



September 2008 will go down in the history books as the month in which Wall Street as we know it disappeared and the face of the global financial system was dramatically reshaped. Escalating concerns about toxic mortgage assets culminated in a crisis of confidence in the strength of our most prominent financial institutions. The global financial system is based on trust between counterparties, and as that trust evaporated so did the availability of credit. The scarce availability of credit, along with very high levels of leverage, triggered numerous firm failures, the combination of which resulted in unprecedented acts of government intervention in an effort to minimize the fall. As we write this in early October, governments and financial regulators across the globe continue to struggle to resolve the liquidity crunch and contain the damage to the real economy. In a few short months, market sentiment has gone from cautious optimism in early May to fears that we are on the brink of, if not in, a serious recession of unusual depth and duration.

On the positive side, the U.S. government has moved aggressively to backstop the system. Global governments are now approaching the financial crisis on a coordinated, policy-level basis. Now that the U.S. Congress has passed legislation to help banking institutions deal with impaired assets and the process of removing bad debts from the banks begins, market participants will be better able to gauge the financial stability of counterparties and confidence will begin to return. Once this floor is found, the system will be on more secure footing from which global growth can proceed.

MARKET AND ECONOMIC REVIEW

In the early part of the quarter, the market trended down on mixed economic signals. On the one hand we had higher-than-expected economic growth, driven in large part by exports and economic stimulus checks, combined with falling energy and commodity prices. This was countered by a further contraction in housing, additional weakness in the labor markets, and worsening credit conditions.

As the quarter progressed, investor sentiment worsened. Despite billions of dollars of write-offs since August 2007, concerns about the quality of the mortgage- and housing-related assets on the balance sheets of some of the most prominent financial institutions in the U.S. escalated. Unfortunately, those concerns proved to be justified. On September 7th the U.S. Department of the Treasury announced it would place Fannie Mae and Freddie Mac into conservatorship under the authority

of the Federal Housing Finance Agency. One week later, with expectations of a bailout fading, Lehman Brothers announced it would file for Chapter 11 bankruptcy protection. That very same night, news broke revealing that Merrill Lynch agreed to be acquired by Bank of America for \$50 billion dollars in an all-stock deal. Initially, some viewed the Merrill deal as a silver lining on a day that saw one of the largest bankruptcies in U.S. history, but that sentiment faded quickly as it became clear that the financial crisis was not under control.

On Tuesday, September 16, Reserve Management Corp., managers of the United States' oldest money market fund, announced that one of its money market mutual funds was unable to maintain a \$1.00 net asset value because of its holdings of Lehman commercial paper. This marked the first time since 1994 that a money market fund had "broken the buck". News then quickly surfaced of the Federal Reserve's (Fed) controversial \$85 billion rescue of insurance giant American International Group (AIG), whose stock price had fallen approximately 90% in a few trading days. That same day, Putnam Investments announced that it was closing its \$13 billion institutional Putnam Prime Money Market Fund to avoid a redemption run on the fund as investors sought to redeem their funds.

To help restore confidence and liquidity in the lending markets, the U.S. government took several bold steps. The Fed made \$180 billion available to major central banks to lend to their local commercial banks in an effort to get U.S. Dollars circulating in overnight and short-term money markets. The U.S. government implemented a ban on short sales on 799 financial stocks, citing rampant short selling as a factor in the steep decline in a number of stocks. The Treasury announced a temporary guaranty plan for U.S. retail and institutional money funds. Reports that the Treasury was working on a comprehensive rescue package similar to that used to address the savings and loan crisis in the 1980's buoyed investors, resulting in sharp equity advances on both September 18 and 19.

Over the weekend that followed, the Fed took the extraordinary measure of agreeing to convert investment banks Morgan Stanley and Goldman Sachs into traditional bank holding companies. As a result, the less regulated structure of large independent Wall Street investment banks has now ceased to exist. Going forward, firms operating in that capacity will be subject to much greater oversight, as well as new capital requirements.

Unfortunately, the bank failures continued. On September 25, in what is by far the largest U.S. bank failure ever, federal regulators seized Washington Mutual and struck a deal to sell J.P. Morgan the bulk of the operations.



FINANCIAL MARKETS REVIEW AND OUTLOOK

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J.P. Morgan agreed to pay \$1.9 billion to the government for the banking operations and assume the company's loan portfolio, which exceeded \$300 billion. The following Monday, September 29, it was announced that Citigroup had agreed to acquire Wachovia's banking operations for \$2.1 billion in stock and the assumption of \$53 billion in debt. Federal banking regulators pushed the deal by agreeing to share a portion of future losses that Wachovia's failing mortgage portfolio generates. However, as this is being written on October 2, Wachovia and Wells Fargo have just agreed to a \$15 billion merger requiring no Federal guarantees, throwing the Citigroup deal into serious doubt.

