The Rikoon Group
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Winter Commentary 2009

Overview

2008 was a year unlike any since the Great Depression. It was the Dow Jones Industrial Averages' worst year since 1931, and the broader based Standard and Poor's index of the 500 largest U.S. stocks were down 38.5%, the most since 1937.

There was no place to hide. Usually, when stocks are going down, commodities such as oil and gold go up. In 2008, commodities plunged the most in 50 years as demand for energy, metals and grains tumbled because of the accelerating worldwide recession.

Real estate prices for single family homes continued to plummet as the credit markets and lending froze up. For the first time in decades U.S. consumers cut back on their spending pushing retailers, automakers, and home builders to the brink of bankruptcy. Emerging markets, formally alternative engines of growth for the world's economy, withered on the vine.

In response, governments and central banks worldwide stepped in and injected massive amounts of newly minted money into the banking system. The U.S., England, Germany and Japan, the four horsemen of the world's economy, all stepped in to rescue their largest commercial, retail and mortgage banks. This took place due to the orgies of unwise lending activities the banks engaged in over the last five years.

In unified step, the main financial institutions of the developed world's economy reduced their interest rates as close to zero as has ever been done. Governments worldwide have pledged massive amounts of spending on public projects in order to take the place of waning private investment. The great hope for 2009 is that these measures stimulate the developed world's economies, preventing unemployment from spiraling upward and deflation from spiraling downward out of control.

The Markets

Volatility was the name of the game in 2008. In the Fall, the U.S. stock market indexes enjoyed two of the six largest one day percentage gains in its 113 year history while it also suffered their worst one week decline ever. Investors in hedge funds saw the rules of the game change midstream as these supposedly astute investors closed their doors and prohibited withdrawals while the markets were in free-fall. Hedge funds typically use borrowed money to make large bets, and when these bets failed in 2008, they contributed

to the selling pressure that saw U.S. stocks lose 8.4 trillion dollars in value between October 2007 and the end of 2008.

Overseas, rapidly worsening economies and a wave of potential bankruptcies kept European markets under attack for most of the year. U.S. investors may not realize it, but they faired better than most of their international counterparts. The German DAX Index tumbled 40.4%, while Britain's loss of 31.3% was its worst record since the index was created in 1984 (how Orwellian!). Ireland's stock market fell 66% while the overall European index, comparable to the S&P 500 in the U.S lost 46%, a record annual loss. The European stock market is back now to price levels of early 1997, effectively wiping out a decade of investment returns. Japan's stock index was down 42%, its worst ever showing, while China and Russia tumbled more than 60%, punishing neophyte investors in those countries. Russia's currency was also in a free-fall, as officials decided to shut down that stock market entirely several times during the last quarter of 2008.

European economies are likely to experience their sharpest slowdown since WWII. Germany and England are expected to shrink by two percent in 2009. The countries in even more dire straights, countries such as Greece and Italy could well buckle under the weight of their economic troubles, much as Iceland did during 2008 when it prohibited depositors from withdrawing money from Icelandic banks.

The U.S. dollar gained in 2008, contrary to the expectations of many investors. Why? Investors worldwide looked for a safe place to put money, and the relative safety of the U.S. Dollar and U.S.Treasury Bonds was appealing, even though the interest rate paid on them was basically zero. The dollar weakened against the yen as Japan's fiscal conservativeness bolstered its appeal during 2008 against all other currencies.

In the bond area, the U.S. Federal Reserve cut its key interest rates seven times in 2008, from 4.25% at the start of the year down to .25% by the end of December 2008. This created opportunities for investors in U.S. Treasuries to gain from appreciation even though they saw their interest rates decline. All other bonds, U.S. corporate, municipals, mortgage and high yield debt, all saw their prices decline. 2008 was the worst year in history for high yield or lower quality corporate bonds. The investment grade corporate bond index lost (6.62)% while the municipal bond benchmark index lost approximately (0.5)%. The Rikoon Group's performance versus the benchmarks is available upon request.

