



HIGHLAND ASSOCIATES

QUARTERLY MARKET REVIEW

February 2009

Investors' mettle was tested again in the 4th quarter of 2008. Markets' September struggles intensified in October and early November before rebounding through year end. December's positive momentum waned in the early weeks of 2009 as the economic picture worsened and experts remained at odds over the length and depth of the current downturn. Some argue that the economy is in a normal cyclical downturn, while others recognize that unlike past financial crises, the current crisis is one both within the system and of the system. In addition to the economic turmoil generated by the bursting of dual bubbles in real estate and credit, the system has been stressed to unprecedented levels. After September witnessed the takeover of 7 major financial institutions including the government takeover of Fannie Mae and Freddie Mac, 2 European institutions, and the end of the independent investment banking model, the 4th quarter saw the largest bankruptcy in history (Lehman Brothers), the largest bank failure in history (Washington Mutual), and the largest Ponzi scheme in history (Madoff \$50b). Encouraging economic news has been rare, and the US government appears poised to utilize its entire arsenal of both traditional and nontraditional policy tools to stem the current crisis.

Government Intervention

To combat a worsening liquidity crisis and economic decline during the 4th quarter the Federal Reserve cut its target Fed Funds rate to essentially 0%. To date the Fed along with the Treasury has embarked on a variety of measures to restore liquidity and confidence to the system.

Chart 1

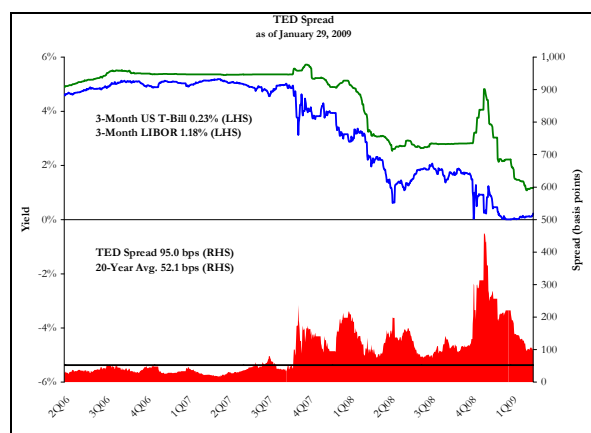
Government Policy Response

- > **Economic Stimulus Act of 2008**
 - \$168b in tax rebate checks
- > **Emergency Economic Stabilization Act of 2008**
 - Troubled Asset Relief Program (TARP) \$700b
 - Capital Purchase Program \$250b to recapitalize banks
- > **FDIC Temporary Guarantee Program**
 - Applies to "all newly issued senior unsecured debt issued by eligible entities on or before 6/30/08" and provides coverage on any maturity until 6/30/2012
- > **Commercial Paper Funding Facility (CPFF)**
 - Fed to purchase unsecured commercial paper to stabilize short term funding market. \$1.5tr of CP estimated to qualify
- > **Temporary Guarantee Program for Money Market Mutual Funds**
 - \$50b from Exchange Stabilization Fund
- > **IRS to allow greater loss recognition when banks acquire other financial institutions**
- > **SEC relaxed fair value accounting rules under FAS 157**
- > **Fed Funds Target lowered by 400 bps to near 0% in 2008**
- > **New Fed Lending Facilities:**
 - Term Auction Facility (TAF)
 - Term Securities Lending Facility (TSLF)
 - Primary Dealer Credit Facility (PDCF)
 - Expanded USD swap agreements with foreign central banks
- > **Money Market Investor Funding Facility**
 - Allows money market mutual funds to setup structured investment vehicles underwritten by the Fed
- > **Term Asset-Backed Loan Facility (TALF)**
 - will purchase \$200b of ABS collateralized by consumer loans

Source: Sterling Capital Management

Recent measures have been somewhat successful in stemming the global liquidity crisis that gripped the markets in 2008. The TED spread (the spread between the 3 month LIBOR rate and the 3 month T-bill yield) reflects the improving liquidity picture, narrowing to 95bps at Jan 29 versus 456 bps on Oct 10, 2008. (See Chart 2 below).

