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A Review of 2008 and Outlook for 2009

by Ashi Parikh, Jim Keegan and Rick Nelson

2008 will be remembered as one of the most difficult investment environments in the post-war period following the popping of the greatest credit bubble in modern history. The themes that dominated the financial markets were: de-leveraging and forced selling; risk aversion; the most dramatic re-shaping of the U.S. financial system since the Great Depression; and investors' focus of return of capital rather than return on capital. The Federal Reserve and the U.S. Treasury resorted to unprecedented activist/ interventionist measures to stave off a potential financial Armageddon. The Treasury/ Fed have already committed upwards of $8.5 trillion to the financial system in one form or another. The Fed has put its balance sheet and the creditworthiness of the U.S. at risk as it has been transformed into lender, owner and financial guarantor of first and last resort. Some of the largest financial institutions have collapsed, been merged into other companies or are effectively controlled by the government (Bear Stearns, Fannie Mae, Freddie Mac, Lehman Brothers, Merrill Lynch, AIG, Washington Mutual and Wachovia). The government also took stakes through preferred stock investments in several banks throughout the U.S.

The U.S. is in the midst of the most severe housing bust in 70 years, the greatest financial crisis since the Great Depression, a deteriorating employment outlook and the worst fiscal outlook ever while having been through an oil shock earlier this year and 40% collapse in the value of the U.S. dollar. The credit/ financial contagion has spread to the real economy and there is now a synchronized global economic contraction unfolding. The National Bureau of Economic Research officially declared the recession in the U.S. started in December 2007 so this recession is already longer than the average recession (11 months). We have been of the view that this consumer-led contraction would be longest and deepest in the post-war period.

EQUITY MARKETS

Most investors entered 2008 with at least some trepidation given the strains already evident in the financial system in 2007, but few expected the relentless challenges that hit the economy and financial markets. The initial stages of the recession had a mixed impact on the equity markets. While S&P 500 lost 10% in the early weeks of January, the

Index	3Q08 Return	Oct 1st through Dec 4th	YTD
S&P 500 (Large)	-8.37%	-27.11%	-41.17%
Russell Midcap (Mid)	-12.91%	-35.05%	-47.72%
Russell 2000 (Small)	-1.11%	-35.12%	-41.85%
MSCI EAFE (International)	-20.56%	-27.54%	-48.74%
NAREIT	5.55%	-48.89%	-49.53%
Lehman Aggregate	-0.49%	1.99%	2.64%
Citigroup 1-3 Year Treasury	1.71%	2.41%	6.35%

markets rebounded as the Federal Reserve continued cutting interest rates and Congress quickly passed a "timely, targeted, and temporary" stimulus package intended to stabilize consumer spending. Moreover, U.S. exports were increasing at a near 20% rate, which provided some support to the economy and stock prices. Consumer sectors in the equity market briefly returned to levels seen at the beginning of the year and commodity-related stocks moved up to new highs. Financials recovered some of their early losses but dropped sharply by mid-year as home foreclosures increased and credit access tightened.

By summer, the demand destruction associated with the spike in oil prices, to nearly $150/barrel, the fading effects of the stimulus package, and clear evidence that the U.S. recession had spread to Europe and Asia, pushed all equity sectors back into negative territory. Housing starts fell to the lowest level on record and auto sales plunged to 25-year lows. The Federal Reserve and the Treasury made a number of aggressive monetary and fiscal policy moves. The unprecedented size and scope of the government interventions, which were primarily intended to support the banking system, allowed equities to remain stable through much of the third quarter. The failure of Lehman Brothers and the seizure of insurance giant AIG in September, however, halted nearly all lending that was not directly backed by the Treasury and sent equities lower.

As the fourth quarter began, only the more defensive Consumer Staples and Health Care sectors were able to show relative strength. International and emerging market stocks were severely punished as the dollar strengthened in a global flight to safety. Overall, equity indexes fell by 50% or more from the cyclical peaks a year earlier.

FIXED INCOME MARKETS

Since the summer of 2007, the credit markets from around the world have been under extreme duress, as the subprime mortgage crisis which began in the United States, mutated and spread internationally and threatened a near global financial collapse.

