



**Austin Calvert Flavin**  
Investment Advisors

Established 1981



# Quarterly Review

GLOBAL RESOURCES • LOCAL PORTFOLIO MANAGEMENT

4Q2008

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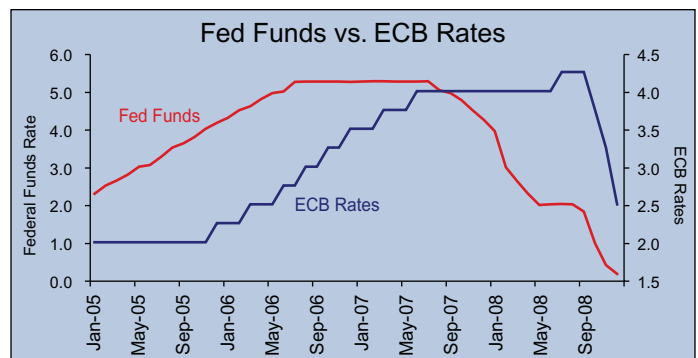
## More Help is on the Way...but Credit Remains the Key

In our last letter, we noted that September 2008 would be remembered for a long, long time given the failures of several prominent financial institutions during the month. At this point, we know the *entire year* of 2008 will be remembered for a long, long time – although many investors would prefer to forget 2008 altogether. We think the media has more than adequately made investors aware of the grim economic and financial market statistics related to 2008.

As we consider the coming year, the answers to many economic and financial questions will derive from the availability of credit – commercial bank loans, mortgages, personal loans and the ability of municipalities and corporations to issue debt. Banks, on the whole, have proved very reluctant to make new loans, choosing instead to hoard cash. Bank cash holdings tripled in the fourth quarter to over \$1 trillion, according to the Federal Reserve. At the same time, fixed income investors moved almost exclusively to U. S. Treasury bonds, driving the yields of these securities to historic lows. Clearly, a thaw in bank lending, combined with a resumption of investor appetite for corporate debt, would be positive first steps on any road to recovery.

Lenders and investors, however, are understandably hesitant to act pending more clarity about both past and future actions by the government, as its actions in recent months have only served to heighten market uncertainty. The Troubled Asset Recovery Program (TARP) is a good example. The TARP was originally intended to be used by the U. S. Treasury to purchase illiquid assets from banks and other financial institutions. However, some of the funds were later used for equity infusions for banks, as well as to rescue American International Group. Investors will re-enter financial markets when they can better ascertain how the government will proceed. The government's game plan has been rewritten so many times over the last 18 months that it is difficult to anticipate when the government will intervene and when it will not.

In addition to a better understanding of the government game plan, investors and bankers need to see a recovery of economic indicators, such as stabilization of housing prices and the unemployment rate. As the chart at right suggests, given that the Federal Reserve was



Source: Federal Reserve Bank, ECB



the first major central bank to begin cutting interest rates in mid-2007, the U. S. economy may be the first to show signs of recovery. After the Federal Reserve began its rate reduction process in 2007, the European Central Bank (ECB) elected to keep rates steady, and actually raised

rates in mid-2008, before finally initiating its own rate reductions in the fourth quarter of 2008. This asymmetrical response should provide a benefit to U.S. markets relative to their foreign counterparts. Beyond rate cuts, we anticipate a \$775 million economic stimulus package of

spending and tax cuts could be passed within weeks of the Obama administration taking office, if not sooner. All indications at this point suggest President-elect Obama will move very aggressively to address the U. S. economy.

## Equity Market Review

### Fourth Quarter was Very Challenging

The fourth quarter of 2008 was the final piece of a very disappointing puzzle. Many key events defined the year, from the Bear Stearns bailout and record high energy prices, to the bankruptcy of Lehman Brothers and the collapse of the stock market. Additional pieces of the puzzle included falling home prices, rising unemployment and plummeting consumer confidence.

