



January 8, 2009

RE: Fourth Quarter 2008

In the worst stock market year since 1931, who would have thought we could have a top headline for the year that didn't really have to do with market performance. I am sure many of you have been following the saga of Bernard Madoff and the "\$50 billion Ponzi scheme" that has unfolded over the past month. Not only have hundreds of individuals and charities alike lost billions of dollars, but the very foundation of trust in the financial markets has been badly shaken by this news. It is very unfortunate that individuals like Mr. Madoff can put a black eye on an entire industry the way he has done.

This situation highlights the importance of knowing your advisor and how your money is being managed. To put a twist on a quote from Winston Churchill – however beautiful the results, you should occasionally look at the strategy. In point of fact, a major warning sign in this situation was the unwillingness of Madoff and his team to meet with clients and discuss the strategy used for generating the returns he reportedly did for his clients. At Greenwood Capital, we pride ourselves on our accessibility and client service; it is what distinguishes us from our competitors in the marketplace today. We recognize that it is more important than ever, in these difficult markets, to keep the lines of communication open and we look forward to talking to you in the near future.

Moving on to more scintillating topics, let's talk about economics for a minute. Ok, so maybe scintillating is not the correct adjective here, but economic policy and theory are foundations for the recovery we hope will unfold this year. Now, for those of you that are not familiar with British economist John Maynard Keynes, you are about to get a crash course. In his seminal work, *The General Theory of Employment, Interest and Money*, published in 1936, Mr. Keynes theorized that certain microeconomic measures taken by businesses and individuals might result in macroeconomic circumstances where the economy produces below its potential growth rate (translated – recessions sometimes happen). During these periods of below average growth, Keynes argued that aggregate demand for goods and services could be insufficient, leading to unreasonably high unemployment and losses of potential output. In such situations, Keynes contented that government stimulus could be used to increase aggregate demand, thereby improving economic activity, and reducing unemployment and potential deflation. Seems rather applicable to our situation today don't you think.

Keynes reasoned that the solution to these economic slowdowns was to stimulate economic activity through the use of fiscal policy tools, including: (1) lower interest rates (*A big check next to this one – 10 year yields at 2.40%, Fed Funds Rate at 0% to 0.25%*); and (2) government investment in infrastructure. The infusion of income from this government spending would create a multiplier effect in the economy where more spending would stimulate more production and investment which would create still more income and spending – you get the idea (*This is coming in a big way in 2009 with the new administration's plan*). So according to Keynesian theory we are doing what we need to do to get out of this mess. While there are certainly long-run implications to the actions being taken today, Keynes would say that "the long run is a misleading guide to current affairs. In the long run we are all dead." In other words, deficit-spend in the short-term to manage the economy through the recession and then keep inflation in check during the good times by increasing taxes or reducing government spending in the future (*Let's all hope the new*

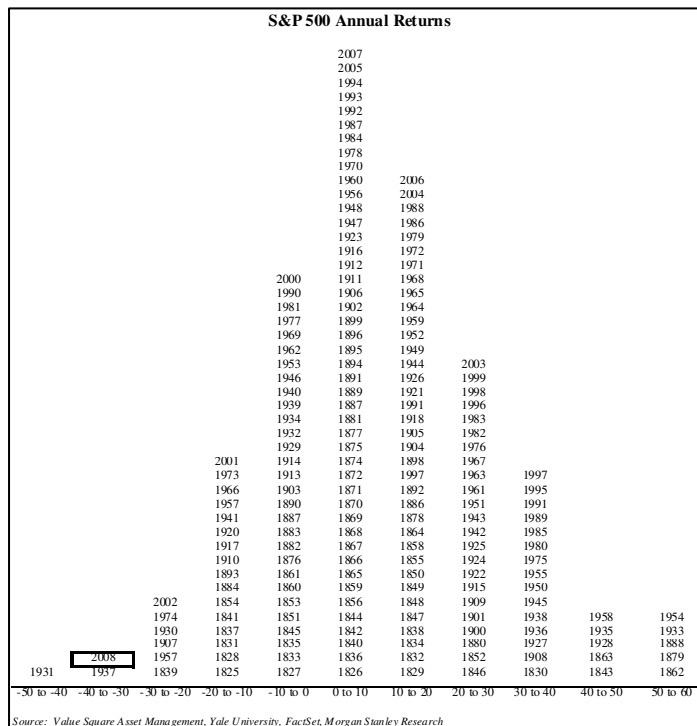
administration remembers this critical piece of information about reducing spending in the future). Admit it, this is exciting stuff, but alas we must move on.

