asset classes.

What We Know

In such times, rather than agonizing over all the things we *don't* know, it's more productive to focus on what we *do* know, as a starting point for charting an intelligent course. This is particularly true with regard to investing. We've constructed a list that may be helpful in framing possible options:

- *Asset prices are way down*—to state the obvious. The table below summarizes the decline in several leading indices from their respective peaks in late 2007 and from the beginning of 2008 through the time we went to press just before the holiday.

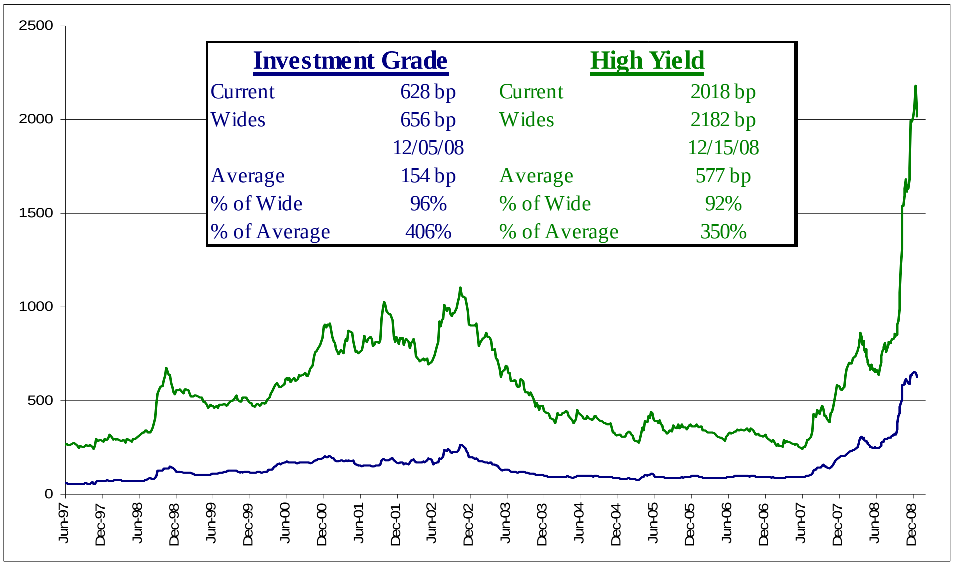
Asset Class	Index	% Change 2008 Through Dec. 22	% Change Peak Through Dec. 22	Date of Peak
Large-cap Growth Stocks	Russell 1000 Growth	-41.37%	-43.87%	10/31/2007
Large-cap Value Stocks	Russell 1000 Value	-41.27%	-47.18%	06/04/2007
Small-cap Value Stocks	Russell 2000 Value	-34.22%	-45.40%	06/04/2007
Small-cap Growth Stocks	Russell 2000 Growth	-41.72%	-46.08%	10/10/2007
International Stocks	MSCI EAFE	-44.59%	-47.61%	10/31/2007
Real Estate Investment Trusts	NAREIT Composite	-44.15%	-60.86%	02/07/2007
Short/Intermediate Bonds	Barclays Capital US Aggregate - Intermediate	-0.11%	-2.21%	01/23/2008
Emerging Markets	MSCI EM	-53.21%	-56.38%	10/29/2007
High Yield Bonds	Barclays Capital High Yield*	-28.28%	-33.72%	02/26/2007
Investment Grade Corporate Bonds	Barclays Capital Security Corporate Bond	-15.95%	-19.88%	02/27/2007
U.S. Treasury Bills	Barclays Capital US Treasury - Bills (1-3 mo.)	0.50%	-0.01%	12/19/2008

*B3+/B-or better ratings

- *Diversification failed to help.* So-called Modern Portfolio Theory (a fancy term for diversification) proved to be of minimal help at a time when virtually every asset class collapsed. Or, as the statisticians would put it, the correlation among asset classes was high. This was particularly true in equities, as international stocks declined about as much as domestic ones, and large stocks sold off about like small ones, etc. Interestingly, only ten stocks in the Standard & Poor's 500 were up for the year at the November market lows, and most of those were special situations (takeovers, etc.). Even bonds weren't spared, as high yield securities and even relatively safe corporates and municipals have been hit hard. The only way to protect portfolios was to go to cash or Treasuries, and we've seen that the demand for Treasuries has been so great that short-term yields have occasionally turned negative—that is, investors have in effect paid the government for the safety that its full faith and credit backing provides.

- *Risk premiums remain extraordinarily high.* Depressed valuations for both stocks and bonds reflect investors' reluctance to take on risk, or, in other words, their need for very high potential returns to offset the risk of owning securities of almost any kind. A good example is the relationship between investment-grade bonds and Treasury securities of the same maturity. High-grade corporates typically trade with yields about 150 basis points above Treasuries of comparable maturity, but now that spread has "blown out" to 600 basis points. High yield or "junk" bonds are trading at yields over 20%, about *2000 basis points* above Treasuries. Similarly, reflecting the turmoil in real estate, the dividend yield on the NAREIT index of real estate investment trusts has moved from a slight discount to the ten-year Treasury bond to close to three times the Treasury yield—an unprecedented level.