Meanwhile, as the global economy fell into recession territory, governments worldwide stepped up to announce massive fiscal stimulus plans and slash interest rates. As these measures began to be broadly publicized, investor sentiment and returns began to improve toward the end of the quarter, though not enough to fully offset earlier losses. As the chart below indicates, given the

significant decline in mortgage rates, housing affordability showed a large jump in the second half of 2008. While the final months of the year produced a few glimmers of hope, we expect the economic backdrop to remain challenging. We believe the two most difficult areas will be consumer spending and housing. A broader solution to the housing crisis will likely come after the Obama administration takes office if policies are put into place to deal with rising home foreclosures and vacancy rates.

### Portfolio - Strong Results Relative to S&P 500

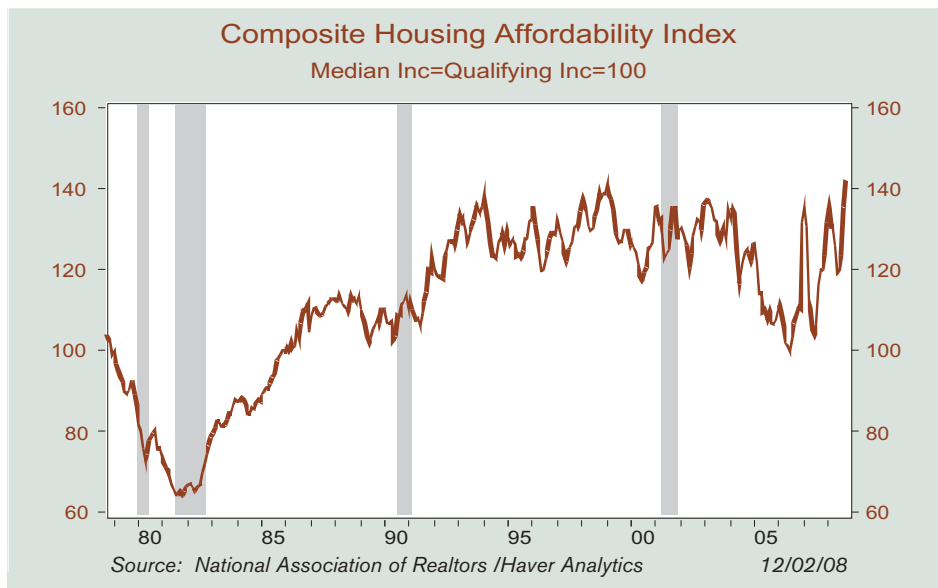
There was no safe place to hide in the equity markets as all industry groups posted negative returns for both the quarter and the year. Cash was our only major defense during the quarter. In addition to cash, stock selection in the

financial and consumer staples sectors positively impacted performance relative to the S&P 500. We believe that Congressional and Federal Reserve policy initiatives will work, and have begun to position the portfolio toward that eventuality. As we noted earlier, it is critical that credit markets begin functioning again. While financial institutions will be central to the recovery process, the industry will look dramatically different with increased regulation, consolidation, and the emergence of diversified powerhouses (which we seek to own).

A significant impact on performance came from energy and infrastructure, where we underestimated how quickly the price of energy would drop. We recently reduced our oil service exposure, as the next phase of the commodity correction will be supply destruction. As energy prices corrected on demand destruction, now we need to reduce supply to correct an over-supplied market. We expect this to take place as we move through the first quarter of 2009. While the portfolio remains defensively positioned overall, we are adding companies that we believe will be the market share gainers as we enter a recovery phase.

### Outlook: Improvements on the Way

As we look back on the last year, it is crystal clear that the financial system was unprepared for this monumental, broad decline in housing prices. To compound the problem, regulatory bodies did not keep up with all the new products and structures being traded





around the world. This created a panic in the financial markets as investors ran toward the safest investment: U.S. Treasuries. After Lehman Brothers filed for bankruptcy, the ensuing fallout in the credit markets was truly unprecedented, and even the most creditworthy borrowers have found it difficult to fund their day-to-day business activities.

