

MARKET UPDATE

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CURRENT MARKET REQUIRES BALANCING ACT

The stock market decline thus far in 2008 has made the positive returns achieved in most asset classes in 2007 seem like a distant memory. The S&P was up 5.5% in 2007, and international stock markets were even stronger; EAFE was up over 11% and emerging markets were up almost 40%. Bond markets also produced positive returns with the Lehman Aggregate Government Credit up 7.3% and the Lehman Global Aggregate up 10.5%.

Though Investors had decent returns in 2007, stocks peaked in October and the S&P 500 has since corrected over 15%.

2007 also marked the end of the sub-prime mortgage market. Initially, many felt that this collapse would be limited to a small part of the economy. However, it quickly

became apparent that the bursting of this credit bubble had broad and global economic ramifications. Many clients have been asking if this will lead the economy into a deep recession or just an economic slowdown. While the months ahead will offer greater clarity, what is now clear is that global economic growth is slowing and central banks around the world are aggressively working to stabilize financial systems.

Credit crisis outlook

Since the start of this credit crunch last summer, banks and other financial institutions have taken combined write-offs in excess of \$100 billion and most believe that this number could end up being at least twice this figure. It is not that the banks are hiding additional

losses, as they likely now want to be more transparent, but they can only write-off what they know, and the landscape continues to evolve rapidly. Clues as to whether banks are finished taking charges lie less within their current loan portfolio and more within the future housing market. Until we start to see declines in both the inventory of unsold homes and mortgage delinquencies, we cannot assume that we have seen the end of this crisis.

Beyond the mortgage market problems, we have concerns of how far this crisis will affect consumer credit and spending. Homeowners are not only facing the negative wealth effect of declining home prices, lower mortgage equity withdrawals, and higher resetting mortgage rates, but also higher energy and food bills. With relatively fixed

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WEB 2.0

The internet is dramatically changing the way people interact and the way businesses operate. Netcraft, a URL tracking service announced that there were 155 million websites this December, a 50% increase from the prior year, with over 6 million new sites during the month of December alone. This growth is being driven by Web 2.0.

Web 2.0 was first coined at a media industry conference in 2005 to describe the business revolution in the computer industry caused by the move to the internet as a platform. It is a knowledge-oriented environment where human interactions generate content that is pub-

lished, managed and used through network applications rather than by traditional "command and control" information distribution. Web 1.0 was characterized with "clicks & eyeballs", and sites like Amazon, Expedia, and Doubleclick ruled the land. With Web 2.0, the focus is on collaboration, and the network effect, and sites like Youtube, Craigslist, Wikipedia, and Myspace are the pioneers. The proliferation of blogs, wikis, and social networking sites are examples of this type of application. Wired Magazine recently stated that "9 blogs are created every minute and 2.3 con-

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CURRENT MARKET . . . (CONTINUED)

budgets, and higher inflation, consumers will continue to be strained and both they and those dependent on consumer spending growth will remain vulnerable.

We continue to believe that a well-diversified, globally positioned portfolio will enable investors to take advantage of growth opportunities throughout the world while mitigating the risk of overexposure to any one economy or asset class. Our goal has been to own non-correlating asset classes that will enhance portfolio appreciation over time while ensuring capital preservation during difficult investment environments, such as the one we are in today. Our historical returns from this approach have been strong and while our clients are not immune

“Our goal has been to own non-correlating asset classes that will allow for portfolio appreciation over time...”

from market corrections, we are pleased that they are exposed to asset classes and individual investments that continue to appreciate during this volatility.

Limitations & opportunities

Bonds and other fixed income securities should always play some role in an investment portfolio. However, we are sensitive to current conditions that limit total return opportunities given the level of today’s yields. The Federal Reserve has been aggressively reducing short-term interest rates to provide liquidity to the markets and are likely to continue to lower the Fed Funds rate.

With CPI running at 4.25%, we are in the unusual situation of

negative “real” yields, indicating that current bond investments are not keeping pace with inflation. While we have seen significant widening of credit spreads in the high yield corporate market (the yield that lower quality companies must pay above the current treasury yield), we remain cautious that investors are not being compensated for risks and likely rising defaults. Certain fixed income investments do seem to offer relative opportunity. For example, tax-exempt municipal bonds along many points of the yield curve are actually providing higher yields than taxable bonds. Likewise, international bonds remain attractive given higher global interest rates and the depreciating dollar.