In September, events accelerated dramatically as the U.S. Government took over FNMA and FHLMC, Lehman Brothers filed for bankruptcy protection, Merrill Lynch and Bank of America announced a merger, AIG was hastily bailed out by the government, Goldman Sachs and Morgan Stanley converted to a bank charter, Wachovia Bank neared collapse prior to announcing a merger with Citigroup (then Wells Fargo), several European banks were nationalized, and a string of U.S. banks were taken over by the FDIC.

Concurrent to these events, the U.S. money market sector was beginning to experience more stress than ever before. As a result of holding a large position in Lehman securities (which filed for bankruptcy on 9/15), The Reserve Primary Fund, founded in 1971, became only the second money fund in history to "break the buck," and not deliver on its pledge to maintain a $1 NAV. The failure of Lehman and the problems with The Reserve Primary Fund triggered an industry-wide wave of redemptions out of "Prime" funds and into U.S. Treasury or Government funds.

Risk assets were punished in 2008 as the risk aversion/flight to quality bid for U.S. Treasuries led to a double-digit return for the Treasury index in the first 11 months of 2008. Despite the relatively low level of Treasury yields at the start of 2008, all spread product (including agency debentures) underperformed Treasuries - a clear indication of investors' focus on preservation of capital. Assets such as investment grade corporate bonds and high yield bonds are pricing in all time record default rates. Agency mortgage-backed securities are trading either side of all time wide spreads.

SUMMARY OF SEVERAL MAJOR GOVERNMENT ACTIONS

As the markets began to enter into a full "panic" mode, governments and central banks from around the world began to move quickly and decisively to restore order and liquidity. Domestically, the U.S. Treasury, Federal Reserve, FDIC and the Administration began a coordinated effort to restore order and announced a series of unprecedented moves to support the money markets.

Temporary Guarantee Program for Money Market Funds

On September 19, three days after The Reserve Primary Fund broke the buck, the Treasury announced that it had established a Temporary Guarantee Program designed to protect the balances of money market fund investors. This program provides a guarantee to shareholders that their investments in participating funds will be guaranteed at $1 NAV up to the lesser of the amount held on September 19 or the amount on the day that the fund applies for the claim. Funds wishing to be covered under the plan must apply to the program and pay the associated fee. The following RidgeWorth Money Market Funds have been accepted into the program: Prime Quality, Institutional Cash Management, Institutional Municipal Cash Reserve, Virginia Tax-Free, and Tax Exempt.

This program has been extended to April 30, 2009.

President George W. Bush approved the use of existing authorities by Secretary Henry M. Paulson, Jr. to make available as necessary the assets of the Exchange Stabilization Fund to guarantee the payment. The Exchange Stabilization Fund was established by the Gold Reserve Act of 1934, as amended, and has approximately $50 billion in assets. This Act authorizes the Secretary of the Treasury, with the approval of the President, "to deal in gold, foreign exchange, and other instruments of credit and securities" consistent with the obligations of the U.S. government in the International Monetary Fund to promote international financial stability.

Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF)

On September 19, The Federal Reserve created the AMLF in order to restore liquidity to the Asset-Backed Commercial Paper (ABCP) market. The AMLF allows for money market mutual funds to sell ABCP through a qualified intermediary to the Federal Reserve Bank of Boston (FRBB) for immediate cash liquidity. The FRBB will only accept first tier ABCP and there are certain maturity and other restrictions. The ABCP is required to be sold from the funds at amortized cost, thus preserving the $1 NAV of the fund.

The expiration of this facility has been extended to April 30, 2009.

Commercial Paper Funding Facility (CPFF)

On October 7, the Fed introduced the CPFF to provide liquidity to U.S. issuers of commercial paper via a special purpose funding vehicle (SPV). This SPV is authorized to purchase 90-day CP and ABCP directly from eligible issuers. While money market mutual funds cannot participate in this program directly, the SPV provides a funding backstop for issuers in the event they encounter trouble rolling-over maturing CP.

The expiration of this facility is April 30, 2009.

Money Market Investor Funding Facility (MMIFF)

The next facility that was introduced by the Fed to improve market liquidity was the MMIFF. This facility provides up to a maximum of $600 billion in funding through five separate SPVs that are approved to purchase money market instruments directly from money market mutual funds. The instruments must have maturities of 90 days or less, as well as other requirements. This facility was established to address the liquidity needs of some money market funds that were having difficulty meeting the high volume of redemption requests, especially immediately following collapse of The Primary Reserve Fund.

