

## CRESTWOOD PERSPECTIVES

### 2008: AFTERMATH & OPPORTUNITY

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When we think back on the markets in 2008, one phrase that comes to mind is, "Good riddance!" Nearly every asset class worldwide except cash, U.S. treasuries and gold — the latter of which only turned positive in December — dramatically declined in 2008. Virtually no country avoided the downturn and the world index of stocks was down almost 50% for the year. In the U.S., the S&P 500 dropped 37% and, thanks to the strong returns of U.S. Treasuries, Barclay's Aggregate Government Credit bond index delivered a positive return of 5.7%.

2008 "Nowhere to Hide"	
<b>U.S. Indexes</b>	
Dow Jones Industrial Average	-34%
S&P 500	-37%
Nasdaq	-40%
Dow Jones Financials	-55%
Amex Oil Index	-38%
<b>International Indexes</b>	
Germany DAX	-40%
FTSE 100	-31%
Japan Nikkei 225	-42%
China Shanghai Composite	-65%
Mexico IPC	-24%
Brazil Bovespa	-41%

### THE IMPACT OF "BLACK SWANS"

It is impossible to accurately and consistently forecast future market events. In our view, any and all forecasts are, at best, educated guesses. Many brokerage houses and investment banks have dozens of in-house economists and market strategists that dedicate their careers to trying to identify changes in the economy before they happen. In reality, no one truly knows what tomorrow may bring. In a survey of Wall Street economists taken one year ago, the "consensus" view was that the likelihood of recession was less than 40%. Clearly, this

What initially began as a housing bubble caused by an over-leveraged consumer has led to a global, near systemic failure of the credit markets and many financial institutions. While the economy has already suffered significantly, the environment is likely to worsen. Businesses are delaying or canceling investments in plant & equipment and aggressively cutting jobs. With layoffs surging, the current 7% unemployment will likely rise towards 10% in the near future. Already hurt by the decline in housing and investment markets, confidence has plummeted with job losses and consumers have dramatically curtailed non-essential spending and have begun to reduce debts and increase savings. The impact of these shifts is readily apparent in the significant decline in retail sales witnessed over the last few months.

Led by the U.S. Federal Reserve,

was far too optimistic.

One problem with these forecasts is known as the "Black Swan Theory", popularized in a book by Nassim Nicholas Taleb. In his book, Taleb argues that the most impactful events are those that are rare and unpredictable. Consider the life of a turkey, for instance! 11 months out of the year, it is good to be a turkey — enjoying a carefree life of abundant food — until Thanksgiving, when quite suddenly, it's not so good any longer. Unpredictable events in the last decade such as the 9/11 terrorist

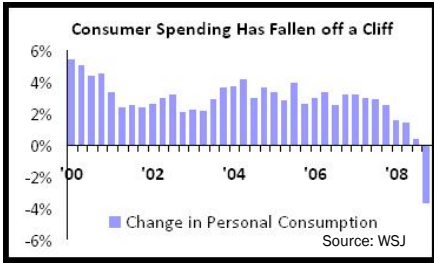
governments around the world have belatedly recognized the seriousness of the crisis and have taken a series of unprecedented steps to provide liquidity, backstop would-be catastrophic financial failures and thaw the credit markets. However, a quick recovery is unlikely. Household wealth declined an estimated \$13 trillion during the last six months of 2008 alone, dwarfing the fiscal stimulus packages already enacted as well as the plans being discussed by President Obama. In addition, government efforts have not created significant liquidity as banks, instead of issuing new loans, have so far hoarded TARP "bailout" funds to protect their solvency. With credit likely to remain tight, businesses, consumers and governments will continue to make adjustments in spending and investment from the previous loose credit cycle.

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AFTERMATH & OPPORTUNITY (CONTINUED)



their underlying fundamentals.

While bad news dominates the headlines, there are reasons for optimism as well. Government actions to backstop the global

banking system have already had a favorable impact on the credit markets. Though credit spreads are still above historical averages, the credit freeze we witnessed in the fall is beginning to thaw and the three month LIBOR rate (i.e. the interbank lending rate) is back down to 1% from over 4% in October. Similarly, the gap between U.S. treasury rates and LIBOR rates has shrunk markedly, indicating a growing sense of pre-crisis normalcy. At the consumer level, fuel prices have fallen sharply and 30 year fixed-rate mortgages have touched historical

lows below 5%, which should eventually help stabilize real estate prices.