With bond yields trailing infla-

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WEB 2.0 . . . (CONTINUED)

tent updates are posted every second" on the world wide web.

Blogs and Wikis are websites that allow readers to interactively contribute to the content of the site. Wikipedia, is an audience maintained site that allows users to add or edit content to its encyclopedia.

Wiki networks can be used publicly or privately to share information that is important to the community. The success or failure of a wiki is dependant on trust, participation, and the quantity of users.

Networking trends

Social media is fast becoming one of the biggest trends of the Web 2.0 wave and contrary to how most people view social network-

ing, it goes way beyond your teenager’s Facebook site. Many adults are using these web communities to meet new people,

explore a new hobby, or network among professional peers. Social media sites can also help audience members keep their fingers on the pulse of im-

portant consumer and business trends. Users of social media sites (i.e. digg.com and del.icio.us.com) vote to signify which stories or ideas are gaining importance. These sites employ algorithms that, with permission, track preferences and interests, in order to best understand their audience. Websites like Pandora.com track their members’ music listening

preferences to custom tailor music. These tools can be a vastly powerful resource for marketing products or services.

Many Fortune 500 CEO's maintain blogs, providing an alternative source of PR and a channel for management to communicate with investors, customers and other constituents. Both hotelier Bill Marriott and Sun Microsystems’ chief, Jonathan Schwartz are frequent posters on their respective blogs. Organizations are finding that by opening these channels of communication they create more intimate and productive relationships with stakeholders. Companies that embrace an open source philosophy can inform, empower and align consumers, suppliers and employees more effectively.

**Crestwood Advisors’
Philanthropic Commitment**



“They have the will. They have the creativity. But they lack the means. We give them the means.” - Lenny Zakim.

The mission of the Lenny Zakim Fund is to identify, support & connect grassroots community organizations operating "below the radar screen" of large charitable groups & government grants. The Lenny Zakim Fund provides assistance to those demonstrating the will & potential to make a difference, but lacking necessary resources. The Lenny Zakim Fund is especially interested in supporting groups involved in constructive coalition building across race, religious and ethnic lines.

For further information we encourage you to visit www.thelennyzakimfund.org.

Really Simple Syndication (RSS) has changed the way we consume internet data. In the past, internet users had to go to websites to get updates; now the changes can come through RSS feeds, allowing a more efficient means of parsing vast amounts of information.

In a web 2.0 world, business models that were once impermeable have now become much more open. Traditionally, successful companies have maintained competitive advantage by having unmatched intellectual property, scale, or customer relationships. Web 2.0 is challenging this, and forcing companies to become more nimble. The lines between producers and consumers are increasingly becoming blurred. Many for-

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CURRENT MARKET . . . (CONTINUED)

tion, it is necessary to ensure that our client portfolios have exposure to asset classes that can grow in inflationary environments. Historically, these asset classes have included equities, real estate and commodities.

As for equities, the daily volatility we are experiencing has created anxiousness that is made worse with the never-ending media stories forecasting doom and gloom. We share concerns that the slowing economic environment will lead to moderating earnings growth and contracting operating margins. However, we cannot ignore that markets tend to be efficient and may be discounting anticipated lower earnings growth and already adjusted accordingly. Recent volatility has

“These environments allow investors the opportunity to identify sound & fundamentally strong investments & improve overall portfolio positioning.”

created a repricing of risk in the global markets and much needed dispersion in valuations. These environments allow long-term investors the opportunity to identify sound and fundamentally strong investments and improve overall portfolio positioning. In addition, unlike consumers, most corporate balance sheets are healthy and many companies are able to take advantage of international sales and the depreciating dollar to augment their bottom lines. While global economic growth rates may have peaked, faster international growth may still allow U.S. companies to buffer their earnings in the face of a slowing domestic economy. The slowing U.S. economy, to-

gether with unrestrained fiscal spending and aggressive interest rate cuts, will continue to put pressure on the dollar, making unhedged investments in international stocks (and bonds) attractive. Finally, driven by exploding infrastructure needs and rapidly expanding middle class spending, emerging economies are growing and most have become surplus nations at our expense. While emerging markets will remain a critical component of a well-diversified portfolio, we have recently tempered our exposure to this asset class, given that valuations in many emerging markets relative to their growth prospects are now less favorable versus more mature international markets.