Looking into 2009, more help is on the way as the Federal Reserve and Treasury are committed to restart the U.S credit engine by whatever means necessary. As highlighted earlier, fixed-rate mortgages are falling, and borrowing rates for even risky borrowers have begun to edge down slightly. Elsewhere, we expect global commodity prices and interest rates to

remain low until the economy is on a more stable footing. The recovery process is likely to be slow, and forced de-leveraging by many financial institutions will create attractive opportunities to invest in high-quality companies. We also recognize that uncertainty creates opportunity, and we remain focused on looking for new ideas to bring to the portfolio.

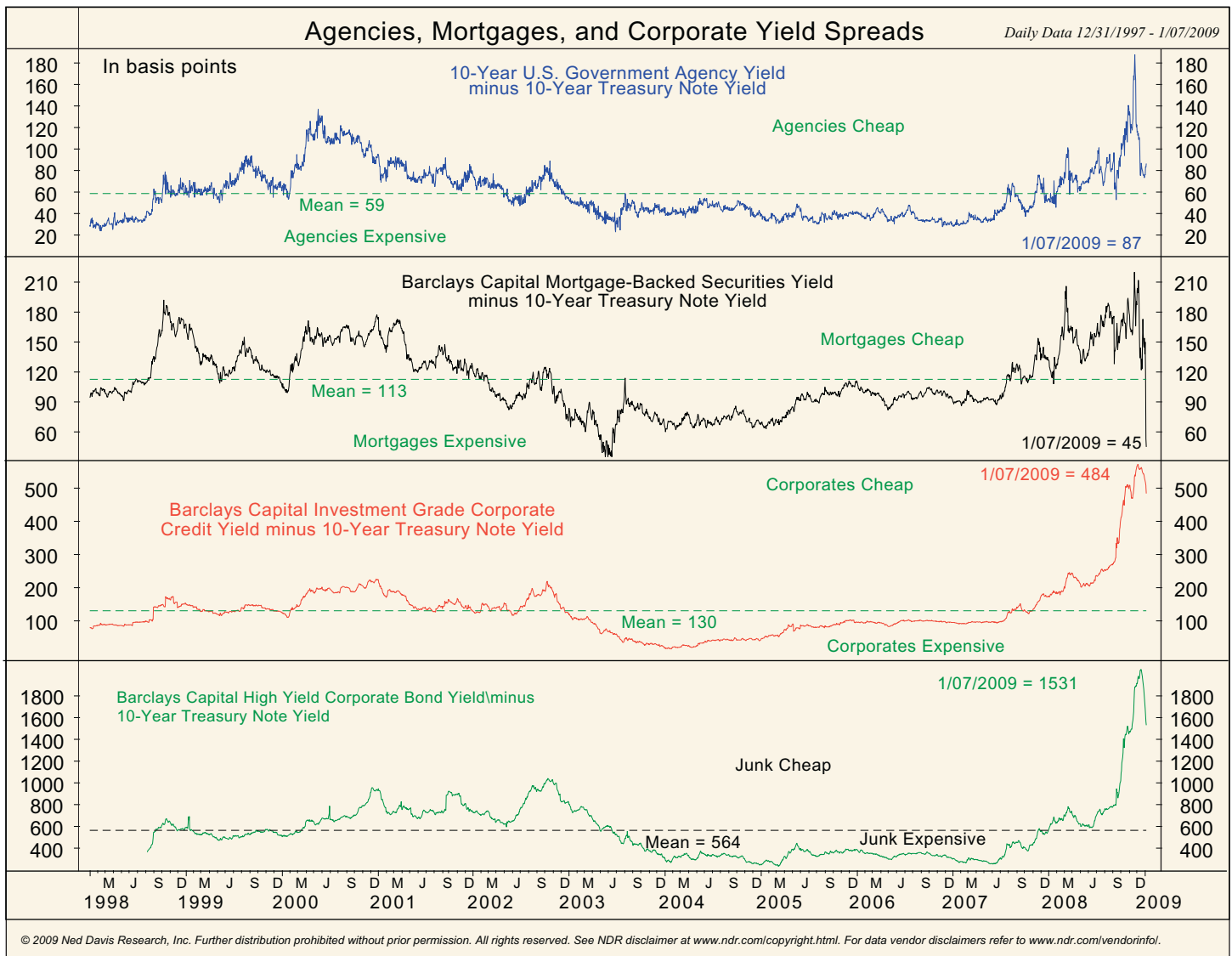
Fixed Income Review

Fourth Quarter Saw Flight to Quality

Interest rates on Treasuries decreased dramatically throughout the quarter, as bond investors were mostly interested in