This does not mean that psychology will rapidly change and investors will move back into more risky growth investments overnight. However, eventually near 0% Fed Fund rates and negative T-Bill rates will encourage investors to seek other more productive long-term investment opportunities.

Our priority is always to balance the opportunity for return with the inherent risks of potentially achieving those returns. Over the past year, we have migrated towards a more conservative posture in all of our client portfolios and continue to have healthy cash levels and

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**A mispricing of risk?**

Insufficient economic visibility, lack of trust in the capital markets and general uncertainty has given way to outright fear. The pressures on financial institutions to raise capital and on leveraged hedge funds to meet margin calls has created an environment of forced selling, regardless of valuation, causing asset prices to fall rapidly and volatility to spike. Just as the markets didn't properly assess risk during the bull market, we believe that there is a mispricing of risk now as almost all asset classes are "cheap" regardless of

**Crestwood Advisors welcomes Matthew S. Morse, CFA as Director**

Matthew joins us from The Capital Group Companies (Capital International Research) where he was responsible for recommending equity investments for institutional client portfolios.

Matt joins our research team and is responsible for originating, researching, and recommending investments based on our strict investment discipline.

Matt began his career at PricewaterhouseCoopers after graduating from the University of Southern California, with a B.S. in Accounting.

THE IMPACT OF "BLACK SWANS" (CONTINUED)

attacks, the 2004 hurricanes and the current credit crisis have been powerful examples of highly improbable events that have had a profound impact on history and investment portfolios.

While there will always be "black swans", we strive to minimize the potential impact of these events by consistently applying probability assessments of future risk and return scenarios. These are typically based upon historical comparisons of prior markets with similar characteristics. The more variables that align, the higher the likelihood that a given scenario plays out in a similar fashion.

Many times these types of comparisons require going back in

time, to make a thoughtful judgment about the future. One of the reasons we decided to exit our Schlumberger position was based on an analysis of the oil services industry and its sensitivity to economic events that happened in 1974 and 1981.

Such an analysis is by no means perfect but by applying a disciplined strategy that

balances growth and income investments, while trying to minimize the current cyclical and fundamental risks, it is possible to increase the likelihood of long term success.

However, even the application of consistent analysis has offered limited protection with the "black

swan" market of 2008. While we took steps to protect our portfolios, we did not anticipate the magnitude and depth of the current crisis. We have been and continue to strategically position portfolios away from exposure to banks, consumer discretionary stocks, and cyclical industries, in favor of increased weightings in health-care, consumer staples, and energy stocks, which are traditionally defensive sectors. Because a "black swan" can have such a large impact on our portfolios, and are so hard to predict, we will continue to embrace diversification.

**We're all credit analysts now!**

The credit crisis that exists today has created limited accessibility to the capital markets. As a result, companies with signifi-

cant debt or near-term capital needs may face additional challenges to meet growth expectations. This has forced us to become "credit analysts" in addition to simply "equity analysts".

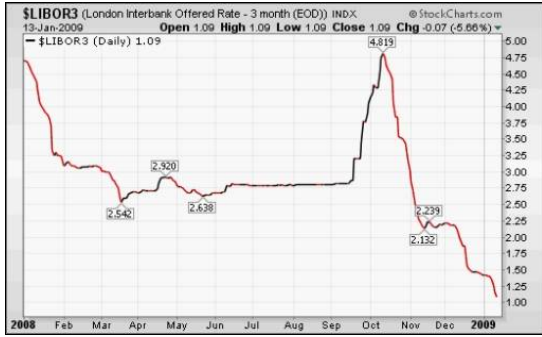
Reviewing debt covenants, credit facilities, and near-term spending needs for each company we own has become routine. As a result, on average, our investments have sufficient cash flow and do not require raising capital to drive growth.

Cash now represents 10%-40% of the current market value for many of our existing holdings, providing further reassurance and downside risk protection. As a whole, our portfolio's cash to debt ratio compares favorably against the broader stock market.

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AFTERMATH & OPPORTUNITY (CONTINUED)



at wider levels than where they are today and all of those occasions occurred during the Depression, between the winter of 1931 and the summer of 1932.

municipal bonds.

