

GREENWOOD

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Insights



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The Stock Market

Writing about the stock market this quarter, I kind of feel like a preacher at a funeral - I am supposed to be here to provide comfort and support, but it's awful hard to do. While the stock market is not dead, it sure seems to be experiencing cardiac arrest on a regular basis these days. To state the obvious, the volatility we have seen over the past month is truly unprecedented. And if anyone tries to tell you they've seen this type of market before, stand back because their nose is going to start growing fast. It really boils down to one factor right now and that is supreme uncertainty. Famed investor Benjamin Graham once said that "most of the time common stocks are subject to irrational and excessive price fluctuations in both directions as the consequence of the ingrained tendency of most people to speculate or gamble... to give way to hope, fear and greed." It's safe to say that most investors have given way to fear at this point. Graham also famously stated in 1934 that "in the short run, the market is a voting machine, but in the long run it is a weighing machine." Tying the two comments together, investors are fearful now and in the short run are "voting" with their feet. By the numbers, the quarter was the worst since the third quarter of 2002 with the S&P 500 and Russell 1000 Growth Index both falling over -8%. Specifically, the S&P 500 was down -8.9% (-8.4% including dividends) and the Russell 1000 Growth was down -12.8% (-12.5% including dividends). Year-to-date both indexes are down over 20%. International stocks were hit even harder with the widely followed international EAFE index down over -18% for the quarter and -29% for the year.

From a sector perspective, there was really no place to hide in this market as previous safe havens found in Energy and Materials in the first half of the year gave way to the selling pressure. These two sectors, along with Utilities were the worst performing for the quarter, down in excess of -25%. Not surprisingly, the traditional defensive sectors of Healthcare and Consumer Staples fared best, with each eking out small gains during the three months ended September 30, 2008. You might be

shocked to know that Financials and Consumer Discretionary sectors actually did relatively well over this time period despite the headlines, falling in the mid-single digits. Year-to-date, Financials are still among the bottom sector performers, it's just that the rest of the market seems to be catching up (in a bad way) with what started in this sector.

To try to summarize what was a very difficult quarter, as the credit crisis has deepened, it became clear to the market that damage was being done to the real economy as a result, not only domestically, but around the world. Whereas the market traded in the first half of the year as if this would be a shallow slowdown or recession localized in the U.S., with Materials, Energy, Industrials and other global economically sensitive areas holding up, investors have recognized this is not the case. So the market is adjusting to this new reality. I certainly don't want to sugar-coat the challenges ahead for the economy and the market, but we are starting to discount these factors so that hopefully we can build a base and move ahead in a positive manner and return to those nice boring days of the Dow being up 40 or 50 points. Amen to that.

The Bond Market

The 3rd Quarter proved to be a very constricting period for the credit markets. The events highlighted in the Economic section of this letter sent investors running for the (perceived) safest and most liquid investment - short term Treasury Bills. So much so, that we briefly saw a negative yield in this investment (i.e. - paying the government to invest in a Treasury Bill). All fixed income instruments other than US Treasuries were under pressure. Corporate bond indexes were lower by -4% to -8% on the quarter with the financial sector providing most of that negative performance. We will look for opportunities in the corporate sector, but there is still much work to be done to ease the credit crisis. We will remain properly diversified in the fixed income area.

Municipal bonds remain “cheap” relative to other fixed income investments. The economic environment is certain to reduce tax revenues so credit selection will be of utmost importance. As always, we analyze the underlying credit rating focusing on general obligation and essential service revenue bonds. Special investment vehicles as well as insurance companies with policy holders in the areas affected by Hurricanes Gustav and Ike are having to sell municipals to raise cash. This presents an opportunity for us.

Economic Outlook

No time to panic but when will it end? Will we sink into a severe recession or will we rebound as the Federal Reserve (Fed) and the Government step in to prop up the financial system? Nobody knows the final outcome but whatever happens we will have a different economy with the Fed and Government assuming a greater role as both owner and/or regulator of many businesses.

Adam Smith, the father of economics, wrote in the Wealth of Nations that as each individual pursues his or her own self interest, the economy as though being led by an “invisible hand” would achieve the greatest good for all. The concept of the “invisible hand”, which forms the foundation for capitalism, has given way in the financial sector to the concept that “greed is good”. The lenient interest rate policies of the Greenspan years fostered greed in the pursuit of making money. Credit was easy to obtain and investment decisions, especially in real estate, moved from investments based on fundamentals and common sense to ones based on the expectation of a quick profit – greed.

The real estate bubble was fueled by the anticipation that the value of the real estate would continue to appreciate without interruption, thereby allowing for the sale of the property or the ability to refinance at more favorable rates and even withdraw some equity. The end result was a bubble which exploded when prices stabilized and began to decline. Without the continued increase in prices, buyers were faced with mortgages that adjusted to higher interest payments and the value of the property fell below the debt on the property. Unable to refinance, buyers were forced into foreclosure. As foreclosures accelerated, the holders of these mortgages were faced with huge write-offs and a declining capital structure; the beginning of the financial crisis.

Government ownership of our financial institutions is not the direction in which a capitalist system needs to move, but the current breakdown demands that a change in the way financial institutions operate has to be made. Without intervention, we could experience a major worldwide recession. The multi-billion dollar rescue plan being debated as I write this review along with policy changes already in place do provide an avenue for the financial institutions to dispose of some their worthless assets and allow for the survival of the strongest. We have already witnessed the demise of several firms including Bear Sterns, Lehman, Indy Mac, AIG, Washington Mutual, Fannie Mae and Freddie Mac. Ultimately, these mergers and/or acquisitions will allow for a stronger financial system to emerge; a system that will be able to provide the capital, at reasonable rates, needed by our businesses and industries to survive. The future will tell whether the system that emerges with more government regulation and ownership will be better. However, it is our belief that not taking any action now would be far worse.

Even though confidence in our overall financial system has been shattered, we fully anticipate that the economy will avoid a major recession. Consumer confidence has fallen but the consumer still has purchasing power, and industries, other than financials, are still doing okay. Energy prices are also falling and this will give some relief to both consumers and businesses and help buffer the weakness. It will still take some time for the economy to work through the current crisis, but we will emerge in a stronger position.

Market Indicators

	YTD 2008 Total Return¹	52 Week Total Return²
S&P 500	-19.29%	-21.98%
DJIA	-16.60%	-19.86%
NASDAQ	-20.64%	-21.92%
RUSSELL 1000	-19.48%	-22.10%
RUSSELL 1000 Growth	-20.46%	-21.07%
RUSSELL 1000 Value	-18.86%	-23.57%
RUSSELL 2000	-10.38%	-14.37%
MSCI EAFE	-28.93%	-30.14%

- 1) Through 9/30/08
- 2) 9/30/07 – 9/30/08

Source: Bloomberg



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