Bond Yield Spreads, 1997 - Present



Source: Merrill Lynch

- *It's impossible to call the bottom.* In every market cycle, one or two prognosticators gains his or her 15 minutes of fame for calling the turn correctly. With hundreds of people offering their views for public consumption on a regular basis, the odds favor someone actually getting it right once in awhile. (Remember Elaine Garzarelli's prediction of the market's collapse just prior to the 1987 crash? We haven't heard much about her since.) Don't be fooled: timing the market is a very low-percentage game. As studies have clearly demonstrated, long-term equity returns are dramatically affected by the largest percentage moves that occur on just a few days, so missing those days imposes a severe penalty.

- *Cash isn't providing a return.* With the flight to quality and investors' desire for protection, money market funds now yield next to nothing. Even in normal times, short-term Treasuries and other similar securities produce returns only slightly more than inflation, so they should be seen simply as defense mechanisms or sources of liquidity. This is not to minimize the importance of cash, since defense and liquidity are valid and essential purposes, but it doesn't add meaningfully to real returns. In a rising market—and let's remember that the markets do tend to rise over time—holding cash involves an opportunity cost.

- *What we know from history.* History can tell us a lot, although when it repeats itself in the markets it does so with different wrinkles. Here are some interesting observations that help shape our thinking:

    - In the ten years ended last October, the S&P 500 produced a total return of 0.4% per year—one of the 15 worst rolling ten-year periods since 1900 and ranking in roughly the bottom 1% of all such periods, according to data from Cambridge Associates. Taking the 25 worst ten-year timeframes (with average returns ranging from -3.9% to +2.9%), the *subsequent* ten years produced an average annual return of 11.5%, and the lowest of those returns was 6.7% (the highest was 15.4%).

    - *Adjusted for inflation*, the ten years ended October witnessed an average annual *decline* of roughly 2.5% in the S&P 500—again, one of the most negative periods on record since 1900. Using the sample of the 25 worst ten-year timeframes in real returns (different from the worst periods of nominal returns), the subsequent ten years saw an average annual gain of 12.2% (in real terms), with the high and low figures at 5.8% and 19.3%.

    - Comparisons to the decline in stocks during the Depression are certainly in the news today, and perhaps they are apt (we won't know for sure for a couple of years). For those who worry that the market today is similar to 1929, however, it's important to keep in mind that equity returns averaged 19.2% in *real* terms during the ten-year period leading up to the Crash, compared to only 0.1% in the ten years *prior* to the October 2008 break. A good deal of excess has already been wrung out of the market.

The lesson here is that long periods of sub-par returns in the stock market are inevitably followed by similarly lengthy periods of robust returns. It's easy to lose sight of this common-sense conclusion when portfolios are losing money and investors are worried about the near-term outlook and protection against further losses. Nonetheless, we think clients need to keep the longer perspective in mind.

- *Earnings matter, but only in the long term.* A great deal has been written about the outlook for corporate profits in 2009 and what it may mean for stocks. Many observers try to calculate the market's "fair value" by placing a P/E ratio on those earnings. An earnings estimate for the index of, say, $60 per share, means that the S&P is selling around 15x, or roughly in line with historical averages. The argument might follow that the P/E, and thus the market, should be lower because today's outlook is so murky, etc. In addition, many are fearful of buying stocks because they can't predict how much lower earnings will be in 2009 than 2008. In this respect, two facts, based on history, should be kept in mind. First, studies show that there is virtually no correlation between year-over-year changes in earnings and year-over-year changes in stock prices. It's only *long*-term, "normalized" earnings growth that affects stocks. A second and related point is that stock valuations reflect the discounted present value of a *stream* of future earnings or cash flows. The market's substantial decline thus appears to predict that earnings will remain very depressed for a period of many years—a remote possibility, in our view.

- *Governments and central banks are taking action.* Stimulus packages, rescue plans and bailouts may be misguided in the view of some, but there can be little question that they are being applied *en masse* around the world. The Federal Reserve's balance sheet has tripled in size over the last year as it has taken a variety of measures to keep key financial (and a few non-financial) institutions alive and to encourage the extension of credit. In most cases, these efforts will take time to bear fruit.

Questions

If what we know fills about two pages, what we don't know would fill several volumes! And perhaps that's the problem with the market: investors are focusing on the unknown. Four items strike us as especially significant.

- *How effective will the government's response be?* At this point, it's too early to tell whether the Federal Reserve's and Treasury's programs will be effective or how long they will take to have impact. The tax rebate of last summer clearly had only a temporary effect, as the economy has worsened since then. At this point, about half the T.A.R.P. money has been invested, helping a number of financial institutions to reduce their leverage, but to date it has had little impact on their propensity to lend. Credit spreads are still historically wide, and both consumers and businesses are finding it challenging to borrow. The next phase of stimulus, probably involving tax relief for the middle class and a massive infrastructure rebuild, will have to await the new administration.

