

CRESTWOOD PERSPECTIVES

FEAR & LOATHING ON WALL STREET

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The events within the investment markets over the past few months have been nothing short of extraordinary. The dramatic stock market declines have captured much of the public's attention and the near shut-down of the less understood credit markets has threatened to wreak chaos in our everyday economic life.

What happened?

History books will describe the events of the past few months much more eloquently but basically the system of trust and faith in financial institutions broke down. As housing related losses accelerated, confidence in struggling institutions fell sharply. Banks froze lending, even among themselves, and hoarded capital to protect their balance sheets as best possible. Governments appeared helpless and, in some cases, hapless as their one-off, inconsistent intervention efforts

further fueled uncertainty in the markets.

The dominoes began to fall in early September as the government took over **Fannie Mae & Freddie Mac**. The failure of 158 year-old **Lehman Brothers** soon followed and "too big to fail" **AIG** was offered an \$85 billion government lifeline. Stealth bank runs at **Washington Mutual** and **Wachovia** forced government facilitated takeovers of both banks under seemingly dramatically different rules. Investor anxiety was further fueled by Congress's bumbling efforts towards the eventual passage of Henry Paulson's \$700 billion rescue plan.

With this backdrop, investors became fearful, selling securities which led to even further asset sales to raise capital and meet additional margin calls, especially among highly leveraged hedge funds. Understandably, some investors panicked and liquidated

assets into the fierce and unprecedented 25% two-week decline to start October.

Risks to Economy

The non-functioning credit markets represent the most immediate risk to our economy and there are reasons for optimism as the strains in the credit market seem to be easing following the globally coordinated government injections of capital into banks. LIBOR rates have finally begun to drift lower from the panic spikes of a few weeks ago indicating that credit is loosening and banks have begun lending to each other again.

Of greater longer-term concern to the fragile U.S. economy is how significantly consumers will curb future spending. For the first time ever, retail sales have fallen for three straight months and are now falling at an unprecedented annual rate of 2%. Driven by tighter credit

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FIDELITY: SAFE & SOUND

During this tumultuous time in the market, investors are questioning things that were – once upon a time – taken for granted. We have been actively engaged in dialogue with our custodial partners, most notably, Fidelity Investments, and remain comfortable and reassured with the strength and soundness of these partners.

We chose Fidelity as our primary and preferred custodian long before the current crisis for many reasons, not the least of which was the fundamentally sound approach Fidelity has taken with their diversified business lines. Fidelity's continued focus on the

core strategies of investment management, retirement and custodial services has helped them avoid the pitfalls that now plague many U.S. banks & brokerage houses. They have not engaged in the types of business that have brought other firms to their knees: credit default swaps, structured products, improper lending and leverage to name a few.

We are pleased to share with you some Q&A that we trust will be reassuring that Fidelity Investments remains a strong and solvent custodial choice.

Can Fidelity fail like Bear Stearns.

Lehman Brothers & AIG?

While any company can fail, it is highly unlikely that Fidelity will fail as a result of current credit market problems. Fidelity's core businesses are essentially investment management and data processing. Fidelity does not offer the same investment

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FEAR & LOATHING... (CONTINUED)

conditions, auto sales are in a virtual free-fall, with many auto company sales down over 30%.

And things may get worse before they get better. Over 1 million jobs have been lost over the past year and the current 6.1% current unemployment rate will likely rise further as the credit crisis spreads deeper onto Main Street. With some estimating that as much as 20% of Americans have mortgages in excess of their home values, it seems clear that the enormous amount of mortgage-equity withdrawals that sustained consumer spending during the brief recession earlier this decade is not available now.

Another "Great Depression"?

Many of today's circumstances, particularly those surrounding the credit crisis, are truly the "worst since the Great Depression" and media comparisons to that time

have made terrific headlines to capture attention and help sell newspapers. However, while the current economic slowdown may be severe, there are significant differences between the 1930s depression and today's economic reality.

In the 1930s, industrial production and GDP both fell by almost 50%. Unemployment reached 25% and stayed above 15% for the entire decade. Today, official GDP growth remains positive despite trending down. Industrial production fell 2.8% in September, which was the most since 1974, but much of that was blamed on hurricanes Gustav & Ike as well as a Boeing strike. Official unemployment will likely rise in the months ahead and though 6.1% may understate all those out of work today, most economists believe unemployment will remain well

below 10%.