Chart 2



As a new administration takes office with the specter of a harsh economic recession looming, a massive economic stimulus package approaching \$1 trillion now seems likely. House Democrats recently passed an \$825 stimulus package including spending and tax cut measures aimed at jumpstarting the economy. The effectiveness of any government policy response or stimulus package will ultimately rely on restoring the confidence of both borrowers and lenders, reversing the wave of job losses, and the end of asset price declines (houses, stocks, etc...) John Maynard Keynes' so called "animal spirits" of entrepreneurship and capitalism, must return to facilitate the flow of capital back into the markets and reinvestment in economically stimulating endeavors.

US Economic Update

In December, the National Bureau of Economic Research (NBER) finally "officially" recognized that the US economy is in a recession that began in December of 2007. Third quarter GDP was surprisingly strong at only -0.5%, but contracted sharply (-3.8%) in the 4th quarter. The 4th quarter decline was less than expected, but was cushioned by inventory buildup. Absent the positive impact of increasing inventories (which may suggest lower output in coming months) GDP contracted 5.1%. The jobs picture remains grim. Over 2.5 million jobs have been lost, and December's 524,000 jobs lost was the worst monthly loss since 1974. The headlines are filled news of job cuts often reaching the thousands, many at America's blue chip companies. Even outside the financial sector, Caterpillar, IBM, Home Depot, Alcoa, Pfizer, and Motorola have all announced plans to eliminate jobs. Circuit City's bankruptcy,

alone could result in 30,000 lost jobs. According to the Bureau of Labor Statistics (BLS), mass layoffs (impacting more than 50 workers) totaled 2,275 in December, (more than 226,117 total jobs). For the year, layoff events jumped to 21,137 (the highest since 2001) from 15,493 in 2007. The unemployment rate stood at 7.2% in December up from only 4.9% a year earlier. Further increases are likely as the economy continues to slow and corporations reduce their workforce. It is unlikely that the economy will be able to recover until the employment outlook improves given the negative impact of rising unemployment on consumer confidence and spending, which represents more than 2/3rds of US GDP.

Inflation versus Deflation

Through the 2nd quarter of 2008, the threat of high inflation driven by rising commodity prices appeared to be a growing economic threat. Consumer prices spiked 1.1% in June, the 2nd fastest pace since 1982. However, with economic growth coming to a relatively abrupt halt in the 3rd quarter and contraction in the 4th quarter and foreseeable future, commodity prices fell dramatically. After peaking at nearly \$150 in July, crude prices ended the year near \$40 per barrel. With the Fed moving to a near zero interest rate stance, and the prospects for an extended US downturn, the concern has turned from inflation to fears of a deflationary spiral, at least in the short term. Whereas inflation reflects a period of rising prices, deflation is characterized by falling prices. Consumer prices dropped 1.7% in November, the most since record keeping began in 1947. At the surface, falling prices don't necessarily seem harmful. Consumers would seemingly benefit and consumption might even be spurred. However, deflation can occur within a systematic evaporation of liquidity. In an inflationary environment, borrowers repay

loans with money that is worth less (in terms of purchasing power) compared to a deflationary environment where borrowers repay lenders with dollars that are worth more than those they borrowed. This serves as a deterrent to corporations who would otherwise borrow to fund expansion plans, invest in plant and equipment, acquisitions, or other expenditures which serve to advance the economy through the reallocation of capital in both product and labor markets. Wages and asset prices in turn, suffer. The last sustained period of deflation in the US was during the Great Depression. While the odds of a severe deflationary environment in a modern economy may seem slim, Japan serves as the modern deflation case study. Since the Japanese real estate and stock bubbles burst in the late 1980's, the Japanese economy has struggled. For the better part of the 1990's, deflation was prevalent in Japan. Even more recently, low interest rates have failed to stimulate the Japanese economy. The ten year government note yield fell below 50 bps in 2003 and short term rates hovered around 0% for several years. It wasn't until 2006, that the Japanese economy began to show improvement.

With the Fed funds target rate now at essentially 0%, the Fed has turned to using its balance sheet to stabilize the credit markets and enhance liquidity. With easy monetary policy and huge injections of capital, inflation is likely the more prominent long term threat to the US economy.

Rapid increases in the amount of money in the system often exert upward pressure on price levels as more money chases the same or fewer goods and services. The impact of the government's policy response to the current economic crisis on money supply is shown in Chart 3. M2 is a measure of total money supply, including checkable deposits (M1) and savings and other time deposits. At this point, the government's strategy is directed at re-flating the economy with massive amounts of stimulus while recognizing the long term threat of inflation. The assumption is that the Fed can more effectively address that threat once the crisis has been abated.

