

# UPDATE

October 2008

Investment Management News

## ABOUT OUR COMPANY

### **C**ompany Profile:

*Concord Investment Counsel is an Irvine based, fee-only investment management company specializing in Domestic Equity and Domestic Fixed Income Management. Our prudent investment philosophy is ideal for conservative investors seeking growth, income, and risk management.*

### **Investment Strategy:**

*Concord invests in mid- to large-cap growth oriented companies with strong leadership, superior products, and sustainable growth plans. Our investment strategy incorporates both growth and value methodologies.*

### **Company Goals:**

- High Alpha
- Low Tracking Error
- Average Volatility
- Excellent Client Communications
- Comfortable Relationships



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## Crisis of Confidence Drives Broad Financial Market Meltdown

**T**he crisis of confidence that has paralyzed the corporate credit markets for the last ten months has now knocked the air out of equity investors as the Dow Jones last week turned in its worst 1 week performance in history, falling 18%. Equity markets around the world suffered similar losses with confidence falling globally. Stocks were sold with a dump truck mentality with few areas spared of the panic mentality. Cash was king as Treasuries and gold gathered only minimal interest from panic struck investors.



Mitch Pletcher  
President & Chief  
Investment Officer

The catalyst for the turn in confidence seemed to be tied to the rhetoric from the Congressmen and Treasury officials as they argued over the bank rescue package the previous weeks. The Bush administration and Fed had to draw very negative pictures of economic collapse time and time again to get Congress to understand the consequences of not passing the legislation. Many argued that the banking system might fail regardless of what Congress does. Unfortunately main street took the Fed and Bush administrations comments seriously and the fear and panic seemed to begin from that point. These conversations might have been better done in a closed door session of Congress rather than on center stage to the world's financial markets.

As I sit here writing this article (October 13, 2008) the markets are experiencing a powerful rally with the dow up close to 1000 points. Still the US markets are down 25-30% YTD with most of the fall occurring over the last few weeks. Meanwhile, trends in the economy have been on a more stable path but still a path that is heading downhill.

Several of the obstacles in the path of the economy, however, have become less of a problem. Oil prices are now at \$80 a barrel with much cheaper gasoline prices likely to follow. Commodities in general are 40-50% lower from the bottleneck prices seen in the spring. Corn, grains, fertilizer, steel, copper, iron ore and coal are now at levels more palatable for the high demand areas of the globe. The recapitalization of Fannie and Freddie has the mortgage world moving a bit from its almost frozen previous state.

Outside of banks and insurance companies, corporate America is financially very healthy with strong balance sheets and lots of cash.

Our financial system has been poorly managed without enough regulation. America is a victim of greed and stupidity once again. America has been so well positioned in the world's economy that we were able to prosper with a lazy, greedy mentality. We leveraged our position and opportunities in an unproductive manner and now we are paying for our errors.

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Can Main Street regain its confidence in our ability to avoid a major economic collapse? Will banks begin to deal honestly and openly with each other and allow trust and confidence to return? A sharp bounce in the markets back to more reasonable levels would seem to hinge on these questions.

Much progress has been made in mopping up the mess the investment banks created over the last decade and the Fed is prepared to continue to provide liquidity and innovative solutions to keep our banking system from failing. The most important ingredient to a successful financial system however is confidence.

Confidence is now under attack but will likely return quickly once our financial house has more sign posts of order. The insurance companies may be the last area needing help before order is restored.

We remain deeply concerned but optimistic.

**Sector Review**

**09/30/08**

**Best Performers**

Quarterly %  
Change

**Worst Performers**

Quarterly %  
Change

<b>Airlines</b>	29.71	<b>Mortgage Finance</b>	-76.90
<b>Banks</b>	26.46	<b>Full Line Insurance</b>	-72.82
<b>Home Construction</b>	23.26	<b>Coal</b>	-54.65
<b>Specialty REITs</b>	18.13	<b>Iron &amp; Steel</b>	-53.58
<b>Nondurable Household Products</b>	14.62	<b>Platinum &amp; Precious Metals</b>	-49.45
<b>Furnishings</b>	13.51	<b>Nonferrous Metals</b>	-49.24
<b>Home Improvement Retailers</b>	12.34	<b>Heavy Construction</b>	-41.44
<b>Residential REITs</b>	11.92	<b>Aluminum</b>	-37.61
<b>Recreational Products</b>	9.99	<b>Oil Equipment &amp; Services</b>	-34.08
<b>Insurance Brokers</b>	9.55	<b>Marine Transportation</b>	-33.62

Source: The Wall Street Journal

**Market Diary**

**09/30/08**

**Equity Returns**

Quarterly  
Change

YTD  
Change

Quarterly  
Change

YTD  
Change

US Large Cap Core	-9.40%	-19.73%	Mid Cap Core	-12.11%	-17.92%
US Large Cap Growth	-14.06%	-22.80%	Small Cap Core	-5.24%	-13.97%
US Large Cap Value	-8.04%	-20.12%	International	-20.74%	-29.37%

Returns are mutual fund averages from Lipper as reported by The Wall Street Journal. Performance includes dividends.