Government support mechanisms and current policy decisions are even more important distinctions of today versus the period of the Great Depression. Important government programs like Unemployment Insurance (created in 1934) and Social Security (1935) as well as government agencies like the FDIC (1934), the SEC (1934), and Federal Home Loan Bank (1932) did not even exist at the onset of the Great Depression. These policies and agencies, along with the Federal Reserve and U.S. Treasury, are focused on applying the lessons learned in 1929 and are playing significant roles in stabilizing the current environment. Further, the current global effort by governments to aggressively add liquidity stand in sharp contrast to the ineffec-

FIDELITY: SAFE & SOUND... (CONTINUED)

banking services, make leveraged trades for their own account or depend on the short-term credit markets to fund long term investments - all of which eventually contributed to the downfall of BSC, LEH and AIG.

How are our clients' assets held at Fidelity?

Fidelity brokerage assets must be segregated from other assets of Fidelity companies and the parent company. Customer assets are pooled at the Depository Trust Company (DTC), with Fidelity doing customer accounting and record keeping, as is the case at every broker-dealer.

If Fidelity should fail like Lehman, what happens?

In the highly unlikely event that Fidelity Brokerage goes bankrupt, accounts would likely be temporarily frozen pending full accounting

by the SEC & SIPC (Security Investor Protection Corporation). Once the accounting of all client assets is verified by the SEC & SIPC, client assets are released to another SIPC custodian (wherever the client prefers). If there is any problem, SIPC covers account values up to \$500,000 per account but capped to the individual, and CAPCO (Customer Asset Protection Company) further covers to the full value of the account. Importantly, in the case of the Lehman failure, no assets were found to be misappropriated and therefore it was not necessary for SIPC to cover any claims.

Who is SIPC?

SIPC is not a government agency, but a non-profit membership corporation that receives its revenue from broker/dealers required by law to be SIPC mem-

bers. If SIPC fund is not enough, they have a \$1 billion line of credit with the SEC, which in turn borrows from the U.S. Treasury. SIPC also maintains a \$1 billion line of credit with a consortium of banks.

Who is CAPCO?

Formed in 2003, CAPCO is also not a government agency and is rated A+ by S&P. CAPCO has been capitalized by its member firms and has a very strong reinsurance program consisting of two financial guaranty reinsurers, one of which is rated AAA and one of which is rated AA by standard and Poor's. It has never needed to respond to a claim in its history as there have been very few excess SIPC claims ever made.

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tive policy decisions during the Depression, including the passage of the excessively protectionist Smoot-Hawley Tariff Act that exacerbated the problem.

So where do we go from here?

Global economies face considerable headwinds and the current problems in housing, credit and the stock market will not be fixed immediately. So far, most of the government efforts to restore confidence in the global banking system and financial markets seem to have had the opposite effect. There are, however, a number of encouraging signs, highlighted by the coordinated actions of governments to both lower interest rates and essentially back stop the banking system. These recent actions provide much needed liquidity and capital to

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Crestwood Advisors welcomes

Aaron M. Beltrami, CFP®



Aaron joins us as Director from Fidelity Investments, where he spent 13 years; the last 4 years as Vice President & Senior Account Executive where he was responsible for over \$1.5 billion in client assets.

Aaron brings significant depth of experience & enthusiasm to Crestwood. He has broad experience managing high net worth relationships for individuals & families, and his commitment to superior client service makes Aaron an ideal fit for our firm and for our clients.

FEAR & LOATHING... (CONTINUED)

restore balance sheets and confidence. At the same time, lower oil prices, lower interest and mortgage rates as well as significant new government programs to assist those facing foreclosure will all be helpful to consumers.

Impact on our investments

Our portfolios, which for much of 2008 had held up better than most, did not escape the selling pressures of the past few months as investors seemingly sold both equity and income securities without regard to long-term (or even short-term) fundamentals.

