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CRESTWOOD PERSPECTIVES

SWIMMING THROUGH THE DEMAND FOR LIQUIDITY

The investment markets in the first quarter of 2009 started pretty much where 2008 left off. The global economy and credit markets remained rocky and government stimulus efforts worldwide expanded dramatically. U.S. stock markets plummeted to new lows as corporate earnings fell sharply. In March, equity market valuations sank to the lowest levels in decades, enticing investors to buy and pushing stocks sharply higher to recover some of the losses. Interest rates generally drifted higher, yet bond prices were basically flat for the quarter.

The Challenges Today

Over-leveraged U.S. consumers seem to be finally out of options. Falling housing prices and the steep stock market sell-off have combined to create record declines in household net worth. Much tighter recent credit conditions and accelerating job losses have caused households to reduce spending. Layoffs have been announced at an alarming rate and over 5 million jobs have been lost since the recession officially began in January 2008. The unemployment rate has risen to 8.5% and there will be further job losses in the months ahead.

While household savings rates have climbed to over 4%, household debt levels remain near historic levels and the ability to service this debt for individuals remains burdensome. With the expectation of ongoing job losses, combined with likely rising energy prices, there is little reason to expect near-term relief for consumers.

At the same time, banks and other financial institutions continue to be plagued by problem assets and, despite significant political pressure to make loans, banks remain focused on shoring up their balance sheets and hoarding cash. Perhaps bankers believe more problems lie ahead, for although the "sub-prime" mortgage mess is largely behind us, "prime" mortgage defaults are rising and significant rate resets remain for "Alt-A" and "Option ARM" mortgages. Losses in commercial real estate and credit card portfolios are also beginning to climb sharply.

The current debt-driven problems are enormous and global in scope and government efforts to stimulate spending and ward off deflationary pressures have been enormous in response. In the U.S., Q1 2009 spending has already dwarfed the $700 billion TARP bailout authorized in 2008. Among other things, the U.S. government approved a $787 billion "stimulus" package and the Federal Reserve announced it would purchase

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STEERING THE SHIP IN ROUGH SEAS

When thinking about the current markets, think about a cruise ship out at sea. While technology provides the Captain with the advantage of warning systems for what may be an unavoidable approaching storm, there is still much that remains unpredictable and uncontrollable. Despite the lack of control over the weather situation, there are important steps that the captain and crew take to ensure that the ship and the passengers withstand the impact of the storm as best possible.

As with today's economic and investment climate, marked by incredible uncertainty and turbulence, where so much is out of our control, we are taking steps to control those things that we can in order to mitigate risks in our clients' portfolios.

Liquidity

First, we continue to carry higher balances in money market funds and short term bonds to reduce risk and build reserves for opportunistic investment, and to meet short-term liquidity requirements. In a "normal" investment environment we might seek to keep a fully-invested portfolio in 2-3% cash. However, given the current investment environment, we have been patient redeploying cash that has accrued in portfolios through dividends, interest, and sales of securities and this overweight cash balance has proved prudent in less-

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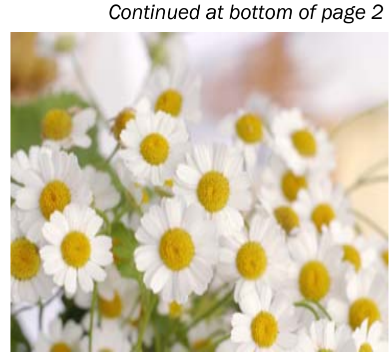

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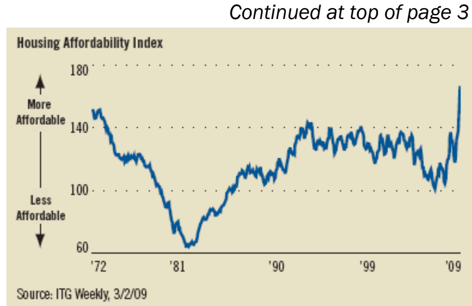
SWIMMING THROUGH...(CONTINUED)

$300 billion of Treasury bonds and dramatically expand to over $1 trillion its planned purchases of mortgage agency debt. Also, the Treasury Department announced the Public-Private Investment Program (PPIP), which is intended to provide a framework to purchase troubled assets from banks to cleanse their balance sheets and restart lending.