CIC Asset Allocation Growth	-9.95%	-18.16%	S&P 500	-8.88%	-20.57%
CIC Growth	-8.60%	-21.50%	DJIA	-4.40%	-18.20%
CIC Diversified Equity	-12.26%	-24.09%	Nasdaq	-8.77%	-21.13%

The data above for Asset Allocation Growth, Focused Growth and Diversified Equity are CIC model portfolios and not composites of client accounts. Performance data for equity indices and CIC model portfolios listed here exclude dividends and are gross of fees. The information and data contained in this newsletter were obtained from sources considered to be accurate. Their accuracy and/or completeness cannot be guaranteed.

**Balanced Portfolios**

**Asset Allocation for Growth**

A dynamic blend of stocks, bonds, and cash for moderate investors with a bias toward growth balanced by income-producing investments.

Allocation as of 09/30/08:

<b>US Stocks</b>	<b>43.9%</b>
<b>Int'l Stocks</b>	<b>6.9%</b>
<b>Bonds</b>	<b>40.8%</b>
<b>Commodities</b>	<b>4.7%</b>
<b>Cash</b>	<b>3.7%</b>

**Asset Allocation for Income**

A portfolio of stocks, bonds, and cash for moderately-conservative investors seeking income and growth with relative stability.

Allocation as of 09/30/08:

<b>US Stocks</b>	<b>31.5%</b>
<b>Int'l Stocks</b>	<b>6.9%</b>
<b>Bonds</b>	<b>56.8%</b>
<b>Commodities</b>	<b>4.1%</b>
<b>Cash</b>	<b>3.9%</b>

**Equity Portfolios**

**Growth**

A portfolio of large- and mid-cap US stocks that are industry leaders with strong brands and timely products.

**Diversified Equity**

A global, all-cap equity portfolio following economic trends across capitalization and geographic ranges.

**Focused REIT**

A portfolio of companies whose primary business is owning and leasing real properties.

**Fixed Income Portfolios**

**Strategic Total Return Bond**

A diversified portfolio of mid-and long-term bonds, actively managed for yield, capital preservation, and strategic capital gains.

**Ultra Short-Term Bond**

A short-duration bond portfolio offering active management for yield, safety, and liquidity.

**R**esearch Spotlight: Abbott Laboratories

Most equities have had a difficult year as the credit markets tightened and economic recessionary fears escalated. We have seen dramatic selling in most sectors, making it difficult to uncover growth companies that will prosper in an economic slowdown. We recently added one stock to our portfolio at Concord that we think is a stable growth company in the relatively defensive healthcare sector. This company is Abbott Laboratories.

Abbott Laboratories is a diversified healthcare company, like Johnson & Johnson, that has some nice things working for it. The company is broken up into three primary operating segments, which include Pharmaceuticals, Medical Products and Nutritionals. These segments make up 58%, 25% and 17% of total company revenues respectively.

The Pharmaceutical segment is made up of a diversified portfolio of drugs, headlined by the blockbuster Humira. Humira is a biologic treatment for numerous autoimmune diseases that include rheumatoid arthritis, psoriatic arthritis, ankylosing spondylitis, crohn's disease and psoriasis. Humira is expected to generate in excess of \$4 billion of revenues for 2008 and is growing at a double digit pace. Abbott also possesses a strong cardiovascular drug franchise which includes a handful of drugs used for lipid and cholesterol management. These include Tricor, Niaspan and Simcor. These medications are used in single pill or combination form to lower triglyceride and LDL (bad cholesterol) levels, and to raise HDL (good cholesterol) levels. Other Abbott drugs include Kaletra, a protease inhibitor used to treat infection by HIV and hepatitis C viruses, and painkiller Vicodin. In addition, Abbott has a solid drug pipeline that includes new indications of Humira, next generation drugs within the cardiovascular franchise, oncology drugs being co-developed with Genentech and treatments for Alzheimer's disease and hepatitis C.