Credit spreads are also historically wide in the high-yield, junk bond market; however, with a struggling economy and tight credit markets limiting refinancing opportunities, junk bond defaults will likely soar in 2009, perhaps eroding the value of the enticing current yields. Instead, we continue to favor the relative safety of senior-secured bank loans, which are better positioned in a company's capital structure, offering us greater security in case of default. While fundamentals in the bank loan market remain strong, these historically stable, shorter-term, floating rate notes have been impacted by massive selling by hedge funds and including them in portfolios allows us to take advantage of

the historically wide interest rate spreads.

The unwinding of this credit cycle has been deflationary and, most likely, it will continue to run its course at least throughout 2009. However, we also recognize that there is a cost to financing trillion dollar deficits and, at some point, inflation will re-emerge. Though still early, we are very sensitive to this risk and, therefore, continue to hold shorter maturities and watch the TIPS (Treasury Inflation Protected Securities) markets very closely.

**Volatility to continue...**

Though equity markets look attractive on almost all valuation metrics, we recognize that earnings are uncertain and,

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quality bond positions.

**The demand for liquidity**

The rush to the perceived safety of U.S. Treasuries and the need for liquidity, which may persist for much of 2009, has driven treasury yields to what will likely prove to be artificially low levels. Today investment grade corporate bonds offer yield spreads that can be 500-600 basis points (5%-6%) higher than Treasuries. In the previous 90 years, there have only been five months where credit spreads were

We have been taking advantage of this anomaly by investing in high quality, shorter-term bonds issued by the likes of Pepsi, Johnson & Johnson, and IBM.

These unusual yield spreads also exist in the municipal bond market where tax-free yields are now higher than comparable taxable treasury yields. While state & local municipal budgets are clearly under pressure, we have been finding terrific opportunity in high quality shorter-term general obligation and pre-refunded

THE IMPACT OF "BLACK SWANS" (CONTINUED)

The pristine balance sheets and strong cash generating abilities of recent additions to the portfolio like **Alcon (ACL)**, **Stryker (SYK)**, and **Google (GOOG)**, have further improved the quality of the portfolio.

Probability assessments are also useful in identifying investment themes and searching for opportunities. Mohammed El-Erian, former manager of the Harvard Endowment and currently the Chief Investment Officer at Pimco, uses the analogy of a six lane highway to illustrate how to benefit from the perceived systemic changes to the investment landscape. He suggests that investors can benefit by identifying and staying with a handful of growth themes (i.e. lanes of highway) in a portfolio. While individual themes may take several years to materialize, investors can benefit most by staying on the highway but shifting lanes to avoid

traffic (i.e. risk exposure).

Within the framework of our investment discipline, we believe we can add value in a similar fashion. In the near term, we anticipate a weak consumer and corporate spending environment; however, recently announced government stimulus programs around the world may offset some of this weakness. President Obama recently announced a massive program designed much like the "New Deal" with huge investments in transportation, telecommunications, healthcare, and power grid infrastructure. These investments are likely to benefit many of our holdings. For example, **Norfolk Southern (NSC)** is likely to benefit from improvements to the nations rail network. Companies like **Cisco Systems (CSCO)**, **Citrix (CTXS)**, and **Google (GOOG)**

are poised to benefit from the "networking" of America's schools and institutions, and names like **ABB** and **ITT** should benefit from increased spending on infrastructure and energy efficiency.

As referenced earlier, accurately forecasting the future is impossible. History suggests that the current economic situation is likely to last longer and require a more complex solution than many investors seem to be anticipating. Controlling risk remains our top priority in managing our clients' portfolios. That said, with risk comes opportunity and many of the darkest, most uncertain times in our history were times that presented the greatest opportunities. We continue to strive to find those opportunities without taking unnecessary or excessive risk.

**Crestwood Advisors welcomes Rushabh R. Shah as Associate**

Rushabh has been with Crestwood Advisors as a full-time intern since May 2008 and we are pleased to welcome Rushabh as an Associate. Rushabh joins our research team and is responsible for originating, researching and recommending investments.

Rushabh graduated from Pune University in India with an undergraduate degree in engineering and earned his MBA from Bentley College in May 2008. He is a candidate for Level III of the Chartered Financial Analyst exam in June 2009.

Rushabh has previously worked at Standard Chartered Bank and State Street Corporation.