Going forward, the U.S. Treasury has committed hundreds of billions of dollars to restore order to the credit markets. It has essentially backstopped short-term money markets around the world in an effort to re-establish consumer confidence.

A common theme here is that the markets worldwide all had experienced a huge boon due to the government sanctioned use of easy credit. Demand for all assets was up due to international growth of money, and the expectation that the party would continue indefinitely into the future. As demand for industrial commodities dried up midyear due to a weakening world economy, oil and most materials started their free-fall in the

opposite direction. Oil dropped from a high of $145 a barrel on July 3rd, down to $33.87 a barrel on December 19. The Goldman Sachs analysts had predicted that oil would reach $200 a barrel by the summer of 2010.

So, what lessons have been learned? Governments have now seen the harm speculators cause when they are left in charge of setting prices. We are likely in for greater regulation and increased controls on the markets. This will hold true not only for oil but for other commodities, stocks and bonds as well.

Commodities are back to their 2002 levels, so inflation is no longer a concern for central banks or investors. Are stocks, measured by traditional valuation yardsticks, a great bargain? Perhaps, but they have only just fallen below their long-term ratios. Since equities were above the long-term ratio for 18 years, it is possible they will spend a good long time below their appropriate valuation levels.

Outlook for 2009

Is it true that the market is likely to go up after having such a bad year in 2008? Generally speaking, after most really bad years in the past, there have been substantial recoveries in the averages. However, after the Dow's worst year, 1931, when blue chip stocks fell 53%, it fell again in 1932 by another 23%. It wasn't until 1933 that the Dow went up and then it exploded an astounding 67%! Similarly, at some point in the not too distant future the great hordes of cash sitting on the sidelines will pile back into the U.S. stock market.

Investors worldwide are looking to their governments to take action in order to stabilize the economy and reignite activity in the credit markets. The most likely result will be deficits never before seen in their magnitude. The price of precious metals, such as gold, will eventually reflect the fact that all this debt will inevitably take the form of inflation. In addition, unchecked money creation will also lead to a long-term decline in the value of the U.S. dollar.

In 2009, we will see continued downward pressure on real estate markets. Currently, 1 in 10 homeowners with a mortgage is either in foreclosure or seriously delinquent on their payments. Government programs have had little success in stemming the crisis. Evidence of this failure is that more than half of the mortgage loans which have been modified to date are already more than 30 days overdue. The $300 billion program that is supposed to be administered by the Department of Housing and Urban Development has not gotten off the ground because most banks refuse to take the losses on their books which would be required under this program.

The next mortgage shoe to drop will most likely be homeowners with adjustable rate resets in 2009, as well as commercial real estate, particularly office building, hotels, and shopping malls. Declining occupancy rates will start to have an effect on companies who need to refinance. No one knows the size of this gaping hole, but the holders of commercial real estate are generally not individuals but companies, pension funds and college endowments. Individual investors who want real estate in their portfolios

generally use a type of stock called REITs. These fell 40% during the last three months of 2008 alone! How much further will commercial real estate drag down the overall market is difficult to know. To what degree will the government step in and help out this beleaguered industry is also largely unknown. The size of this next potential bailout will be another political football.

What else is likely to happen in 2009? The U.S. government will need to rescue more banks and the automobile companies will be in trouble continuously. As the Federal Reserve has already reduced interest rates to almost zero, we will see new methods of stimulating the economy being tried out. Government involvement in industry will increase. U.S. consumers will finally look at their own balance sheets and try to pay their way out of debt. It is interesting that the right thing to do for an individual, i.e. paying off debt, is generally negative for the economy as a whole. The new administration will direct an increase in bank lending activities, and this will be the first sign of a stock market upswing.