buying so-called "risk-free Treasury Bonds." The rates for 10-year Treasury bonds dropped from 3.83 percent to 2.21 percent at year end, which equates to a 42 percent

increase in Treasury prices. The lowest yield recorded since the 1930s occurred on December 30 when the 10-year Treasury yield hit 2.055 percent. As a





result of this flight to quality, prices on all lower quality bonds suffered.

### Government Action to Stimulate Borrowing

On December 16, the Federal Reserve lowered the Fed Funds rate from 1.0 percent to 0.25 percent in hopes of making borrowers more active. The government stimulus programs now include:

- \$168 billion in the 2008 tax-rebate stimulus
- \$700 billion Troubled Asset Relief Program (TARP) - \$350 billion has been allocated
- President-elect Obama's proposed \$775 billion spending plan and tax stimulus
- \$25 billion in Treasury loans and aid to the automakers
- Billions of dollars in new FDIC-backed bond issuance from corporations under the Temporary Loan Guarantee Program
- \$600 billion in agency bond and mortgage bond buybacks by the Federal Reserve
- Treasury Department direct investment and aid to financial corporations and the proposed Asset Guarantee Program
- Proposed legislation to adjust mortgage loan balances in bankruptcy court
- There will be more to come.

All of these measures are beginning to have an impact on lessening the price associated with risk in the bond markets. We will not know the direct and indirect costs and benefits of these policies for some time, but are optimistic about their implementation.

As you can see on the Yield Spread chart on the previous page, the spreads on all the illustrated bond sectors have decreased significantly, particularly agency and mortgage bonds. The yield spread is the additional yield required to compensate an investor for risk that is greater than a 10-year U. S. Treasury bond. Simply stated, decreasing yield spreads signal investors are willing to assume more credit risk, which can be perceived as a positive sign for sentiment in the economy.

### Outlook is for Continued Low Rates

We expect a reversal of the Treasury flight to quality trade. In general, we expect interest rates to remain low to slightly higher for the next three to 18 months, then to move higher as economic growth prospects improve. While any concern regarding inflation has abated, deflation (a decrease in demand for goods and

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services and a general reduction in prices) remains an issue. As we noted in prior letters, deflation can lead to higher unemployment and a contraction in credit – both of which we are witnessing in today's economy.

In terms of value in bond markets, both municipal and industrial corporate bonds offer compelling valuations as investors continue to focus most of their buying in the Treasury bond sector as we have noted earlier.

As always, and particularly in this uncertain economy, we value your business and the relationships we have built with you over the years. Please feel free to call or visit with us if there are any questions or concerns that you have.

## 4th Quarter Scoreboard

Index	12/31/2008	9/30/2008	3-Mth Chg	12-Mth Chg
S&P 500	903.25	1,166.36	-22.0%	-37.0%
S&P/Citigroup Value	447.11	593.48	-23.8%	-39.2%
S&P/Citigroup Growth	450.55	567.75	-20.3%	-34.9%
Russell 2000	499.45	679.58	-26.5%	-34.8%
10-Year T-Bonds (interest rates)	2.25%	3.75%	14.2%	20.1%
Crude Oil - W.T.I. (nearby future)	\$44.60	\$100.64	-55.7%	-53.5%
Gold (Troy oz.)	\$884.30	\$874.20	1.2%	5.5%
CRB (Commodity Research Bureau) Index	229.54	345.50	-33.6%	-36.0%