Our growth investments were particularly impacted by the significant decline in the prices of our energy and commodity related investments. Demand will surely ebb as global growth slows but we remain committed to our energy and commodity investments. The unprecedented volatility and sharp

declines of the past few months has been impacted at least in part by the same de-leveraging and forced selling by leveraged investors and prices seem to have gone beyond the economic reality of slower growth.

The full impact of the ongoing de-leveraging and the resulting forced selling of those struggling to raise capital and meet margin calls remain unknown. However, our research suggests that even with pessimistic economic growth assumptions, many energy companies currently trade at significant discounts to the value of their known reserves. Growing world populations will continue to generate increasing global demand. With an impaired supply infrastructure for oil and virtually all commodities, we suspect energy and other commodity prices will stabilize with broader stability in the credit markets and once

again start trending higher in the future.

Where are the opportunities?

The dislocation in the credit markets and the fear-driven rush to the perceived quality of U.S. Treasuries have widened interest rate spreads, providing a range of opportunities in other bond investments. High grade **corporate bonds** are now available at almost twice the yield of similar maturity Treasuries and even **U.S. government agency bonds**, which seemingly carry the same credit risk as government backed U.S. treasuries are offering 200 basis points (bps) more yield versus their historical 20-40 bps spread.

Municipal bonds are also very attractive. Historically municipal tax free yields ranged from

70%-90% of taxable Treasury yields. However, in the current chaos, municipal bonds are paying interest rates higher than treasuries all along the yield curve. Oddly, even treasury-backed, pre-refunded municipal bonds (i.e. basically treasuries) are offering tax-free yields that are in some cases as much as 125% of the taxable U.S. yields. It is not hyperbole to suggest that municipal bonds have never looked so attractive versus U.S. Treasuries.

Given our view of the struggles yet to come for the U.S. economy, we have not yet been tempted to add **high yield bonds** to our portfolios. However, "junk" bonds now pay mid-teen interest rates and offer spreads over 1000 bps (10%) versus treasuries, which

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FIDELITY: SAFE & SOUND... (CONTINUED)

Can CAPCO support the potential exposure should multiple brokers fail?

While multiple failures would cause stress and likely lead to government intervention, this remains extremely unlikely. Excess SIPC claims are very rare, and CAPCO has a very different business model than an insurance company like AIG. CAPCO's investment portfolio is nearly entirely invested in U.S. Treasuries with maturities of 3 years or less. As a result, the risk of material loss because of investment performance is low and the liquidity of the portfolio is high.

What is Fidelity doing to protect its money market funds?

Fidelity Investments has recently elected to participate in the U.S. Treasury Temporary Guarantee Program for Money Markets. Under this program, the Treasury

Department will guarantee payment if any participating fund's net asset value falls below \$0.995. We are confident through our own due diligence that Fidelity does not need to participate in this program, but chooses to for two reasons.

The first is to reinforce and instill confidence in shareholders and use this current government guarantee to reassure clients that their traditionally "safe" assets are indeed enormously safe. Fidelity currently manages over \$431 billion in money market fund assets, and have enrolled all money markets (both taxable and tax exempt) for participation in the 3 month guarantee program.

The second reason is to support the Treasury's effort to send a clear message to the public that these are the responses needed to create further stability. It al-

lows the normal function of the short term debt markets to resume trading properly. The money market industry stands at \$3.4 trillion and it is extremely important to stabilize this market and help loosen the short term credit markets.

Importantly, Fidelity's money market offerings remain strong. We are continually reassured that the funds are safe and managed prudently and discussed this with Fidelity money market fund managers during multiple conference calls. Fidelity employs rigorous research with the intense focus of "safety" first, "liquidity" second, and "competitive return" as a third priority. Firms that have chased higher yields at the risk of holding junk issuers, stressed mortgage backed debt, and unsecured paper are now finding pressure on the thing that mat-

ters most, security and confidence in the shareholders. Fidelity money markets funds have not held any impaired investments.

If you should have any questions about Fidelity, or any other custodial partner, please do not hesitate to contact any one of us. We remain vigilant on the protection of client assets and continue to strive to provide frequent updates and information on these and other timely issues.



FEAR & LOATHING... (CONTINUED)

has historically indicated a favorable future total return.

