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Global Investment Review & Outlook • Second Quarter 2008

First Quarter in Review

As 2008 began, the themes of 2007 accelerated. Credit markets deteriorated further as investors pondered where and how big the next shoe to drop would be. Although the Federal Reserve aggressively lowered interest rates from 4 1/4% to 2 1/4%, they appeared unable to restore confidence in the credit markets. Banks continued to not lend to each other and consumer credit became tighter. Investors questioned whether the Fed fully appreciated the depth of the problem. Restoring confidence in the credit markets is extremely difficult. Developed World central bankers met in March to try to determine what, if anything, they could do to restore confidence.

Finally, in late March, the Fed was provided with an opportunity to show their strength. Bear Stearns had run out its credit lines and was unable to liquidate enough assets to pay back their lenders. It was a good old fashioned "George Bailey" run on the bank. Bear had no choice but to call the Fed, who arranged the shotgun purchase of Bear by JP Morgan. Why did this matter to creditors?

> JP Morgan has a very strong balance sheet which gave Bear's creditors much more confidence in the likelihood of being paid.
>
> The Fed agreed to absorb some of the most problematic mortgages, enabling JP Morgan to keep them off their balance sheet.

This action was crucial to the markets for two reasons. First, it showed that the Fed really did understand the seriousness of the credit situation. And second, the Fed would not allow a large financial intermediary to default on it's loan obligations.[1] "Armageddon was off the table."[2] . This was a huge relief to the credit markets. Yield spreads[3] did narrow somewhat from their excessive levels.

Although Global Equity markets rebounded sharply after these developments, it was not enough to erase prior losses for the quarter. Domestically, large-cap stocks[4] lost -9.5% small-caps[5] lost -9.9%. Internationally, developed market equities were down -8.8% and emerging market equities were down -11%. There was no place to hide[6]

The markets that did reasonably well were fixed income and currency markets. Domestic bonds were up 2.2%. International bonds returned 8.5% for the quarter, mainly due to foreign currencies rallying against the dollar. The Japanese Yen, for example, rallied 13.2% against the dollar.

1 Bear's stockholders, as you may know, were virtually wiped out. One top executive's fortune, which had been $1 billion several months ago, was now worth $13 million.
2 John Authers, Financial Times, April 7,2008
3 "Yield spread" refers to the difference in yield between a risky bond and a risk-free (treasury) bond.
4 Standard & Poors 500
5 Russell 2000
6 There were some notable rebounds in specific homebuilding stocks but I'm not sure I'd want to take that bet.

6320 Quadrangle Drive, Suite 310, Chapel Hill, NC 27517
Phone: (919)401–3500 • Email: Cleedy@ChapelHillAdvisors.com• Web: www.ChapelHillAdvisors.com

Commodity markets continued to rally. Especially notable were foodstuffs as shortages started developing in the third world. "This years cereals crop will be 1.66 billion tonnes, the largest on record and 89 m tonnes more than last years harvest, another bumper crop. That the biggest grain harvest the world has ever seen is not enough to forestall scarcity prices tells you something fundamental is affecting the world's demand for cereals."[7] Unfortunately even small production shortfalls can have large effects. Already there have been scattered food riots in Asia, Africa and South America.[8] With the price of oil remaining high and ethanol plants consuming large quantities of corn, it is very likely that the global food situation -and correspondingly inflation – will only worsen.

Looking Ahead

Although Global Equities have rebounded somewhat we remain tepid on their outlook. Yes, the credit markets dodged a huge bullet but there still are large unrecognized losses out there.

The economy continues to slow, and it's difficult to see the forces that would lead to a rapid rebound. Housing, the cornerstone of individual wealth, is still declining. Consumers entered this recession highly leveraged and they now need to rebuild their balance sheet. In addition, it's hard to get people to spend when they are out of money and really need to save. Corporations hold a lot of cash and could conceivably take up the slack. However, that's unlikely because corporations base their spending plans on the outlook for business. Right now the outlook is not positive.

US Equities

We had dramatically reduced our overall equity exposure last Fall to preserve the gains we'd enjoyed and protect you during this period of extreme market volatility. This served us well in the first quarter. We recently added back some exposure but remain significantly underweight.

Our exposure remains concentrated in the mega-cap sector: this sector lagged the S&P 500 in the first quarter but our research is driving us to the mega-cap sector because we believe their valuations are attractive and they will be best able to weather an economic downturn.

International Equities

We remain underweight this asset class as well. These markets are still attractive and should receive some cushion from their domestic economies. We did add back some exposure but remain underweight.

Emerging Market Equities

We had gradually reduced our exposure over the past year. This sector was down -11% in the first quarter which, given the historic volatility of these markets, was actually very impressive. Normally, given the loses in developed market equities, we would have expected a much worse performance.

One of our perennial favorites, China, was down 30%. Although we haven't owned any positions in China for quite some time, we think the valuations are not unreasonable and, while volatile, the risk/return tradeoff is now more favorable. We anticipate adding some exposure back to China.

7 Garrit Buntrock, The Economist, December 6, 2007

8 To quote Charles Dickens: "Annual income twenty pounds, annual expenditure nineteen nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery." David Copperfield (1850)

US Fixed Income

Although interest rates remain very low, we have started to add some positions in higher quality bonds. We added some municipal bonds to our taxable portfolios. Longer-dated municipal bonds have become very attractive due to problems in the short-term market. In fact, many municipal bonds enjoyed tax-exempt yields that were higher than those of taxable treasury bonds. This is a rare occurrence, therefore one we wanted to take advantage of for out investors.

We anticipate adding some exposure to the agency mortgage-backed market for our tax-exempt accounts. The yield spreads are very attractive and the credit quality is very good.

Inflation-protected securities (TIPs) still make up a significant portion of our portfolios. Although their price has rallied they still nominally yield more than fixed-rate treasuries and will provide a hedge against inflation.

International Fixed Income

We are maintaining our exposure here as the long-term fundamentals for the dollar are negative. Our yen-denominated bond positions recently matured. They had performed very well, returning 12.8% for the first quarter and 17.8% since we purchased them in July of last year. We are looking for an opportunity to replace them.

Emerging Market Fixed Income

Our accounts have not held any positions in this sector for several years as we felt the yield advantage over other bonds was unattractive. Now, it appears that the fixed-currency regimes of many of these countries are nearing their termination point. These countries have huge inventories of US Dollar securities and the costs of maintaining a peg to the dollar have increased significantly. Thus we anticipate adding some exposure this sector and, correspondingly, to their currencies.

Absolute Return

This strategy continues to provide both solid returns and diversification for our portfolios. We don't anticipate any major shifts in weighting.

Final Thoughts

These, of course, are more difficult times than usual. Our forward-looking research had raised these concerns for us this past summer. We will continue to maintain a diversified portfolio; both to dampen volatility and preserve value. In addition, we are diligently researching the markets and looking for opportunities where they exist.

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

Charles D. Leedy, CFA
Chairman and Chief Investment Officer

April 14, 2008