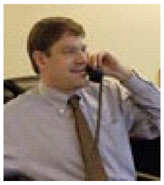
INVESTMENT UPDATE
NEWSLETTER

ALLEN TRUST
COMPANY

DECEMBER 5, 2008



William A. Harris, CFA
Portfolio Manager

Welcome to Hard Times, but "Safety" Won't Necessarily Stay Safe

The news gets grim and grimmer. Employment is plummeting, mortgage delinquencies and home foreclosures are accelerating, and durable goods orders, capital expenditure plans and retail sales are deteriorating fast. The S&P 500 is off more than 40% on the year, the Global Dow is off by 50%, many commodities are down even more, and corporate and municipal bonds have suffered beyond recent experience.

Yet, in a year when long municipal bonds (as measured by the ML 22-plus year index) have returned -18%, we now find the 30-year Treasury ("the long bond") changing hands at a 3% yield. We are bullish on the former, which have given up so much in value, and believe that while the latter promises near-term comfort to the shell-shocked, it will extract a long-term penalty from its holders.

Allow me to illustrate what I'm getting at. Let's say that purchasers of the long bond right now are correct in assuming we're entering a stretch of bone-grinding stagnation, one in which it's appropriate for a bond maturing in 2038 (!!!) to price at a 3% yield for the next few years. Great, you will have held onto principal and picked up a little in interest. But let's say that three years out, rates bump up to where they were just a month ago, 4.2% on the 30-year; present value on the bonds will drop over 12%. And suppose the trillions of dollars now being conjured to enable Federal intervention in the markets result in expectations of even mild inflation; five years out, at a 6.0% yield (comparable to where we started the decade), that bond's value will be down more than 25% from purchase. If we reach yield levels seen in the mid-1980s, say 10% (which actually felt moderate at the time after experiencing yields over 13% just a few years earlier), the loss in principal value will be nearly 50%. What looks safe now may be painful to own in the not-so-distant future. Oh yes, and at a 13% yield five years from now? Count on a principal loss of over 60%. We don't think that will happen, but for a 3% coupon, we're not going to hazard the possibility, and while the bond would pull eventually to par at maturity, the wait would represent a good chunk of anyone's adult lifetime.

So where can we turn? Well, let's talk about those munis briefly. Right now, tax-exempt 30-year AAA general obligations are yielding 5.55%, a tax-equivalent yield of 7.71% for anyone in the 28% tax bracket, or more than two-and-a-half times what you get to keep from that long Treasury. While munis too would price downward to reflect a return of inflation, they should offer a couple of compensating benefits: higher coupons which can be reinvested at rising interest rates, and tax status whose valuation will increase if tax rates go up in the future. While we don't think 30-year *anything* represents any sort of sweet spot, when we're reaching out on the curve, we'd rather do it anyplace other than Treasuries right now.

Firm News: Giving Thanks, and Giving

First of all, we'd like to thank you, our clients, friends and colleagues who keep toughing it out through this time of acute and (we hope) maximum stress. We love what we do here because we get to work for and alongside people for whom we care so much. Happy holidays to you all.

Second, we'd like to recognize the contributions of a couple of our team members who don't often appear in this market-focused letter: VP and Senior Trust Officer Tara Hendison, and technology specialist Andreas Steven.

One of our clients lives in an adult care home. She has limited mobility and the use of only one hand, and she cannot communicate verbally. Tara and Andreas were able to find her a tablet PC with a touch screen so she can send and receive e-mail as well as surf the web. Andreas hand-delivered the computer and set it up complete with a wireless network for the entire home. This should greatly improve our client's feeling of independence – whereas before she had to rely on the world coming to her, now she can reach into it as well. Thank you, Tara and Andreas for going the extra mile. You make even the hard times good.