

4th Quarter 2008

Portfolio Insight

As we close out the year, 2008 will be remembered as the worst year for investors since 1931. Global markets in stocks, non-Treasury bonds, real estate and commodities all posted terrible returns. The subprime mortgage problems of 2007 metastasized into a full-blown credit crisis in 2008. A self-reinforcing negative cycle of financial institution writeoffs, credit default swap blowouts, hedge fund redemptions, forced selling of financial assets, and consumer retrenchment all contributed to the deleveraging process. The global financial system delivered this shock around the world and the reverberations have brought us to the brink of a synchronized global recession.

The National Bureau of Economic Research (NBER), charged with determining the onset and end point of U.S. recessions, this month declared that the U.S. officially entered a recession

“2008 will be remembered as the worst year for investors since 1931”

in December 2007. The U.S. has suffered 12 recessions since the Great Depression. The two longest lasting of these were the 16-month recessions of 1973-75 and 1981-82. Using NBER's dating, the current recession is already close to the duration of those downturns. History suggests that NBER will likewise declare a post-dated recovery and equity markets will anticipate an economic recovery roughly two quarters before the official declaration of the end of the recession.

The ultimate duration and magnitude of recessions are never clear except in hindsight. We think the proactive response from the Federal Reserve and the Troubled Asset Recovery Program (TARP) administered by the Treasury will aid in recovery. Whatever critiques we may have of U.S. Federal Reserve chairman Bernanke and his predecessor Alan Greenspan in creating asset bubbles, we believe that Bernanke is well suited to the policy challenges of a deflationary environment. He earned the nickname “Helicopter Ben” from past discussions of how aggressive the Fed could be in combating deflation. Accordingly, Bernanke is using “quantitative easing,” an extreme policy

measure where the central bank purchases long-dated bonds to lower long term rates. When the economy recovers, the Fed will need to restrain monetary growth or run the risk of stoking inflation. However, with the effects of deleveraging and asset price declines, the near-term inflation risk may be muted.

POLITICS

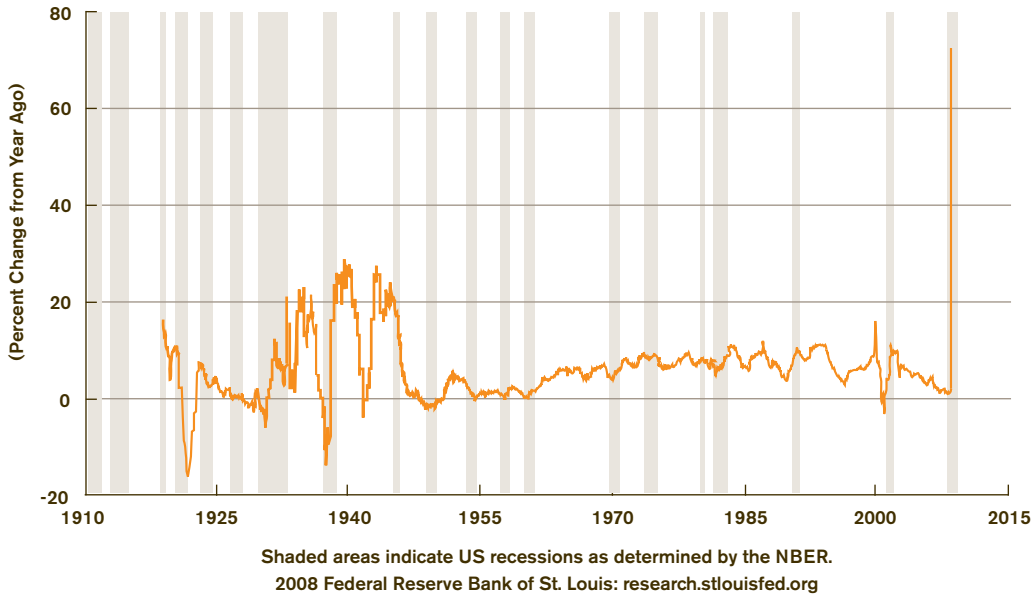
President-elect Obama's recent economic appointments appear more moderate than pre-election rhetoric might have indicated. We believe that Obama's recent appointments of selected Hamilton Project members is positive, and the equity market reflected its favor of this centrist view with its rally during the last week of November. We previously addressed policy implications of the Hamilton Project in our newsletter from Q4 2006: “...its strategy is a call for fiscal discipline; increased public involvement in key growth-enhancing areas such as education, innovation, and infrastructure; and encouraging personal financial security through increased savings and social insurance.” We are encouraged by the centrist and pragmatic appointments of Timothy Geithner, Lawrence Summers, Peter Orszag and Paul Volcker, among others, to Obama's economic team.