- *How long will balance sheets take to be rebuilt?* Beginning with the financial sector, which had reached a particularly excessive degree of leverage at the peak of the last cycle, the process of rebuilding balance sheets has begun. Consumers, too, have started to pay down credit card debt and refinance their mortgages where possible. In addition to the various federal programs designed to inject equity into the financial sector, the key to the rebuilding process is incremental savings. The "shift to thrift" would add a stable deposit base to banks and other institutions and reduce the leverage that so many families managed to achieve in their desire to maintain or improve their lifestyle. The challenge is that every dollar of incremental savings is a dollar of decreased spending, thus detracting from the trajectory of the potential recovery. It will be interesting to see whether the rise in savings turns out to be merely cyclical or part of a longer-term re-ordering of national priorities. For the health of the nation, we hope it's the latter, although it would mean a slower and more protracted rebound.

- *How long will the economy remain depressed?* From all reports, economic activity is still declining at a significant rate. In its message following the decision to lower the federal funds rate aggressively from 1% to a range of 0-.25%, the Federal Open Market Committee cited deteriorating consumer spending, business investment and industrial production and stated that the outlook had weakened in recent weeks. Unemployment could easily move up another two to four points from its current level of 6.7%. According to the National Bureau of Economic Research, the U.S. has been in a recession for a year now. In this context, it's useful to keep in mind that the average length of post-World War II recessions has been about a year, with the longest running 16 months. Before long, we'll be in record territory from the perspective of length as well as depth.

- *Will regulation kill the American propensity for risk-taking?* The demise of several leading financial institutions in 2008 is bound to precipitate a new wave of regulatory oversight and a tighter rein on leverage, risk-taking, and ultimately profitability. Morgan Stanley, for example, has indicated that its already lower leverage will result in a three- or four-point drop in its return on equity. The collapse of a number of hedge funds, together with the arrest of Bernie Madoff for fraud on an unprecedented scale, will no doubt trigger calls for greater transparency in reporting and financial statements. The natural resilience of U.S. institutions that has helped lead us out of past recessions may be restrained by regulation this time around.

Opportunity

Taking a long-term view, we see significant opportunity in both stocks and bonds. As mentioned earlier, risk premiums are now at historically high levels in the bond markets, and equity valuations, while not at extreme lows, appear to discount an extended period of depressed profits. Alternative assets, too, offer patient investors considerable upside potential. Real estate values have fallen considerably, and private equity investors are finding attractive entry points for deals because of the collapse of public market comparables. The current dearth of liquidity opportunities from these funds will eventually change. In short, *risk assets in general are cheap today and non-risk assets (cash, Treasuries, etc.) are dear.*

The challenge is to align one's overall portfolio so that risk levels are in proportion to the return potential. In an environment of compressed valuations, daily price swings are relatively large in percentage terms and can have an out-sized effect on portfolio returns in the short run. Maintaining more cash or short-term, quality bonds can mitigate these fluctuations, as can certain hedging techniques.

In this sense, one of the more attractive opportunities we see in today's market is investment grade corporate bonds. With yield spreads at historically high levels, one can buy quality corporates at a yield to maturity in the range of 6-9%, depending on the bond. If spreads narrow as we expect with the eventual thawing of the credit markets, returns would exceed that level over the next couple of years. Moreover, with proper research to identify issuers with strong business models, balance sheets, and cash flow, we believe the risk of default will be negligible. Thus, equity-like returns can be generated with significant downside protection. Of course, stocks would be expected to perform better still if and as credit conditions improve, but they carry lower yields and a considerably higher level of risk in terms of price volatility. Creating the right balance among asset classes like these is a decision that has to be made in light of each client's circumstances and risk tolerance.

Changing Plans

Radical change in the financial markets over the last few months has caused a large number of investors to re-assess their overall financial plans as well as their appetite for risk. Many baby boomers who looked forward confidently to retiring in the next few years now plan to continue working in order to allow more time for their nest eggs to recover. Others, who have stopped working and were counting on a portfolio of a certain size to fund their living costs and other objectives, are faced with smaller asset pools and considering how to re-build them in an environment they perceive as exceedingly treacherous. Is it better to stay with an 80/20 stock/bond mix on the premise that stocks have bottomed, or move to a more conservative 60/40 or 50/50 ratio that will entail more time for the portfolio to recover? How do changes in mix affect one's cash flow? How much of the "draw" from the portfolio should be funded by its income vs. principal? How much should be allocated to cash and bonds in order to: 1) fund short-term living expenses and 2) allow you to sleep comfortably? The answers to these questions vary considerably from client to client, but they have never in our lifetimes been more important. We think the next couple of years will offer a good opportunity to re-build portfolios, and we look forward to continuing our dialogue with each of you toward that end in the New Year.

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