The expiration of this facility is April 30, 2009.

Amortized Pricing for the Purposes of Shadow Pricing

On October 10, the SEC, in response to unprecedented volatility in the money market sector, issued a "no action" letter that provided for temporary relief from the requirement that money market mutual funds "shadow" price their portfolios on a periodic basis. In essence, the SEC stated that if a security in a money market fund met certain conditions, the security could be accounted for at amortized cost, for the purposes of shadow pricing. The eligible securities are limited to portfolio securities that (i) have a remaining maturity of 60 days or less, (ii) are First Tier Securities as that term is defined in paragraph (a)(12) of rule 2a-7, and (iii) the fund reasonably expects to hold to maturity.

This exception is set to expire January 12, 2009.

PERFORMANCE AND 2009 OUTLOOK

The new administration and Congress have promised massive stimulus to try to combat the economic contraction as consumption declines and the financial system de-leverages. There are some secular forces at work that lead us to believe that the stimulus may not have the desired impact on consumption and economic growth. A shift is occurring in consumption patterns of American consumers as the consumer balance sheet repair process starts. The consumer needs to pay down debt and start saving the old fashioned way by spending less and putting money from each paycheck aside. Houses will once again be viewed as places to live and not as investment vehicles that appreciate at double digit rates each year. Specifically, the U.S. consumer will revert back to living within its means and stop trying to borrow its way to a prosperous life. Demographics are another force at work that should lead to a higher savings rate as the onslaught of baby boomers approaching retirement grows. Fixed income should benefit from the demographic/savings wave that is coming.

Our 2009 outlook calls for a consumer-led economic contraction with further deflationary pressures on asset prices, particularly real estate, due to continued tightening of credit/financial conditions. "Zero interest rate policy" (ZIRP) will be the new catch phrase in 2009 although 50 basis points seems a more likely terminal fed funds rate with additional Fed action coming in the form of unconventional measures such as quantitative easing and outright purchases of Treasuries. The interest rate and yield curve outlook will be complicated by the tug of war between economic weakness/contraction (low rates/steep yield curve) on the one hand and record U.S. Treasury supply that may reach $2 trillion (higher rates) due to record budget deficits and commitments to the financial system on the other hand. The more immediate risk is deflation as de-leveraging continues and credit is tightened with the longer term risk before hyperinflation due to massive liquidity and stimulus being applied to counteract the de-leveraging in the financial and consumer sectors.

MARKET COMMENTARY

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2009 will be a year characterized by a global synchronized recession with massive government stimulus/fiscal deficits. The key to investment markets will be the length and depth of the global contraction and when investors' risk appetites increase. Secular changes are occurring that will have a long-term impact on investors' risk profiles and we do not expect a return to the days of investment returns predicated on cheap credit and high leverage.

The investment grade corporate sector, particularly within the industrial, utility and regulated pipelines sectors represent areas where investors are being compensated as many of these companies head into this recession with strong balance sheets while their bonds are pricing in record default rates while trading at all time wide spreads. We will continue to opportunistically trade and rotate within the securitized sectors balancing valuation against supply/demand dynamics as government intervention attempts to ameliorate the continued negative fundamentals of the residential and commercial real estate and consumer credit sectors.

We believe that investors with long-term investment horizons should start to establish a position in high yield bonds as this sector is trading at an average price of $56 with a current yield of 22%. While high yield default rates may exceed levels not seen since the modern high yield market came into existence, we believe that investors can expect to see double-digit returns as crossover buyers emerge at these historically attractive valuation levels.

While the end of the current economic recession is difficult to forecast, the markets have already discounted a significant earnings decline. Moreover, investors appear to have given policymakers a green light to address the economic and financial crisis. With inflation, interest rates and equity valuations all at historically low levels, we expect equity markets to improve in early 2009. Even given the uncertainty of the macro economy, the equity boutiques within the RidgeWorth family will continue to implement the respective investment disciplines that allowed many of the boutiques to deliver very competitive performances in 2008.

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