ASSET CLASS REVIEW

An old Wall Street saying is that the only thing that goes up in a bear market is the correlation between asset classes. In other words, when an investor most needs the diversification offered by international stocks or corporate bonds to offset the losses of domestic equities, the benefits of diversification often disappear. This year has not been an exception with miserable returns in lower-rated corporate bonds, convertible bonds, international equities, and REITs as well as U.S. equities. Even the lower rungs of investment-grade bonds show stress. According to Societe Generale's equity strategist “...the yields on Baa-rated bonds are pricing in an environment akin to the 1930s with the spread between Baa corporate bonds and treasury bonds ~550 basis points vs. just over 700 basis points at the depths of the Depression.”

By contrast, U.S. Treasuries have seen panic buying and three month treasury bills recently reached a price

ST. LOUIS ADJUSTED MONETARY BASE (AMBNS)



which measures expectations of volatility conveyed by S&P stock index option prices. We recently witnessed the second-highest value for this measure on October 24, 2008, when intraday, the VIX reached 83.5. The all-time high for this measure occurred after the 1987 Crash, when the VIX briefly hit 172. These extreme values compare to an average of approximately 20 from 1990 through 2008. In previous periods of market stress, each of the VIX spikes above 50 proved to be solid buying opportunities.

EARNINGS

Although the stock market has gone nowhere over the past decade, S&P 500 earnings have grown at a 4% annualized rate since 1998. As seen in Fig. 3, earnings grew above trend in 2005 to 2007, and the current recession will keep estimated earnings growth below trend for 2008 and 2009.

Fig. 2

Source: Federal Reserve Bank of St. Louis

historic perspective, since 1950 the S&P 500 has had 157 days during which the index was up or down by more than 3%, or about 1% of all trading days. Since September 2008, the S&P 500 has had 37 days during which the index was up or down by more than 3%, almost 50% of trading days. A widely used measure of volatility is the CBOE Volatility Index® (VIX),

The earnings decline from the peak in 2007 is predominantly driven by the financial sector woes. Looking ahead, earnings declines for 2009 are partially driven by lower energy company earnings. To put the magnitude of the decline in perspective,

S & P 500 QUARTERLY EPS TREND (Earnings from Operations)