The Medical Products segment of Abbott Laboratories is made up of a diversified group including vascular, molecular diagnostics, diabetes care and animal health. The Vascular group is a leader in vascular disease treatment, interventional cardiology and arterial closure technologies. Abbott's next-generation drug-eluting stent (DES), Xience, was approved by the FDA in July of this year. Drug-eluting stents are small metal scaffolds placed in diseased coronary arteries to keep them open and re-establish blood flow. They slowly release a drug to prevent future blockage of the stented artery, and are an alternative to open-heart surgery. Xience has shown clinical superiority over a key competitor and has demonstrated a solid safety profile. Many experts forecast Xience to capture 40% market share by 2009, in a somewhat crowded U.S. DES market. The Molecular Diagnostics group develops automated instruments for molecular testing and monitoring of viral loads in patients with such diseases as HIV and hepatitis C. The Diabetes Care group has a leading position in the blood glucose monitoring market, with devices that replace the traditional finger-stick testing for diabetic patients. The Animal Health group provides blood glucose monitoring, anesthesia and medical devices for animals.

Abbott Laboratories also has a respected portfolio of nutritional products focusing on pediatric, adult and performance nutrition, along with an assortment of snack products. Brands within the group include Similac, Pediasure, Ensure, Glucerna and Zone Perfect. The nutritional group is experiencing particularly strong growth internationally.

We like Abbott Laboratories as a long-term growth holding for a number of reasons. Abbott has an appealing long-term growth profile with a diversified product mix and a focus on cost containment and margin expansion. Abbott has a dividend yield of 2.5%, and has increased its dividend payment the past twenty years. The company also invests a consistent 8%-10% of sales in research and development to insure future growth. Although Abbott lost patent protection on its bipolar disorder drug Depakote this year, they do not have significant patent exposure over the next 3-5 years, unlike many of its competitors. Abbott has a lot riding on Humira and Xience, so a failure to meet expectations on either of these products are a risk we take in purchasing shares of the company. While few equity positions are immune to the current market crisis, we think that Abbott Laboratories is a solid defensive play that exhibits many of the qualities that we look for in a growth company.

**A**n extremely difficult 3<sup>rd</sup> quarter in the credit markets saw things go from bad to worse to ugly. July began with mortgage titans Fannie Mae and Freddie Mac continuing to deteriorate, unemployment rising, and ongoing suffering in the housing market. Confidence remained largely intact through August, however, with interest rates and credit spreads stable and equities tilting modestly upward. Then came September, which began with the government's takeover of Fannie and Freddie, and things quickly unraveled. Credit markets came to a standstill, as financial institutions like American International Group and Lehman Brothers faced demise. Liquidity disappeared for everything but super safe Treasuries, sending borrowing costs for companies soaring.

Bond spreads grew dramatically during the quarter, even on highly rated corporate issues normally considered very safe. The premium over Treasuries on double-A-rated bonds widened to 398 basis points, from 235 at the start of the quarter. On single-A-rated bonds, the spread widened from 286 to 491. According to Standard & Poor's, 29% of the high-yield debt market was trading 1000 basis points or more over Treasuries as of Sept. 15, qualifying it as "distressed." That ratio has grown by 15% in three months, 23% from the start of the year, and is expected to rise again in the 4<sup>th</sup> quarter. Bad conditions also caused issuance of investment-grade corporate bonds to shrivel, dropping 68% from the 3<sup>rd</sup> quarter of 2007 to \$72 billion.

Demand for Treasuries skyrocketed during the quarter, though the 10-year note was little changed at 3.83% on Sept. 30 (versus 3.99% on July 1) after spiking down as low as 3.41%. Very short-dated Treasuries saw the strongest demand which created an increasingly steep yield curve. A few times near the end of the quarter, investors were willing to pay more for one-month Treasuries than they would receive when the notes matured—in effect opting for a small, known loss over uncertainty.

The third quarter also saw unprecedented efforts from government officials to stabilize the credit markets and financial sector of the economy. The Treasury's \$700 billion TARP facility got the most headlines, with its eventual passage by Congress met with jeers, not cheers from the market. It appears now that a return of investor confidence will only follow some tangible progress on this and other programs. The Federal Reserve also disappointed investors on Sept. 16 by holding the Fed Funds rate steady at 2% and continuing to discuss the threat of inflation.

Credit markets remain strained at a level that has rarely been witnessed in history. We are experiencing a very difficult cycle that has produced both outsized risks and opportunities. When normalcy eventually returns to the market, investors will head back to spread product and away from plain-vanilla Treasuries.

# No Shelter From Stormy Markets

By Chad King

**I**nvestors may find it difficult to find encouragement in their quarterly performance reports for the third quarter of 2008. As the economic clock moved into the contraction phase, the initial illness in the credit markets began to manifest itself elsewhere. As the table below shows, not only was there little shelter to be found in domestic equity markets, there was little hope in the equity markets of Europe, the Far East, Australia or emerging markets. Further, commodities, which had been a source of positive returns for investors heading into the third quarter, experienced a decline of more than 25%. The best performing asset class was bonds, represented below by the Lehman Aggregate Bond Index. However, even bonds produced a slightly negative return for the quarter.