Does hindsight offer an appropriate comparison?

It is tempting to look back at the 2000 market correction and point to the 45% decline in the S&P 500 to suggest that stocks have a lot further to fall before the current correction is over. However, this observation ignores that the price earnings ratio at the peak of that market was close to 33 times earnings while at its trough it settled closer to 15 times earnings. Conversely, the stock market is not as “expensive” today. The S&P 500 currently trades at 14 times earnings and unlike then, earnings yields today are attractive relative to bonds and other asset classes. While earnings may slow, even the draconian scenario of a 25% decline leaves the S&P at a reasonable valuation. Finally, though we can’t know when earnings will bottom, a recent UBS research

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WEB 2.0 . . . (CONTINUED)

ward looking companies are now looking at their customers as “prosumers”, or co-innovators, and proactively seek input about new products design. **BMW** offers a digital design kit on its website to garner feedback from its customers about its vehicle designs and preferences.

Procter & Gamble has had enormous success with its Innovation-360 program, where the R&D team solicited ideas through an innovation contest held on the internet, that attracted hundreds of new ideas from the scientists and “prosumers” across the globe. Internally, the company has a goal of generating at least 50% of its R&D innovations from outside the com-

pany. In fact, the company lists every one of its thousands of patents on yet2.com in the hope that it will facilitate connections and ideas from the outside.

Many experts attribute **Boeing’s** recent success versus **Airbus** to the “open-source” collaborative nature of its “Dreamliner” design, while **Airbus** remained highly guarded of its A380 technology. By sharing information with over 200 partners and suppliers, the Dreamliner avoided many of the highly publicized early challenges that the A380 has encountered.

Not only are businesses recognizing the enormous leverage of web communication, but many groups of people are using the web as a means of solving our social challenges. MIT has recently launched an internet based curriculum that offers quality higher education to stu-

dents around the world, without paying a single penny in tuition, through its OpenCourseWare initiative. The Scripps Research Institute has made enormous strides in the fight against AIDS with an initiative in which millions of individual internet users donate spare computing capacity to power a supercomputer that seeks a cure for the disease.

How does this impact investments?

Several of our investments are benefiting from Web 2.0. **Cisco** markets the telecommunications infrastructure technologies that allow data to be delivered via the web. **Adobe** creates software allowing for richer content and more efficient sharing of documents, photos, and multimedia. In today’s economy, there is a direct correlation with market leadership and techno-

logical innovation. Many “old economy” names are embracing software and the web to improve operational performance. **Norfolk Southern** and **Starwood Hotels** use the internet for logistics and yield management and are undisputed technological leaders within their industries. **Medtronic’s** Carelink program allows patients to wirelessly transmit data via the internet to their cardiologists, enabling more efficient management and more attentive heart monitoring.

We constantly evaluate global trends and the investment landscape, but are careful not to simply invest in a “concept”. When our fundamental investment research identifies a potential investment and that investment is benefiting from macro trends such as web 2.0, we have greater confidence for continued growth.



CURRENT MARKET... (CONTINUED)

report indicated that in the past 5 recessions the S&P has risen over 22% on average two quarters before earnings trough.

Economic growth in the emerging markets and the rise of a global middle class will continue to drive demand for natural resources, especially those with inelastic supply. Though the current economic slowdown may further ease oil prices from their current \$90 level, oil prices are not likely to

"We prefer to own a basket of commodities which include agriculture, energy & metals to ensure we are diversified & participating in the demand drivers for natural resources."

return to the \$50 or \$60 levels of just a few years ago. We continue to prefer to own a basket of commodities which include agriculture, energy and metals (including gold) to ensure we are well diversified and participating in the demand drivers for natural resources. In the current environment of accelerating inflation, exposure to these asset classes has contributed to the growth of our clients' portfolios.

