Quarter Notes
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Worst Dow Since 1931

Anyone owning stocks felt the pain. So did bond holders. The Dow Jones lost more than a third of its value and the S & P lost even more, nearly 39%. Extreme volatitality made matters worse. The markets moved more than 5% in a single day 18 times.

Oil and the Dollar

The dollar rose against the Euro. After peaking near $1.60 this summer, the Euro fell to $1.25. As US interest rates plummeted, the dollar weaked again to the $1.40 level. Oil prices have dropped to under $40 a barrel after peaking this summer at more than $145.

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The Year Just Past and What's Ahead for 2009

The only good thing we can say about 2008 is that it is over. What started as a sub-prime mortgage crisis became a full-blown credit crisis, and progressed to a worldwide global recession. Stock and bond investors, even those who avoided the perpetrators of fraud and deception, experienced the worst year since the Great Depression.

There was truly no place to hide as all asset classes fell in unison. The Dow dropped 34% with the S&P off 38.5%. The small stock Russell 2000 fared no better. Some of our tactical positions, while not immune to the carnage, dampened losses, but could do little to mitigate the overall financial meltdown.

One of our clients' CPAs put it best: "We expected a hurricane, so we put up the shutters, brought in anything not tied down, inventoried water and staples, gassed up our cars, and had several days' worth of cash; then we got hit with Hurricane Andrew." No amount of preparation helped when the roof blew off.

Over the past six months, there was debate about whether we were technically in a recession or not. That question has been answered definitively. We are in a recession, probably severe and possibly enduring. The most probable economic scenario for 2009 is bleak. Predictions include unemployment rising, continued reduction in household spending, and scarcity of credit at reasonable rates. Stock and bond prices already reflect these expectations. Therefore, long-term valuations might now present better opportunities than we've seen in decades.

The average postwar recession has lasted 14 months. Even if this one is twice as long, we could be halfway through it.

Index	12/31/2008	% YTD
Dow Jones Indust.	8776.39	-33.80%
S&P 500 Index	903.25	-38.50%
Nasdaq Comp.	1577.03	-40.50%
Russell 2000 Index	499.45	-34.80%
MSCI EAFE	1237.42	-45.10%
DJ Corp. Bond Index	209.43	1.11%

For the five-year investment horizon, we believe most asset classes are now priced to deliver tempting returns, with some priced to deliver outstanding returns. We are sensitive to the emotional impact for clients of increasing equity exposure only to see more declines in the short run. There is no sugarcoating the very serious challenges to the global economy. That being the case, it is important to remember that markets almost always bottom while the conditions still look grim and fundamentals are still weak. Bull markets generally start while the bad news is still in the headlines and can be well underway while corporate earnings are still declining and unemployment is increasing. We do expect markets, which are a leading indicator, to begin to recover six to nine months before the recession ends. Waiting until it feels safe is a sure way to miss the initial recovery.

We are likely, but not indisputably, in for some significant inflation. Aggressive actions taken by the Fed and Treasury to combat recession have the potential to create inflation. Government actions from the nationalization of Fannie Mae to the latest GMAC bailout are all part of a coordinated, worldwide push by the Fed and other central banks to fight global economic slowdown. The Obama administration is committed to a massive stimulus package with investments in infrastructure, clean energy and job creation. Inflation would be a certainty if the government were competing with private entities for goods and services.

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Other Notes

Introductions: We welcome and want to introduce the new employees of Firestone Capital: administrative assistant Nanette Merino, and associates Anthony Poppe and Karen Rosen. We have expanded our capacity to serve you and future clients.

Anthony joins us from AON insurance and is serving as our coordinator of our research. He is currently working on his CFA Charter. Karen, who has spent most of her career as a corporate and securities attorney, will be a planning associate and will sit for her CFP exam later this year.

IRA RMD Rules for 2009: On December 23, President Bush signed a bill that effectively waives Required Minimum Distributions (RMDs) for 2009 from IRAs and retirement plan accounts. This affects plan participants and IRA owners who are at least 70-1/2 years old, and beneficiaries who are taking (or must take) withdrawals from retirement plans or IRAs.

But in the present environment, government demand might well be a substitute, not a competitor. In addition, concern that rising government deficits will cause inflation is offset by two important factors: the government is refinancing its debt at lower interest rates, actually reducing interest expense; and political stability makes the U.S. an attractive place for foreigners to invest, despite low yields and fluctuation in the value of the dollar.

However, we still need to prepare for an eventual up-tick in inflation. Unchecked inflation erodes purchasing power and can devastate the best financial plan. Tactical assets like commodities, metals, and real estate help portfolios keep pace in an inflationary environment. Inflation-protected bonds and short-term bonds can also be used.

We don't know what the next few months will bring, but portfolios need to be positioned for the next leg of the cycle. The markets may have already bottomed. Even if not, we view the downside risk as limited. It would be easier if we didn't have to regularly check our portfolios and could come back in five years without worrying about what happened along the way. Since we can't do that, we reiterate the importance choosing the portfolio strategy that is right for you. This means assessing your ability to endure any further market decline in the coming months. Being able to sleep at night is an important part of the equation.

How We Manage in This Environment

We use Modern Portfolio Theory (MPT) to build our investment policies. MPT is used to combine assets with different risk attributes into an optimal portfolio. Each asset type (stocks, bonds, commodities, real estate) has different fundamental characteristics. These differences help determine the risk profile. There are four types of risk that affect investments: business risk, financial risk, interest-rate (or purchasing power) risk, and market risk. During normal investment environments, including investments in each portfolio that behave differently from each other helps to distribute and "moderate" returns during various market cycles.

Our asset allocations are developed on these principles and driven by expected returns, variability of those returns, and how assets react in a portfolio together.

Since September 2008, diversification has given us little benefit as all assets moved in tandem. This is a rare occurrence that usually doesn't last long. Despite risk/reward differences, an asset is worth only as much is somebody is willing to pay for it, and recently nobody has been willing to pay much. The only recent positive return in our investment pool was government debt.

Massive deleveraging (reducing debt) is changing the world economic playing field. While each asset class retains its unique risk profile, the difference now is that investors have been shunning all risk. Anxious investors have avoided investments lacking government guarantees. Eventually, markets will stabilize and correlations will revert to historic norms. We continue to prepare our portfolios for this inevitable correction.

Planning Considerations

We recommend periodically reviewing your planning goals, and now is a good time to do so, after the asset meltdowns in 2008. While we hope that the markets will soon turn positive with a strong rally, we are not counting on that possibility to keep clients on track to achieve their goals. Now is the time to review your financial goals and be realistic in adjusting your expectations in case this recession lasts longer than hoped.

Aside from making changes to the portfolio for 2009, consider making adjustments to your personal goals or spending patterns. These are some of the actions you might consider:

- Postpone your retirement date: work a little longer.
- Reduce spending. Fewer dinners out, shorter and less lavish vacations, keep your old car an extra year.
- Adjust your life-style expectations after retirement. Snow-birding might seem desirable, but owning two homes can be quite costly.
- Temper excessive gifts to charities or family members. You can still give to them in affordable amounts, or later through your estate plans.
- Save more on a regular basis. Build up larger cash reserves for emergencies.
- For younger investors, this is a tremendous opportunity to invest at depressed levels. Maximize those IRA and 401(k) contributions now while the markets are down.