Most investors are wondering how Bernard Madoff got away with his $50 billion hoax. This unfolding scandal should be an important lesson to people that those who fail to conduct due diligence are eventually punished. Fortunately, our clients have not suffered at all from the Madoff affair. Below is an article I recently published on the subject in Santa Fe's local paper, The New Mexican.

Our prognosis for the markets has some bright spots. We believe there are a few large US corporations that have extremely good business outlooks and those who participate in the infrastructure boom about to be unleashed by the new administration will be good places to put money. Because fear still holds sway over the credit markets, we believe that some corporate and municipal bonds are cheap. This is one of the main areas of opportunity in 2009. States such as CA and NY are in severe straits due to declining tax budget shortfalls. We do not believe that any state will go bankrupt, subsequently creating another investment opportunity. We are enthusiastic buyers of certain kinds of municipal bonds while the states broadcast their woes. Behind a state's credit rating are large amounts of natural resources and real estate holdings which could be used to pay off creditors in the event of default.

To recap, in 2008 we saw many major financial institutions worldwide effectively go down the tubes. Some were bought out by competitors with the help of government aid and some were directly bailed out by government injection of money. Government intervention was required to keep global capital markets functioning. 2009 will likely see some emerging market economies collapse. There will be calls for increased help from the International Monetary Fund, which will not be able to cope with the crisis without active participation by the oil exporting nations and China. The fire is not over or out.

Here in the U.S., our recession will be deeper and more protracted than any since the 1930's. We expect it will last through the end of 2009 and into 2010. U.S. equity markets, however, will likely experience a strong rally well before the actual economy turns up. Worldwide, the global recession will create a period of falling prices and deflation, as demand for imports on the part of developed nations will stay way down.

This will severely impact the exports on which the rest of the world depends. Rising unemployment will produce political instability and governments will need to take action to stave off unrest. U.S. consumers will start to save, which will create onerous conditions for many governmental entities that rely on tax collection for funding their operating budgets. The governments will need to resort to directly buying securities in the open market. To keep order, they will end up participating to an astonishing degree, in many "free" markets. The excessive debt taken on by consumers in residential mortgages, credit cards, auto loans and student loans will be subsidized by the government.

The decline of the hedge fund industry will lead to continued downward pressure on the stock market as credit losses continue to mount in early 2009. Solutions that require rapid government intervention and coordinated central bank action will stave off a depression, but many players in the market, especially those who have used borrowed money, will effectively go bust. 2009 will be a year of painful news. Investors will do well to look for investment opportunities that are created by the public's fear of massive defaults, which we do not believe will actually happen. It will be a long time before confidence in the stock, bond, real estate and commodities markets comes back to the level of the early 2000's. Expect stops and starts, bear market rallies, and frustrating developments. We wish the outlook was brighter for more people, but the way out of the current malaise will take a long time to fully root.

In times like these, there are opportunities to make money, particularly in individual stocks, bonds and countries whose economies and markets are resilient due to local demand. As we enter 2009, it is important to find individual investments as opposed to relying on broad-based indexes or mutual funds. We believe that true diversification, independent verification of financial reports, a cash flow emphasis, achieving tax efficiency, and integration with a solid individual financial lifestyle is the key to weathering this storm. Stay tuned!

Reprinted below is a recent article I published in the local Santa Fe newspaper, **The New Mexican:**

For those of you who don't know Bernie Madoff, let me assure you he is a good guy. He gives money to charity, loves his family, and helps his fellow professional financiers regulate themselves. In the words of my bubba (Jewish grandmother), he was a "mensche".

Turns out Bernie is also a pathological liar, one of a large cadre of salespeople whose sole genius is being able to schmooze. These are people we often respect, even idolize. These are the hedge fund guys that made a billion dollars in 2007, the managers of America's financial empires, the road warriors who help raise money for cities and states.

