

Red Granite Advisors LLC

Fourth Quarter 2008 Commentary

With U.S. stock indices down more than 20% in the quarter, investors endured broad price declines to end one of the worst yearly performances on record. The Russell 1000 Growth and S&P 500 Stock Indices fell -22.79% and -21.96% in the quarter and depressed yearly returns to -38.44% and -37.00%, respectively. International diversification provided little protection as foreign stock markets, which became highly correlated due to economic globalization, experienced similar, if not worse, declines.

Red Granite's Large Cap Growth portfolios out-performed in the quarter and year. Though all sectors produced negative quarterly returns, we were overweight Materials, Health Care and Consumer Staples, which had better relative results. Above-average cash balances helped protect capital.

Investor selling reached a crescendo in late November in response to the Lehman Brothers bankruptcy and concerns that Congress might withhold financial support for U.S. auto manufacturers. In heavy trading on November 20, the S&P 500 closed below its 2002 low and sentiment was extremely negative (a contrary technical indicator) consistent with past market lows. Since then, the index has advanced roughly 20% in response to the Federal Reserve's aggressive credit market and interest rate policies and greater clarity regarding Obama's \$800 billion economic stimulus package.

We believe economic recovery, albeit labored, should become evident later in 2009. Fourth quarter real GDP estimates now range from -5% to -6%. The Federal Reserve has effectively lowered the Federal Funds rate to near 0% for an indefinite period. With mortgage rates falling, refinancing activity is brisk, yet unstable real estate is the predominant collateral for the fragile banking system. Tight lending standards and the need for banks and consumers to repair their balance sheets temper our outlook. Increased government regulation should stifle excessive use of leverage, thereby limiting potential growth. Corporate bankruptcies could escalate further destabilizing the system. And finally, significant dollar depreciation, ultimately resulting in rapidly escalating inflation, could ensue if foreigners' confidence wanes in the U.S.' ability to finance and/or repay its massive debt.

While we doubt the full economic impact of the housing/credit crisis has been felt, investors may have seen the worst as stocks appear to be in a bottoming process. With more than \$3.8 trillion in money fund assets earning very modest returns, and valuations at levels where dividend yields on the S&P 500 exceed Treasuries for the first time in 50 years, risk-taking should re-emerge. We see evidence in the narrowing of investment grade bond spreads and the recent advance in stocks.

As we wait for policy actions to gain traction in this bottoming phase, we are positioning portfolios for the market's next cyclical advance. Looking forward, we believe that the market will reward companies that carry low debt levels, embody well-devised business plans, evidence sensible valuations, and can increase market share.

Joel D. Vrabel, CFA
Chief Investment Officer

David W. Bowman, CFA
Senior Portfolio Manager