Reasons for Optimism?

Despite this tepid backdrop for the economy, there are reasons for optimism. Credit market conditions have improved dramatically and, although credit measures like the "TED Spread" (an indication of liquidity and perceived risk) are still elevated compared to pre-crisis levels, they have declined significantly from Q4 2008. In response to the Fed's program of purchasing Treasury and mortgage bonds, mortgage rates have dropped to their lowest level in decades. Thirty year mortgage rates are now generally under 5%, providing a wonderful opportunity to refinance existing mortgages for those that can qualify. (See related article on page 4.)

While the U.S. housing slump continued during Q1, there were some signs of stabilization and even improvement. Falling construction activity and a decline in housing permits suggest a continued trend down in the inventory of unsold homes. With housing prices down and mortgage rates low, by at least some measures, homes have never been more affordable and existing home sales in some beaten down areas such as California moved higher in Q1 2009.



Opportunities for Investment

The massive global stimulus efforts are clearly aimed at creating liquidity to slow the current deflationary forces. Spending plans are being financed with deficit spending and new issuance of Treasury debt, and some is the result of what is euphemistically referred to as "quantitative easing" or effectively printing money out of thin air.

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STEERING THE SHIP...(CONTINUED)

ening day to day portfolio volatility.

Quality, Duration and Expected Inflation

Many corporations and municipalities carry enormous debt levels. With the economy deteriorating, we have been buying high quality AA and AAA rated corporate bonds and similarly high quality general obligation and essential purpose revenue municipal bonds. We have focused on high quality bonds to best protect principal in a rising default environment.

We have also targeted a fairly short average duration (i.e. maturity) portfolio to mitigate interest rate risk and protect from future inflation and rising interest rates.

Reducing the duration of a bond portfolio reduces the volatility bonds experience due to interest rate fluctuations. As outlined in "Swimming through the Demand for Liquidity" (above), credit spreads, the difference between "risk -free" Treasury yields and other interest rates, are at historically wide levels and represent an attractive total return investment opportunity.

> *"The recent focus on deflation has presented an opportunity to protect against future inflation & we have initiated investments in TIPS over the past several months".*

The recent focus on deflation has presented an opportunity to inexpensively protect against future inflation and we have initiated investments in TIPS (Treasury Inflation Protected Securities) over the past few months. The combined effects of all the government spending and stimulus plans may result in significant inflationary pressures as the economy stabilizes and eventually recovers.

We are also adding to our exposure to gold and other natural resources, including energy investments, to protect against the devaluation of the U.S. dollar and future commodity inflation. The current relatively low valuations are likely to prove unsustainable as the global economy stabilizes and global growth resumes.

Weighing Risk & Reward

There is potentially tremendous opportunity in the stock market today, but tremendous risks remain. Much like our approach to credit analysis, we work hard to understand the

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Crestwood Advisors' Philanthropic Commitment

Achieve In Africa

AIA strives to provide the children of Africa with a structured learning environment by rebuilding & aiding schools in need of reconstruction and supplies. This goal stems from the belief that education attacks the root causes of poverty in under-developed countries. Through education, these children will find greater opportunity to reach their full potential, lead better lives, and inspire future generations.

AIA, a 501(c)3 foundation, was started by Brendan Callahan, a Crestwood client service & operations intern since May 2008, after he visited Tanzania in 2007 & saw children "thirsty for knowledge, but lacking the facilities & supplies needed for a proper education." He was inspired by the enthusiasm the students had for learning despite their lack of resources. This experience fueled a desire to better equip these and similarly disadvantaged children with supplies and facilities to support a better education.

One current project is to rebuild classrooms & provide supplies for the Olasiti Primary School, an overcrowded school for over 1900 children in a rural village of Tanzania. Villagers in Olasiti are subsistence farmers and each household makes an average of only $90 to $100 per year.

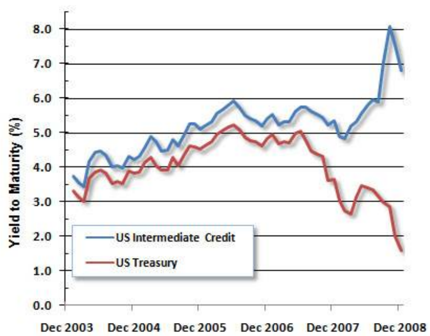
For further information about this organization, please visit www.achieveinafrica.org.