Now that we are teetering between a recession and a depression, let's put Bernie alongside his compadres: U. S. Treasury Secretary Paulson, former Merrill Lynch CEO

Stan O'Neal and his successor John Thain, and a myriad of other bankers, lawyers, politicians, regulators and local Santa Fe real estate magnates. They all are running a racket, taking the public's money and parlaying it into fortunes for themselves. Curious how few women are in these ranks.

Bernie has confessed to running a Ponzi scheme, where early investors get paid with later investors' money. Shame on him but shame on investors who put money in a brokerage firm with the same name on it as their advisor. No checks or balances there. If someone promises returns above CD rates with no fees or risk and you believe them, double shame. If it sounds too good to be true, then …?

Insurance company annuities, real estate partnerships, anything with guaranteed higher than market returns sound good but these promises are never fulfilled. Our government is pledging 750 billion for banks and mortgage companies, 50 billion for car companies, 1000 billion for infrastructure . All seem like good ideas, but who is going to pay for them in the end?

The biggest pyramid money ruse scheme in history is not Bernie Madoff's. The charities and universities and rich people who lost their life savings with him should have known better. Much bigger, and yet to come to light, is the debasement of the American dollar and the sale to foreigners of America's assets at wholesale prices that will be the result of the current policy of unlimited government bailouts.

The money lie we seem unwilling to face is that we cannot fix our problems by continuously borrowing from the future. The old fashioned remedy for being in the hole is hard work, not more debt. Bernie Madoff will go to jail for taking from new clients to satiate old ones. Perhaps some bankers, politicians, and captains of what otherwise would be failed enterprises should suffer a similar fate?

Personnel News

Rob: The holiday season was much welcomed as my two daughters, Robyn and Hannah, came from the East Coast to visit. We had a snowshoe adventure together which was cold, but not as cold as some days this past month when I foolishly ventured out to above 10,000 feet in elevation to do some cross country skiing! Robyn has landed a regular guest role on an upcoming ABC television series about the New York Police Department called "The Unusuals". Stay tuned for more details.

Juliana: The end of 2008 has been uneventful with only one quick trip to Flagstaff~ via the train. It was lovely to see and watch the New Mexico/Arizona scenery and to appreciate the benefits of public transportation.

Jeff: We built a greenhouse in the backyard this fall and so my wife has planted all kinds of greens that she says we will be able to harvest throughout the winter. Stephanie and I are excited that we will start skiing with her school program in a couple more weeks. Our dog, Tulip, is now 10 months old and weighs 60 pounds. I think, hope and pray that she

has finally stopped growing. We call her a "collabrador", as she seems to be a mix of collie, labrador, and other stuff.

Patricia: I am putting together another Young Investor newsletter. Things have been very busy this last half of the year and the latest edition had to be postponed. Look for it soon in your mail or e-mail. As we move further into the winter, I am planning a summer vacation this year in the Northern Colorado Rockies. Let me know if you know of any good camping spots up there.

Emily: I enjoyed the holiday season, visiting with family and seeing high school friends. While I haven't played much tennis since the weather has turned, I hope to get back into the "swing" of things before long. I recently undertook a few house projects, starting with a Marimekko poppy flower inspired bathroom.

Dana: The holidays were busy with family comings and goings. I've recently begun volunteer work with a local hospice group and continue with a weekly Vedic Chanting class…om shanti om!

LOCAL TEA & CALL-IN DATES:

Our upcoming tea will held on Thursday, February 5, at the Ghost Ranch Conference Center in the Perea Room at 3:30 p.m. and 6:00 p.m. These stimulating roundtable discussions are a favorite with our local clients who are invited to bring interested guests.

The following Tuesday, February 10th, will be our quarterly telephone conference call where people around the country pose challenging questions to Rob. They may be submitted via email to rrikoon@aol.com, either before or during the call.

Please join us on February 10th at one or both of the following two times: 3 p.m. and 6 p.m. (Mountain Time). If you can let us know that you are on the line, it would be much appreciated! The call in number for both sessions is: 218-936-4700 and the Access Code is 425993#.