If we experience a prolonged slow-growth environment, rather than deep recession, it may signal that stocks are likely to lead given their deeply oversold current condition. Ultimately, time will tell. Regardless, portfolios with a broad diversification of asset classes may experience less volatility and possibly measured growth when weakness afflicts the economy.

	Index Name	MTD	QTD	YTD	1 Year	3 Years	5 Years	10 Years
<b>Large-Cap Equity</b>	Russell 1000® Growth	-11.58	-12.33	-20.27	-20.88	0.04	3.74	0.59
	Russell 1000® Value	-7.35	-6.11	-18.85	-23.56	0.09	7.12	5.55
<b>Mid-Cap Equity</b>	Russell Midcap®	-12.26	-12.91	-19.50	-22.36	0.09	8.62	8.34
<b>Small-Cap Equity</b>	Russell 2000®	-7.97	-1.11	-10.38	-14.48	1.83	8.15	7.81
<b>International Equity</b>	MSCI Eur/Asia/Far East	-14.46	-20.56	-29.26	-30.50	1.12	9.69	5.06
<b>Int'l Emerging Equity</b>	MSCI Emerging Markets	-17.50	-26.95	-35.54	-33.20	8.37	18.67	14.48
<b>Fixed Income</b>	Lehman Aggreg Bond	-1.34	-0.49	0.63	3.65	4.15	3.78	5.20
<b>Commodities</b>	S&P GSCI	-12.44	-28.61	0.96	12.72	0.29	13.27	12.18

Percent returns ending 09/30/08. Source: Russell Investments, Barclays Global Investors

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## Economic Sector Allocation

By Brian Thomas, Senior Analyst

**I**t is understood that in the world of equity investing there are two distinct ways to achieve relative outperformance versus a benchmark index. The first is via economic sector allocation, which tends to be associated with a more top-down or macro style of management. More specifically, a manager will attempt to outperform by over- or underweighting the portfolio's exposure to various sectors (tech, energy, consumer discretionary, etc). The second approach is a more bottom-up process that relies on correctly picking which stocks to own in a given sector, while holding the sector weightings constant relative to the benchmark.

Concord's approach is consistent with the more bottom-up style of management. We allow our economic perspectives to take shape as a result of the research we perform on individual companies. Accordingly, the equity portfolio will get assembled based not on a desire to be heavy in a particular sector, but rather a desire to own certain individual businesses in that sector. While we are mindful of the sector weightings that result from this process and do not allow the portfolio to become excessively exposed in any area, we do not necessarily remain sector-neutral at all times. Unlike a very strict style of bottom-up management, we instead let our sector weightings drift higher or lower (within set parameters) relative to our growth benchmark. This will sometimes get the portfolio into a position that requires us to do some analysis and forecasting that is in addition to our core process.

A few such examples are relevant at this moment. An overweight position in energy, for example, forces us to consider the longer term outlook for consumption and pricing of oil and distillates. Through the oil price volatility of 2008, it was likely that the expected earnings for many companies would be delivered whether oil stayed at \$150 or slid back below \$100. Additionally, the stock prices of these firms were not discounting the earnings upside from higher oil. Our bottom-up work was highlighting these opportunities and our energy exposure grew. Now that the stock prices have corrected even more than the commodity prices, a secular and not just cyclical downturn is being discounted. If the long-term consumption themes for energy are still intact, an overweighting in energy will reward investors who ride out the cyclical slowdown which seems more than priced into energy stocks.

The consumer staples sector is another example. We have been underweight this group as our bottom-up work was not revealing many compelling opportunities that exploited the growth vs. expectations balance we focus on. Yet as the slowing economic environment has depressed more cyclically sensitive sectors, consumer staples names have benefited from the defensive rotation at work in the market. The longer term outlook for growth cannot sustain the current valuations of packaged foods makers and other such companies, so we have to focus more on the secular versus cyclical outlook to avoid an incorrect manipulation of the portfolio.

Investing for all of the economic cycles in force is often very challenging. As has been explained, creating an "all weather" portfolio forces one to sometimes deemphasize important secular trends. This potentially confuses the risk/reward relationship in the short- and long-term. If our bottom-up process is going to yield results over a full economic cycle, we occasionally have to intensify the focus on the large secular trends at work in the economy to remain well-positioned. A troublesome under- or overweighting of a sector in the shorter cycles is therefore likely to be temporary.