Chart 3



Source: US Federal Reserve Board

Market Update

Fixed Income

T-bill yields followed the Fed funds rate to zero, even turning negative for a brief period during the quarter. The continuation of a global flight to quality and aversion to risky assets pushed the Barclays Treasury Index up 8.8% for the quarter and 13.7% for 2008. Spread sectors all trailed dramatically for the year. Investment grade corporates were up 4% for the quarter but down 3.1% for the year. High yield bonds were off nearly 18% in the 4th quarter and 26% for the year. High yield had its worst month ever in October, losing 16%. Agency backed mortgages rebounded in the last half of the year to post an 8.3% return for 2008, trailing only Treasuries among index sectors. Overall, the Barclays Aggregate

Bond Index gained 4.6% for the quarter and ended the year up 5.2%.

There are some indications that conditions in the credit market are improving. The Barclays Aggregate posted record excess returns over Treasuries in December. In the first two weeks of 2009, corporate issuance was \$80b; the second highest two week period since 1993. (Source: Ned Davis Research) High quality corporate yields remain at attractive levels relative to Treasuries, with AA spreads at about 335 bps over Treasuries as of Feb 2 down from a peak of 491 bps in 2008.

Equity Markets

An ugly 4th quarter brought a brutal year in the stock market to a close. During the quarter, the S&P 500 fell 21.9%, ending the year down 37%. The 5 year annualized return for the S&P is now -2.2%, and the 10 year annualized return is a disappointing -1.4%. The only positive news was the late year rally that drove the S&P 500 up nearly 20% off the November 20th lows. However, the momentum faltered in January and year to date as of Jan 30th the S&P is down approximately 9%.

The latest corporate earnings season has been abysmal. According to NDR, "2008 saw an all time record miss in Wall Street projected earnings, even operating earnings that leave out the bad stuff. Operating earnings \$65 vs \$102 estimates a year ago. Actual GAAP earnings are just \$46 for the last 12 months...Why earnings estimates were too low in 2004-2007 and too high now? Leverage." At December 31, the S&P 500 Price /Earnings ratio stood at 19.6 according to Standard & Poors. Most valuation measures that utilize normalized or peak earnings, imply that currently stocks are undervalued, but not extremely cheap in a historical context. It should be noted that there is little empirical evidence that

annual stock returns have any correlation to annual corporate earnings growth. Stocks can trade both above and below prices levels implied by fundamental valuation for many years in some cases, but eventually fundamentals do matter. Additionally, even the most severe historical long term bear markets have encompassed huge rallies. The outlook for the stock market and the economy is cloudy at best, and investors should expect a market characterized by sharp reversals and high volatility.

Alternatives

Hedge funds continue to endure an extremely challenging environment including record stock market volatility, regulatory intervention, investor withdrawals, and now an alleged fraud of epic proportions. The HFR fund of fund composite dropped 9.6% for the quarter (-21% for the year) compared with a 10.6% loss (-19.1% for the year) for the fund of fund conservative index. For the year, convertible arbitrage (-34.4%) and emerging markets (-36.7%) were the worst performing strategies while macro (+3.7%), merger arbitrage (-1.2%), and equity market neutral (-3.4%) were the best performers.

The well publicized multi-billion dollar Ponzi scheme orchestrated by Bernard Madoff cost investors billions of dollars and cast a pall over the entire industry. Investors are left questioning the legal, regulatory, and accounting professions in the wake of such a far reaching fraud involving such a staggering amount of money. Clearly, investor confidence in the industry has been shaken. Concerns have only been exacerbated by the widespread invoking of gates and limited withdrawal provisions preventing investors from exiting their hedge fund investments.

It is important to recognize that fraud risk is not limited to hedge funds, or even

investing. Fraud risk exists in all aspects of our lives. Being defrauded carries with it the emotional sting of feeling foolish and exploited, in addition to the financial loss. In hindsight, most scams seem obvious, leaving many to wonder how anyone could have been so naive. Certainly the press coverage of the Madoff situation has implied that defrauded investors should have seen this coming. Interestingly, though, after several weeks, details of the whole scheme remain sketchy. Regulators, lawyers, forensic accountants, etc...still don't have a clue where the money went or how a fraud of this magnitude could have even been carried out. A successful fraud is by definition well concealed, and in this case even the benefit of perfect hindsight has yet to produce solid evidence of what actually took place.