**AFTERMATH & OPPORTUNITY (CONTINUED)**

therefore, we remain very selective. Importantly, by no means are we willing to declare the bear market over and the dramatic volatility experienced in 2008 will likely persist in 2009. For some perspective on the current extreme volatility, consider that the S&P 500 rose or fell by more than 5% in one day 17 times in 2008, the same number of times that this occurred during the previous 50 years!

Importantly, during this unprecedented environment, we continue to derive value from our fundamental investment process. We continue to seek high quality global franchises with strong balance sheets and solid free cash

flows. Given the uncertainty of future earnings in this current environment, we are using “draconian” estimates in our valuation work. The companies we are comfortable owning have significant cash positions on their balance sheets, often pay attractive dividends, and maintain a below-average ratio of debt as a percent of capitalizations. For example, as concerned as we are with the health of Steve Jobs, Apple continues to deliver innovative and profitable growth, and we are comforted by their lack of debt and approximate \$31 per share in cash.

Given the enormous developing

budget deficits and the declining international interest in purchasing U.S. debt, we continue to have a bearish view of the dollar. Therefore, we have maintained exposure to the international and emerging markets, tilting our positions away from Europe and towards Asia, and emphasizing dividend paying and smaller companies.

While the global economic slowdown has had a devastating effect on the demand for commodities, the production cuts in oil, combined with the ongoing demand for food stocks, will make the declines in these specific asset classes short-lived. Additionally, hard assets such as

gold, whose supplies cannot be replaced as fast as printed money, are also likely to appreciate over time. These asset classes have demonstrated non-correlating returns that have proved to be very good hedges during uncertain geopolitical times.

Given the eroding economic picture, we expect continuing turbulence in the financial markets in 2009. We believe investors will be best served by a continued focus on risk and diversification and we will continue to use sound and informed judgment to both preserve and grow our clients’ assets as best possible.

**2009 IRS & TAX CHANGE UPDATE**

There are numerous changes being implemented in 2009 in estate tax, gift tax, minimum required distributions (MRDs) and other financial planning issues. We want to highlight a few of these changes that are important to consider as we enter the new year. We look forward to continuing the dialogue with our clients around what these changes mean and how it all fits within a sound financial plan.

**Federal Estate Tax Exemption**

As of January 1, 2009 the federal estate tax exemption rises to \$3.5 million, from an individual’s ability to pass \$2 million estate-tax free. In fact, with proper planning a married couple can now pass up to \$7 million free of federal estate tax. The plan passed under the Bush administration eliminates the federal estate tax in 2010; reverting back to \$1 million per individual starting in 2011. From what the new

Obama administration has inferred, we are likely to see changes in the form of setting a permanent exemption at roughly the \$3.5 million level.

Importantly, states are not as eager to increase the estate tax exemption. Massachusetts, for example, still has an exemption of only \$1 million.

The changes in the estate tax exemption on a federal level, however, are important enough to warrant a consult with an estate attorney to ensure that the proper planning is in place to maximize the potential tax savings these new limits provide.

**Gift Tax**

The “annual exclusion” is a routinely overlooked strategy which allows individuals to make a tax-free gift of a certain amount to any other individual, and it has just increased from \$12,000 per recipient in 2008 to \$13,000 in

2009. A quick calculation of a married couple with two children gifting in this manner over the span of 20 years produces an estate reduction of over \$1 million. When you factor in the potential growth of gifts outside the estate the impact is far greater.

**2009 IRA MRD Rules**

The IRS requires that individuals take a “minimum distribution” out of nearly all retirement accounts at the age of 70 1/2.

Recently, in an effort to allow investors relief during a very difficult market, a law was passed allowing individuals to “skip” the calculated MRD for 2009. This will undoubtedly be a significant tax advantage for investors with large distribution obligations.

**Roth IRA Conversions**

It may be advantageous to consider converting a traditional IRA to a Roth IRA in 2009. However,

this year there remains the income limitation of under \$100,000 AGI (adjusted gross income) in order to qualify to complete the conversion.

Why should this be the year to convert? The depressed valuation of the investment markets and the still historically low income tax rates together present a unique opportunity to pay less taxes on tax-deferred assets now in exchange for future tax free growth. Under current tax law, 2010 will provide an opportunity for the conversion to all regardless of income limitations.

There are multiple considerations as to how to best take advantage of these 2009 changes. We are actively engaged in conversations with our clients about optimizing their circumstances.