

April 3, 2008

RE: First Quarter 2008

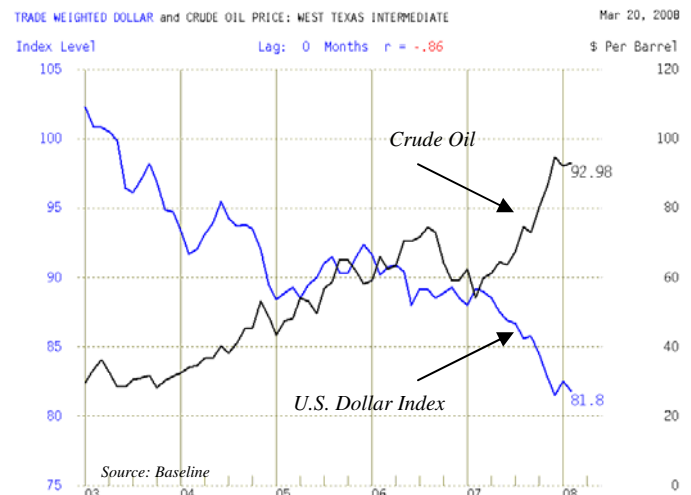


Webster's Dictionary defines the word "volatile" as "likely to change suddenly". In 2008, the equity market looks like a living representation of this definition. Consider the action in the Dow Jones Industrial Average over a period of nine trading days in March – "Dow up 416, Dow down 215, Dow up 420, Dow down 293, Dow up 262." If legendary Chicago Cubs announcer Harry Caray were calling this game, we would hear a big "Holy Cow" coming from the press box. Considering the investment professionals at Greenwood Capital average over 22 years in investments and related fields, with select individuals going back over 30+ years, we have seen many different types of markets, but the past several weeks and months have been some of the most tumultuous we can remember. One of the factors that create volatility in the marketplace is uncertainty, and no one would argue with the fact that there is plenty of that to go around. So where do we go from here? We want to cover a few topics, including the answer (at least our answer) to that question in the letter this quarter. In addition, we will provide some timely discussion on diversification and also follow up on a few things we mentioned in our correspondence over the past several quarters.

Let's start with the latter. We talked last quarter about the financial crisis typically associated with Federal Reserve tightening cycles. While at the time we had tentatively penciled in "Subprime/Housing" as the crisis this time around, the Bear Stearns collapse will probably overshadow that more generic phrase when the history books are written. Certainly the housing downturn played a significant role in the troubles at Bear, but a stock plunging from \$60 to \$5 in a week is too good of a poster-child for the financial media to pass up. If indeed the Bear Stearns episode marks the culmination of the financial meltdown that started last year, the irony that it all started with a seemingly isolated event at two Bear Stearns hedge funds should not be overlooked. Perhaps this is a bit of poetic justice. Of course, it is a little easier to ponder Bear's eventual place in history since we did not own the stock, but rather owned the acquirer, JP Morgan, whose stock rose smartly, even as the financial system seemed on the brink of disaster; but we digress. We believe that this incident is significant, in that it may (and we stress may) mark the bottom for a market that has seen more than its fair share of false dawns in the past few months. Don't mistake a bottom for a decrease in volatility, but perhaps we can start to work higher off of what was clearly one of the more harrowing weeks for financial markets in the past 20 years.

Another factor that supports a potential bottom for the equity markets is the aggressive action taken by the Federal Reserve. We commented in our outlook for 2008 that the Fed needed to do something sooner rather than later to get the credit markets moving again. I guess they were listening, because 15 days from the date of our letter they shocked the market with a surprise 75 basis point interest rate cut on January 22, 2008. The Fed's actions then and over the past several months, including its most recent meeting in March, should ultimately start to flow through the monetary system and help the economy stabilize in the second half of 2008. Stocks today are trying to discount that outlook, but investors are just not sure they believe it yet, hence the volatility in the market.