Highland has always recognized that fraud risk is unfortunately a reality of hedge fund investing, and recommended our client access the strategies through a hedge fund of funds vehicle in order to achieve diversification among managers and draw on fund of funds managers' expertise and due diligence in selecting underlying hedge fund managers. While some of the funds of funds we utilize have been impacted by frauds and hedge fund blowups including Madoff, losses have been limited to both the fund of funds and ultimately our clients because of the level of diversification afforded by prudent allocation decisions across the portfolios.

Returns in the commercial real estate market had remained largely isolated from the recent credit crisis and dramatic declines experienced by many asset classes until the fourth quarter. The NCREIF Property Index was down 8.3% to finish the year down 6.5%. A 9.5% decrease in property values overwhelmed a 1.3% income return during the period.

Property values declined sharply across all property types and geographic regions. Commercial real estate will likely face a more challenging operating environment going forward, along with rising cap rates and downward pressure on property values. Preliminary returns for the NCREIF Fund Index reflected a -11% net return for the quarter. (Note: The NCREIF Property Index (NPI) is made up of 6,287 properties valued at over \$300b and reflects property level performance on an unlevered basis. The NCREIF Fund Index –Open End Diversified Core Equity (ODCE) is comprised of 26 open-end commingled core real estate funds. Leverage is present at the fund level and reflected in the index return.)

In the public market, REITs were hammered during the quarter as the NAREIT index dropped 38.8%. The index was basically flat year to date through September 30th but ended the year down 37.7%.

Portfolio Reflections

Diversification is a powerful yet not fool proof approach to risk mitigation in a portfolio. Diversification is generally effective at addressing security specific risk, but cannot protect against common risks shared by securities or asset classes. To the extent they are linked, in any way, asset prices are potentially positively correlated, yielding diversification less effective. For example, stock portfolio diversification is often achieved through position size limits, sector limits, and even country or region allocation guidelines. This approach results in a portfolio that is perhaps well shielded from company, industry, or country specific risks, but to the extent a broad market decline like we saw in 2008 occurs, a stock portfolio, no matter how well diversified, will see sharp losses.

The concept also applies to asset class diversification in periods of extreme capital or financial market stress. The common denominator across investment markets is cash (or liquidity). Investors hold risky assets in lieu of stable, liquid cash positions with an expectation that they will be compensated for taking the additional risk. Under normal conditions, cash tends to be somewhat frictional in nature. Cash facilitates flows of funds among asset classes or securities based on relative valuations or investor sentiment. Generally speaking, cash balances are relatively small and temporary. However in a crisis, investors retreat to the most safe, liquid assets (typically US Treasuries). Cash balances balloon as risky assets are liquidated, but the proceeds are held in cash, and thus not redeployed back into the system. Cash is therefore extracted and not redistributed, driving prices down simultaneously across asset classes. When large pools of money are invested alongside one another in a variety of asset classes, and a liquidity crisis unfolds in which those investors are forced to liquidate entire portfolios at the same time, correlations also increase because of the economic link established by the common ownership across investors'

portfolios. The old investment maxim "correlations go to one" refers to the phenomenon whereby asset class correlations rise, directly undermining the concept of portfolio diversification. The mathematical truth is that for diversification to be effective, correlation between investments must be at or near zero and they must remain stable. Unfortunately, correlations are not stable and tend to rise when investors flee a security, industry, region, asset class, etc. That increase in correlation undermines even the most mathematically sophisticated diversification strategies. The result is that when investors need the protection offered by traditional diversification the most, it is the least effective. The implications for portfolio construction are (1) models are simply not capable of quantifying risk prospectively because of the reliance on historical inputs, (2) strategies must be tempered with common sense and prudent judgment, and (3) true diversification must look beyond traditional methodology to identify economic links among securities or asset classes.

Additional Sources:
Ned Davis Research (NDR)
Google Finance
Wall Street Journal
US Federal Reserve Board
Bureau of Labor Statistics (BLS)
JP Morgan Asset Management
Wilshire Compass