

CHAPEL HILL INVESTMENT ADVISORS

Global Investment Review & Outlook • First Quarter 2008

Fourth Quarter in Review

The year 2007 embodied investing's timeless struggle between fear and greed. Fear won. Well, it's not quite *that* simple. "Greed" held a raucous party all year long and fear twice tried to force its way in. But by the end, fear had stopped the party and greed was holding a vigil for the times that were.

Throughout most of the year investors continued their love affair with risky assets. And risky assets such as emerging market equities continued to do well. Optimism was high and was reflected in the low volatility levels in the market. But investors had all the conviction of a timid deer and rightly so. In the back of everyone's mind was the tremendous leverage in hedge funds¹ and the possibility of a self-reinforcing sell-off, should they be forced to sell.

A chart of the S&P 500 gives the impression of a market that, despite a few sharp setbacks, was working its way higher. Late February was the first setback when an overnight selloff in the Chinese stock market triggered a global sell-off. But, after 2 weeks greed reemerged and investors added even more leverage and risky assets to their portfolios.

In July and August the subprime chickens came home to roost as the first losses were reported on bonds backed by these loans. When lenders refused to fund Chrysler's² buyout it became clear that the liquidity environment had changed from too much money available to nowhere near enough – a so-called "liquidity crisis." Central banks aggressively provided funds through their daily operations, but banks kept those funds to shore up their own balance sheets; so, few loans were made and the funds had little impact on the "crisis."

The first actual losses were taken in the subprime mortgage sector as several hedge funds failed and even some normally "safe" funds revealed that they, too, had exposure to this sector. Via repackaging, subprime loans were a virus that not only infected hedge funds, they found their way into high-grade mutual funds and money market funds. No one could be sure where the next announcement would come from.

The turmoil continued through the Fall as every week seemed to bring another announcement of a big write-off. Investors headed for the safety of Treasury Bills and Treasury Bonds while non-treasury yields rose. The first signs of the long-awaited slowing in consumer spending appeared; caused by perceived job risk, declines in home prices and a sense that the whole financial system was somewhat precarious.

For all the volatility, the S&P 500 finished the year up 5.5%. Bonds reflected the flight to quality, returning 6.97%. But Treasury Bonds were the stars, finishing the year up 9.01%.

Looking Ahead

As we write this (January 24, 2008) the markets are down sharply for the year. The US economy has not started contracting but growth has slowed to ~1%. The Federal Reserve (despite its 75 basis point cut) is still walking a tightrope. They need to ease enough to keep a slowing economy from exposing the cracks in the financial system but also remain vigilant against inflation. Unfortunately, as we mentioned above, much of their easing is being sterilized as banks keep the funds for themselves. In normal times they would be making loans with these funds which would stimulate the economy.

1 As well as leverage in the whole system.

2 Given the performance of Chrysler (as a company) since then, I imagine their investors wish they hadn't been able to raise the funding at all. As their chairman recently stated "we're not technically bankrupt." Not exactly confidence-building words.

Correspondingly, interest rates for “risky” credits (like corporate bonds and consumer loans) have not fallen in concert with Treasuries. In fact, mortgage rates were at their highest since mid-2005.

Although these are not good economic conditions, the economy may possibly muddle through. All known credit problems appear to be manageable and smaller than previous credit crises. But, the unknown credit problems³ are potentially much bigger and dangerous. So we continue to advocate the same cautious stance we’ve had since the third quarter of last year.

US Equities

We continue to maintain the significant underweight that we started last fall. Valuations – on the surface – appear reasonable. But adjusting for a likely contraction in profits would push valuations into richer territory. Although equity markets could experience a sharp upward correction⁴, the drop experienced so far in 2008 will do little to sharpen investors appetite for stocks.

We continue to hold positions in the mega-cap sector as we have for several quarters. They represent better value and are more likely to weather an economic downturn.

International Equities

We’ve trimmed some exposure to International Equities. These economies are in better shape than the US but if global growth slows they will as well. Also, because their rallies have been partially fueled by US investors, there is the risk that any significant selling could bring these markets under pressure.

Emerging Market Equities

Although these economies are still growing, their stock markets are vulnerable to any large withdrawal of foreign funds. We continue to reduce our exposure to this sector. Early this year we sold the last piece of our China position (1/5 our original position). Although highly rewarding in the past, this market is vulnerable to selling by both foreign and domestic investors.

US Fixed Income

Even though treasury interest rates are very low, we are looking to possibly add some positions in both the credit and mortgage sectors. Some of these

securities have cheapened to attractive levels. Additions will, most likely, be in the form of closed-end funds which have been abandoned by most investors.

International Fixed Income

We are maintaining our exposure here. This is mainly a position that will benefit from continuing weakness in the dollar.

Emerging Market Fixed Income

We haven’t owned anything in this sector for a few years. The incremental yield these securities offered over treasuries was not wide enough to be compelling. However, we are now looking to add some positions in bonds denominated in the local currencies of these countries. Many of these currencies have been artificially held-down against the dollar and should do well if the dollar weakens against all currencies.

Inflation Hedged Securities

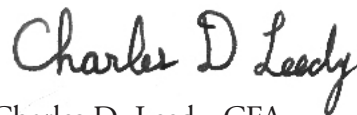
This asset class attracted increased investor interest as last year progressed. We still view the class (especially TIPS) as being attractive because we think inflation is more likely to rise than fall; and will maintain our exposure here.

Final Thoughts

It is periods like the first weeks of this year that illustrate the importance of exhaustive investment research along with thorough analysis and thinking. As one investment sage said “I spend most of my time worrying about things that never happen.⁵” It is that kind of proactive discipline that helps adjust your portfolios for storms like the one we’ve seen this year.

As always, we appreciate the confidence our clients and friends have placed in us. Please let us know if we can serve you in any way.

Sincerely



Charles D. Leedy, CFA
Chairman and Chief Investment Officer
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³ Undiscovered further sub-prime loans and credit default swaps

⁴ Bear market rallies tend to be both sharp and dramatic.

⁵ Jeremy Grantham