SWIMMING THROUGH... (CONTINUED)

In more normal times, this type of spending would be quite inflationary and certainly one of the significant future challenges for the Fed is how to sop up this liquidity when economic conditions stabilize. With the world understandably preoccupied with fighting the deflationary pressures of de-leveraging, inflation protection is relatively cheap today. Dollar-based commodities (including gold) and inflation protected bonds should be two beneficiaries of higher future inflation and we continue to build positions in these asset classes in our client portfolios.

This inflation will be exacerbated by the likely higher bond yields that will be necessary to entice bond buyers to finance the enormous and growing U.S. debt. To protect against higher future interest rates, we are targeting a relatively short average duration for our bond portfolios, sacrificing some yield today to protect principal from future inflation and providing the opportunity to reinvest at higher future interest rates.

With the economy slowing and the bond market in disarray, credit spreads (the difference between "risk free" treasury yields and other interest rates) are at historically wide levels. The chart below highlights the spread between investment



grade corporate bonds and Treasuries.

Spreads have gapped higher for a few reasons. Corporate bond prices have suffered as the slowing economy has hurt revenues and led to increasing bond defaults. Likewise, falling property values and slower retail sales have hurt tax revenues and crimped municipal budgets.

While these two factors are quite significant, the demand for liquidity from major institutional investors, hedge funds and governments may be playing an even more dominant role today. Liquidity in the bond market has all but disappeared. With banks and brokerages too preoccupied with survival to commit capital to the secondary market, only the treasury market can meet today's demand. If not because of relative liquidity, why else would a pre-refunded municipal bond backed by U.S. Treasury notes offer a tax-free yield that is higher than the taxable yield on a similar maturity U.S. Treasury note?

These circumstances have created an environment where current bond prices imply default rates and future recovery scenarios that seem improbable even given today's economic problems. For example, since 1970 the worst 5 year default rate among investment grade corporate bonds was only 2%. Today, analysts at Goldman Sachs and Merrill Lynch suggest that the implied default rate is almost 60% assuming historical recovery

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STEERING THE SHIP... (CONTINUED)

balance sheets of our equity investments. In our view, any company with near-term debt to refinance or that is dependent on the capital markets to fund their growth plans will have greater struggles in the years ahead. In putting together investment portfolios, we are emphasizing industry leaders with unimpaired balance sheets and strong ongoing operating performance.

Embracing Pessimism & Higher Hurdles

Finally, we are embracing uncertainty and pessimistic views of future earnings growth to avoid over-confidence when building our individual equity portfolios. Reviewing our analysis of **Google** may be a helpful articulation of our strategy.

Google first became interesting to us as the valuation appeared to suffer disproportionately compared to its relatively strong operating performance.

Despite the challenging environment over the last few years, Google has continued to report solid revenue and earnings growth but its relative price to earnings (P/E) ratio declined from 3.5x to 1x the P/E of the S&P 500. Google also offers a debt free balance sheet with significant cash balances totaling roughly $56 per share.

While these qualities are attractive, we recognize Google is not immune from the global economic slowdown. Therefore, in our analysis, we are taking a more bearish view on future revenue, margins, and earnings growth projections. For example, while consensus expects Google's revenue to grow 10% in 2009 and 16% in 2010, our models assume 0% revenue growth in 2009 and only 5% in 2010. Further, Wall Street consensus estimates Google to grow earnings per share (EPS) 8% in 2009 and 15% in 2010, we have built our valuation models using -2% EPS growth in 2009 and -5% in 2010. We believe this approach reflects the uncertainty of the future and creates a greater margin of safety for our clients.

We have also raised our "hurdle rates" (i.e. the discount rate) that new and existing equity investments must deliver. With historically wide credit spreads reflecting opportunity in high quality bonds, more volatile equity investments must provide for the opportunity for even higher returns.