With this background on the policies that are being deployed right now, let's focus on evaluating what exactly happened in 2008 and what 2009 might hold in store for investors. Webster's Dictionary defines an investor as one that commits money in order to earn a financial return. Sounds fairly simple in theory, but 2008 proved to be a difficult year for even the savviest investors to "earn a financial return." A year that through three quarters could be described as challenging turned into a disaster as a confluence of policy mistakes and economic forces combined to create the worst calendar year stock performance since 1931. No doubt that fingers will be pointed in every direction for years to come regarding the market collapse in September and October, but if you had to focus on one event that started the cascade of financial unraveling look no further than the bankruptcy of Lehman Brothers in mid-September. Whether one looks at the reaction in the stock market, credit derivatives, bond yields, etc., that Monday morning on September 15, 2008 seems to be the turning point when things went from bad to worse.

Back to our friend Mr. Keynes, he reportedly said once that "if you owe your bank a hundred pounds, you have a problem. But if you owe a million, it has (one)." In the case of Lehman, it owed banks and other institutions not millions but hundreds of billions of dollars, and these firms indeed had problems. In retrospect, the decision by our esteemed Treasury Secretary and Fed Chairman seems a bit arbitrary. After all they had saved Bear Stearns in March and just two days after Lehman failed they bailed out insurance company AIG. But I can imagine Mr. Paulson and company using a one liner from Keynes in response to the criticism – "When the facts change, I change my mind. What do you do, sir?" No question the facts were changing fast and furious this fall as policy makers responded to one crisis after another. It almost seemed for a while that every Monday morning we would be greeted with the latest "financial armageddon" du jour.

Ladies and gentleman, we are not here to sugarcoat what has happened. We have experienced unprecedented volatility and market stresses. The U.S. economy is about to finish what will most likely be the worst quarterly GDP performance in over 25 years. The first quarter of 2009 will likely not be much better.

But I'm probably not telling you anything you don't know already and that's the main point here. The equity market, through its precipitous decline in 2008, has discounted a dismal economic picture. The market is actually up over 15% from the lows reached in late November. History would support the notion of a move higher. As the chart above illustrates, with the exception of 1930 and 1931, each year where the



Source: Value Square Asset Management, Yale University, FactSet, Morgan Stanley Research

market fell more than 20% was followed by an up year. In fact, in 5 out of 6 of these periods, the following year was up more than 20%. Now, I'm not saying a +20% year is in the cards for 2009, but I do believe we are headed higher from current levels. Although this move up will probably not be in a straight line as most of us would like.

The bond market is another story entirely. While stocks have been grabbing the headlines for their volatility, the action in the bond market has been equally as extreme. Yields on Treasury securities have fallen dramatically in the past several months as we have witnessed unprecedented flight to safety, with yields on 90-day treasury bills only slightly above 0% (see chart below). This has occurred as we are likely to witness one of the largest issuances of U.S. debt in history in the coming year to fund the many spending initiatives outlined by the current and new administration. While some would argue that with the current deflationary scare these moves to lower yields make sense, we would tell you that these are levels that are unsustainable and therefore likely to move higher in the coming months. This would actually be a welcome sign as it would mean that investors are moving out of ultra-safe investments into more risky, longer-term assets. We have started to see some of this recently with yields rising slightly and the stock market posting its best annual two-day finish in history, up nearly 4% over December 30-31, 2008.

While the first day of trading in 2009 continued this trend, it's hardly the time to sound the all clear bell. To use a technical investment phrase, there's a lot of wood to chop between now and December 31, 2009.



Sincerely,

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