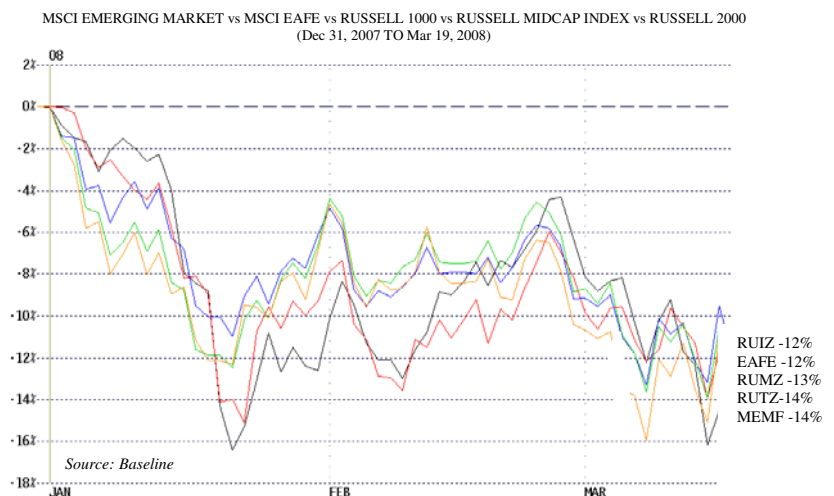
There are several ramifications for both debt and equity markets if in fact this outlook for economic stabilization becomes clearer in the months ahead. There is a chain of related events that would help equity markets. First, the Fed would be able to stop lowering rates which should in turn stabilize or even strengthen the U.S. Dollar (can you imagine that). We believe this would have the beneficial impact of lowering commodity prices, perhaps dramatically, as they have run-up on the weakness in the U.S. currency. As an example, see the chart at right on the inverse relationship between the U.S. Dollar and Oil. Falling commodity prices should help the inflation outlook which will help valuations of U.S. stocks rise. So to summarize – the economy stabilizes, Fed stops cutting rates, dollar rises, commodities collapse,



inflation cools, stocks go higher. If only it were that simple. Now for fixed income markets, the upshot of this scenario is that corporate bond spreads, or the risk premium associated with owning corporate bonds over Treasuries, should start to narrow. As our head of fixed income, John Wiseman, detailed in the newsletter, we are starting to selectively buy corporate bonds in lieu of Treasuries anticipating this event. So to sum up our thoughts on the markets, despite an incredible amount of bearishness out there, we think we can start to work higher in the second half of the year in stocks and we are starting to put some of the cash we raised in the fourth quarter of 2007 back into the market.

So far we have followed back up on some topics we highlighted in previous quarters and we have given you our outlook for where we may go from here. The final topic we wanted to touch on is diversification. Understanding how to properly diversify a portfolio must take more into consideration than what did well the last year. A truly diversified portfolio must be developed with an understanding of how various assets perform in isolation and in a portfolio context. Ultimately, the correlations of the assets in a portfolio determine its diversification benefits, and like most things in the markets, those correlations change. We are very considerate of these factors in developing portfolio strategies and understand that true diversification is meant to reduce the risk of a portfolio while optimizing its return potential.

Unfortunately, many practitioners in our business have sold “diversification” as a way to simply enhance your returns. While their “type” of diversification may lead to higher returns, it is more related to increased risk in the portfolio not true diversification. The graph below demonstrates how major equity indices, whether large-cap (RUIZ), mid-cap (RUMZ), small-cap (RUTZ), developed international (EAFE) and emerging international (MEMF), are all moving together. This is occurring as the correlation of these major indices are reaching significantly positive relationships. An example of an asset that is not highly correlated with the equity markets is the 2-year Treasury bond which is up over 3% this year and has a negative correlation to stocks. While there is absolutely nothing wrong with having a variety of different equity styles in a portfolio, in fact we offer these portfolio strategies today to our clients, it is very important to understand how a properly diversified portfolio is developed, implemented and maintained.



We know that this has been a very stressful time for investors and we are here to serve you in any way that we can. While we certainly do not enjoy these types of markets, we would also tell you that these are the times that Greenwood Capital’s conservative style of management stands out. We are exceptionally proud of how our accounts have held up in these markets. In addition, our bond portfolios have provided much needed relief from stocks’ downward trend.

Sincerely,

The Greenwood Capital Investment Team

Philip Bell, Will Bond, Cheves Boyce, Bill Harper, Ashley Sherman, John McAlhany,
Michael Nix, Walter Todd and John Wiseman