When we apply these high hurdle rates and our own severe "haircuts" to future growth and earnings expectations, we estimate Google's intrinsic valuation to be still much higher than the current market price. While this approach certainly does not ensure that we buy at the "bottom", it does ensure that we are selecting attractive investments within the context of a severely strained and uncertain environment. We have gone through this exercise for each of our existing holdings as well to "stress test" our portfolios effectively.

In conclusion, while the ongoing economic storm continues to swirl, we anticipate that the actions we have taken and the analytical approach we have embraced will best protect our investment ship in the stormy seas that we expect will continue.

SWIMMING THROUGH... (CONTINUED)

rates and almost 30% assuming 0% recovery to bond holders. For high yield bonds, these analysts suggest that the current prices for junk bonds imply a default rate of over 80% with historical recovery rates. These figures compare to a worst 5 year default experience of about 30% for junk bonds over a period that included the 1970s bear market, the S&L crisis, the Milken-era junk bond bust and the 2000 burst of the technology bubble.

In our view, the current dislocation in the bond market is providing a unique opportunity for investors who can absorb this illiquidity and effectively manage needs for personal liquidity at the portfolio level. We believe that the relative return opportunities from "credit" will rival returns historically associated with the long-term stock market returns. As a result, we continue to buy municipal bonds, investment grade corporate bonds and senior secured leveraged loans (i.e. bank loans) to capture these spreads.

<u>What's next for the Stock Market?</u>

Over the very near term, policy from DC will continue to drive stock prices. Longer-term, earnings will have a bigger impact on stock prices and the picture for earnings growth over the next few years is murky at best.

Earnings estimates have come down sharply over the past year and they continue to be trimmed as we enter Q1 earnings season. In early March, stocks traded at about 10x these sharply reduced estimates and, over the past six weeks, stocks have bounced sharply off of these "oversold" valuations. We remain cautious of the sustainability of the recent rally as fundamentals have continued to deteriorate. The fact that this rally has been led by the most previously beaten down financials gives us further doubts that the torrent pace of gains will be sustained.

It is our view that the economic changes we are going through are so significant that no one knows with any certainty how the economy will evolve in the years ahead. Earnings growth remains a challenge and, if prior bear markets are any guide, we should expect more volatility even if firmly on the path to economic recovery.

To protect ourselves against becoming too enthusiastic on the pace of the recovery, we are embracing a significant degree of near-term pessimism into our investment analysis and raising the "hurdle" rates that new and existing investments must meet. (See "Sailing the Ship in Rough Seas".) While such an approach may cause us to miss some opportunities, we are comforted by the greater margin of safety this provides and believe it is the right approach given the enormity of the ongoing problems and the uncertainty of the effectiveness of the evolving solutions.

TIME TO REFINANCE?

For most, the combined effect of the falling stock market and the decrease in home values has done considerable damage to family balance sheets. This has resulted in a shift in consumer behavior by spending less and an interest in paying down debt more aggressively. While not contributing to economic growth today, this is a necessary factor in correcting the over-leveraging of households over the past several years.

One silver lining of the current economic environment is that the Federal Reserve has made lower consumer interest rates, especially mortgage rates, a priority of current policy. Current rates are among the lowest in history, and we have been actively speaking with clients regarding refinancing opportunities and are eager to facilitate discussions with lenders.

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How much can this affect wealth? Assuming a $500,000 thirty-year fixed rate mortgage at 5.875% could be refinanced into a similar thirty-year fixed rate mortgage for 4.875% with no closing costs and no points. The monthly difference would be over $300 and the "life of loan" difference in payments would exceed $112,000. For those that have the cash flow to support a greater monthly payment and refinance using a fifteen-year fixed rate at 4.875%, the "life of loan" difference would be in excess of $358,000. Now that's a stimulus package!

Here are a few simple questions to keep in mind when you speak with your lender.

- Does it make sense to refinance given my amortization schedule?

- Which loan type is the best for my situation (fifteen-year fixed, thirty-year fixed, adjustable rate, interest-only, etc.)?

- What are points and how can they affect my overall payments and costs?

- What are the total costs associated with refinancing?

- Do you offer rate locks?

- Are there any prepayment penalties if I choose to pay down principal?

- How much time will the process take?

Importantly, everyone's situation is unique and we would be more than willing to have an initial discussion to kick start the process.