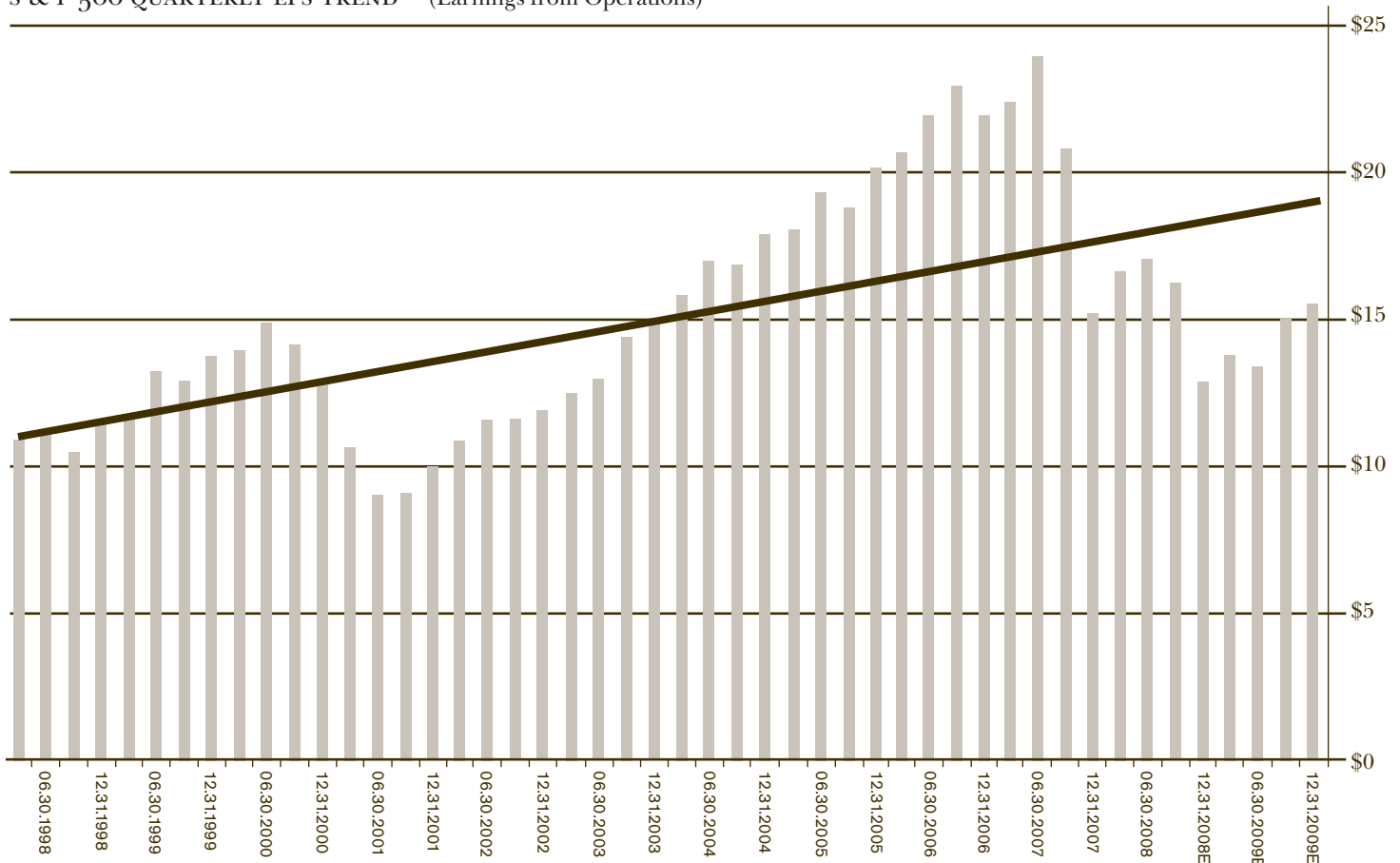


Fig. 3

**S&P 500 COMPOUND ANNUAL RETURNS
BY DECADE**

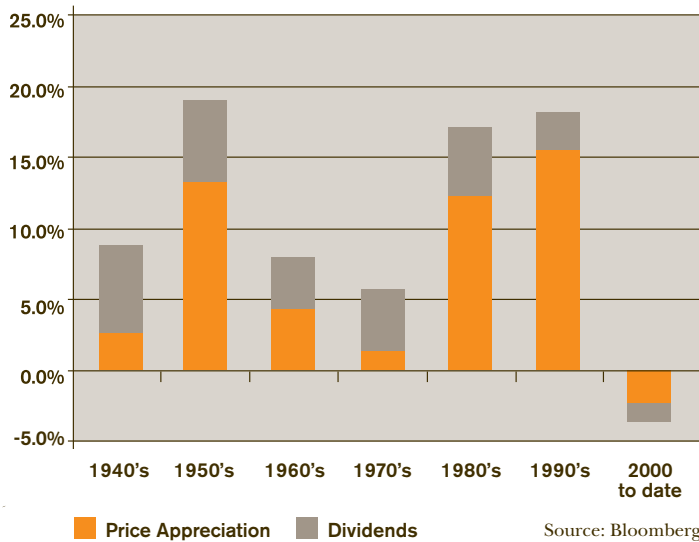


Fig. 4

WORST TEN-YEAR PERIODS IN THE PAST 100 YEARS & SUBSEQUENT TEN-YEAR ANNUAL EQUITY RETURNS		
Year	Prior 10 Year Annualized Return	Next 10 Year Annualized Return
1920	1.3 %	12.8 %
1938	-0.8%	7.1%
1974	1.2%	14.4%
2008	-1.0%	?

Fig. 5

Source: Bloomberg, Stifel Nicolaus

the combined *decrease* in 2009 estimated net income for ExxonMobil, Chevron and Conoco exceeds the *total* estimated 2009 net income for General Electric, Proctor & Gamble and Cisco Systems combined.

DIVIDENDS

Because dividends have risen with earnings and stock prices have declined, the dividend yield of the S&P 500 (3.3%) now exceeds the yield of the 10-year U.S Treasury Note (2.5%) for the first time since late 1958. The market's current dividend yield matches the average dividend yield from 1946-2001. *Fig. 4* shows that prior to the 1990s, dividends played a major role in supporting total equity returns. Today's higher dividend yields will provide a greater source of total return for equities and are an indication that equity markets are more attractively priced.

MARKET PSYCHOLOGY

The headlines are littered with negative news as companies continue to lower expectations, layoff workers and reduce capital expenditures. Accordingly, fear, uncertainty and doubt dominate investor sentiment. This is evidenced by the increased volatility, high levels of cash on the sidelines, lower equity valuations and also by investor allocations. A recent study by Hewitt Associates found that the allocation of 401k plans invested in equities was at an all-time low of 53.8% compared with 74.2% in 2000. Today, it appears as if investors have low return expectations for equities because they recently have lost money in equities. In 2000, investors expected high returns because they had previously enjoyed high returns. Sentiment is often more important than valuation in determining short-term returns, but the converse is true with respect to long-term returns. As seen in *Fig. 5*, isolating the four absolute worst ten-year periods over the past 100 years, investors have enjoyed a more positive experience in the subsequent ten-year period.

OPPORTUNITY

The Chinese character for "crisis" is comprised of the characters that represent the concepts of "danger" and "opportunity." At Chilton Capital Management we believe the same dualistic thinking applies to the present investment environment. While timing the absolute bottom in equity prices is a fruitless endeavor, we will continue to adhere to our strategy of seeking high-quality companies at reasonable prices. We continue to focus the bulk of our effort on identifying companies with: (1) unique products or technological innovations; (2) pricing power and unit growth; and (3) defensive balance sheets.