Of more interest to us so far has been the market for **senior-secured leveraged loans**. These are short-term floating rate loans made to operating companies generally undergoing some sort of corporate restructuring (i.e. acquisition, LBO, etc.) Historically market prices for these loans have fluctuated very little given their low default and loss history. However, the credit market seizure of 2008 and the forced liquidations by many leveraged hedge funds has created an enormous pricing discrepancy that does not reflect the current or likely future fundamental conditions of the underlying companies.

Opportunities are not limited to the bond market as the sell-off in

equity prices over the past year, and in particular, the past few weeks, seems to also have gone beyond the fundamentals.

Many of our current investments are suggesting a somewhat implausible future and we are loathe to sell them at what we believe are currently excessive discounts to their intrinsic business values.

While hardly definitive, we reviewed each of the 30 stocks within the Dow Jones Industrial Average to guesstimate the impact of significant further reductions to already reduced earnings and significantly lower valuations to the average P/E multiple over the past decade. Our work suggests that the current level for the DJIA reflects a greater than 25% additional

haircut to earnings and a more than one-standard deviation lower historical P/E multiple.

To us, this does not mean that the stock market has necessarily hit bottom as the ongoing impact of de-leveraging to near-term prices is simply unknowable. It does however suggest that the current stock market is discounting significant further economic deterioration that may not be forthcoming. We are in a climate where fear is dictating the near-term market; but over time, fundamentals and valuation will determine how stocks will perform. Today the broad stock market trades at roughly 11x-12x earnings, and while there remains considerable questions as to future earnings, current valuations are anything

but excessive.

Perhaps these same basic fundamentals and valuations were on Warren Buffett's mind when last week he wrote a New York Times Op-Ed piece titled "Buy American. I am." In this note, he highlighted that he was buying U.S. stocks in his personal account and that his non-Berkshire net worth would soon be 100% U.S. equities "if prices keep looking attractive". While it is certainly easier to be brave when you have a few billion dollars to fall back on, we certainly agree with his premise that over the next decade equities will almost assuredly outperform the cash investments that some have fled into for safety.

TAX STRATEGIES FOR A BEAR MARKET: TAX LOSS HARVESTING

The volatility in the market this year has been highly unfavorable to most investors.

While the objectives of long term investing are typically not tax-based, investors are required to manage tax consequences as a result of realized gains and losses each year.

In an extraordinarily challenging investment environment like the one we have experienced thus far in 2008, it is advantageous to utilize the strategy of **tax loss harvesting**. As we enter the final quarter of the calendar year, we thought we would share some thoughts on the value and advantages of this important strategy available for taxable accounts only.

Tax-loss harvesting involves the

"While sometimes uncomfortable from an investment goals perspective, harvesting tax losses creates a valuable asset for any taxable investment portfolio."

sale of a given security for less than its purchase price. If the security is purchased and sold within a 12 month period it is considered a realized "short-term" loss.

If the security is sold after a 365 day holding period, it is considered a realized "long-term" loss.

Tax Loss Advantages

While realized capital losses are first used to offset realized capital gains, the IRS then allows taxable investors to deduct up to \$3,000 of net tax losses against ordinary income. The arbitrage created between the existing 15% capital gains rate and the individual's income bracket (up to 35%) makes the tax losses used against ordinary income that much more valuable.

The "wash sale" rule prevents investors from realizing a loss if the same security is purchased within thirty days. However, one strategy to take advantage of the tax loss but maintain exposure to a security that continues to have beneficial growth prospects is to buy additional shares and to sell the original lot at a loss 31 days later. This enables investors to continue to have exposure to a particular investment but also allows for a tax loss to be realized.

Finally, tax losses never expire. Net losses greater than \$3,000 can be carried over to subsequent years to offset future realized capital gains and subsequently future ordinary income.

These tax-loss carry forwards will likely become even more valuable in the years ahead. During this election season, both McCain and Obama have discussed an in-

crease in the capital gains rate. If the long-term capital gains rate does move higher than the present 15%, any tax losses harvested this year will be more valuable in future years.

While sometimes uncomfortable from an investment goals perspective, harvesting tax losses creates a valuable asset for any taxable investment portfolio. These losses equate to reduced tax liabilities for investors and offer the opportunity to rebalance the portfolio in preparation for future positive capital returns.