Our view

We expect economic activity to contract during 2008 followed by a gradual recovery driven by fiscal and monetary stimulus. Given that we are in an election year, we anticipate that there will be many proposals for spending and tax cuts to "help the middle class" though we are skeptical on their timing and potential effects. Importantly, we do not think that this is the time to depart from well constructed investment plans. Rather, it is the time to use the environment to improve one's overall positioning.

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Total losses over the past two quarters within the financial sector

Merrill Lynch	\$22.1bn
Citigroup:	\$18.0bn
UBS:	\$13.5bn
Morgan Stanley:	\$9.4bn
HSBC:	\$3.4bn
Bear Stearns:	\$3.2bn
Deutsche Bank:	\$3.2bn
Bank of America:	\$3.0bn
Barclays:	\$2.6bn
Royal Bank of Scotland:	\$2.6bn
Freddie Mac:	\$2.0bn
JP Morgan Chase:	\$3.2bn
Washington Mutual:	\$1.9bn
Credit Suisse:	\$1.0bn
Wachovia:	\$1.1bn
IKB:	\$2.6bn
Paribas:	\$197m

Source: Company reports, BBC

NEW MASTERS OF THE UNIVERSE: SOVEREIGN WEALTH FUNDS

As U.S. financial companies have swooned due to their exposure to sub-prime debt instruments, we have seen the very public emergence of sovereign-wealth funds (SWFs) as the "white knight" investor for many of America's largest financial services firms. The enormous financial clout of these SWFs is staggering. These state run investment arms were originally the domain of oil-producing

nations; a conduit to invest oil profits at a higher return. Now, non-Middle Eastern countries such as Russia, China and Singapore have also established SWFs and are pursuing Western investment opportunities.

Some perspective

SWFs control more than \$3 trillion in capital. The International Monetary Fund and others pre-

dict that SWFs could control \$12 trillion in capital by 2015.

Recent multi-billion dollar deals include Abu Dhabi's investment in Citigroup, China's infusion into Morgan Stanley, and Singapore's investments in UBS and Merrill Lynch. These deals are remarkable not only for their size but also for the speed in which they are being consummated.

Are SWF investments passive, strategic or political?

The answer is likely "yes" to all the above. SWFs have made long term investments on favorable terms into companies at what may prove to be trough valuations. Strategically, SWFs have the opportunity to buy significant stakes in global businesses with deep intellectual, financial know-how, allowing them to potentially leapfrog years of developing the expertise themselves.

These stakes can also be seen as helpful strategically for the enti-

ties receiving the capital as they not only receive necessary funding but also gain a potential strategic partner willing to open doors and create opportunities.

Politically, recent SWF investments have not drawn much Congressional scrutiny. In contrast, last year the deal for Dubai to buy U.S. ports and China's efforts to buy Unocal were thwarted under intense political pressure. The more recent willingness to overlook potential political consequences may be indicative of how desperate these financial institutions are for capital.

A slowing U.S. economy together with a need for fresh capital is driving SWFs to be more active. Their ample, growing liquidity and their reasonable investment terms to date speak clearly that these funds are likely to be a major investment force for years to come.

Government Riches		
How some of the world's largest sovereign wealth funds invest their money:		
Country	Assets	How assets are invested
United Arab Emirates	\$250 billion to \$875 billion	Allocation unknown
Norway	\$308 billion*	40% equities; 60% global fixed income
Saudi Arabia	More than \$250 billion	Allocation unknown
Kuwait	\$160 billion to \$250 billion	Reserve Fund invests in Arab, international markets. Future Generations Fund invests under board-approved guidelines
Singapore	More than \$100 billion	Government Investment Corp. invests in all major asset classes
	More than \$100 billion	Temasek Holdings† assets are 38% in Singapore; 40% elsewhere in Asia and 20% in OECD countries
China	\$200 billion	Allocation unknown
Russia	\$127 billion*	Largely fixed income, with 44% in U.S. dollars, 46% in euros, and 10% in pounds sterling

*Latest data available †Temasek is a private company that manages government investments
Source: International Monetary Fund

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