The Fed took action again to combat the crisis, this time by doubling the size of its Term Auction Facility to \$300 billion, significantly increasing the available funds to commercial banks. The Fed also more than doubled the size of its swap facility with foreign central banks to \$620 billion (from \$290 billion), an action designed to counter strains in the European banking system where demand for U.S. Dollars was far outstripping supply. Unfortunately, stocks plunged after the House of Representatives unexpectedly voted down the proposed Troubled Asset Relief Program (TARP). The TED spread, the difference between the three-month T-bill interest rate and three-month London Inter Bank Offered Rate (LIBOR), measures the willingness of banks to lend to one another. Normally, this spread is between 10 and 50 basis points (bps). It set a record, however, first on September 17, 2008 when it exceeded 300 basis points, and again on September 29 at 350 basis points after Congress rejected the bailout package.

On October 3, a TARP package was finally signed into law. Investor sentiment continued to be bearish, however, as questions remain as to the ability of the proposed rescue plan to improve credit conditions in the short term, and amid mounting evidence that the real economy is faltering.

BONDS

Fixed income performance varied considerably in this challenging environment with higher-quality bonds – particularly treasuries and agencies – sizably outperforming corporate, international, and longer-term municipal bonds. Performance in the mortgage-backed securities market was mixed with agency securities far outperforming non-agency securities, thanks in part to the placement

of Fannie Mae and Freddie Mac into conservatorship as noted above. Agency securities rallied on this news while non-agencies were left largely unaffected and continued to be weighed down by credit concerns, and more specifically, concerns about whether more homeowners would default on loans.

Interest rates fell across the yield curve although the declines were pronounced on the shorter end of the curve. In fact, at one point the yield on the three month T-bill dipped briefly into negative territory, the first time this has occurred in decades. Yield spreads widened significantly as investors became increasingly concerned about the financial crisis and whether select prominent corporate issuers would survive. This is best illustrated by the +2.3% and -6.4% returns generated by the Lehman Brothers Aggregate U.S. Treasury Index and the Lehman Brothers Credit Bond Index, respectively. Meanwhile, the Lehman Brothers U.S. Aggregate Index returned -0.5%. Foreign bonds, due in part to U.S. Dollar strength, fell further with the Lehman Brothers Global Aggregate Index dropping -3.8% for the quarter.

STOCKS

Aside from a modest decline at the start of the quarter, equity performance was relatively subdued during July and August. That changed in September as volatility spiked and prices plunged amid concerns about the health of some of the most prominent U.S. financial companies. As has been the case in recent quarters, investment returns varied greatly across styles, sectors, and capitalizations in the domestic equity markets. In a reversal from last quarter, value indices outperformed growth indices. Specifically, the Russell 3000® Value Index returned -5.3%, while the Russell 3000® Growth Index returned -11.9% for the quarter. Within the Russell 3000® Index, consumer staples, financial, and health care stocks rebounded from last quarter's weak results (+4.2%, +3.6% and +1.4%, respectively) while energy, materials and utilities declined the most (-26.9%, -24.1%, and -17.7%, respectively) on fears of a global recession. Meanwhile, small-cap stocks well outpaced their large-cap brethren for the second consecutive quarter, as the Russell 2000® and Russell 1000® Indexes returned -1.1% and -9.4%, respectively. The solid relative performance of the Russell 2000® Index largely reflected the strong results generated by the Russell 2000 Value Index®, which gained 5.0% during the



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quarter. This index benefited substantially from its large allocation to small-capitalization financial stocks, which advanced 18.0% for the period. The current crisis has had a significant impact on companies with complicated balance sheets, a characteristic not normally associated with smaller companies.

International stocks underperformed their domestic counterparts by a wide margin for the quarter, as increasing evidence of slower growth worldwide, recessionary concerns in some of the world's largest economies, unease about the global affects of the U.S. financial crisis, and a third-quarter rally by the U.S. Dollar all served to pressure foreign stocks. Emerging markets stocks suffered the steepest declines, due in part to large index markets such as Brazil and Russia, which are heavy natural resource exporters, coming under pressure as demand for oil and metals weakened. By quarter's end, the MSCI Emerging Markets Index had fallen -26.9%, while the MSCI EAFE, a barometer for the performance of developed foreign equities, had declined -20.6%.

OUTLOOK

As we head into the final quarter of the year, the critical question is how long it will take to thaw the credit freeze. This requires an orderly process of allowing banks to remove bad assets from their books and to establish their creditworthiness. While the details of the methods and timeframe to accomplish this are uncertain, it is clear that enormous resources in the government and business community are devoted to achieving this objective. Once credit has been restored and the financial system is once again functioning, the markets will be taking stock of the real economy and the damage that the credit freeze inflicted. Recent research from The International Monetary Fund shows that periods of turmoil related to stress in commercial and investment banks such as this one are more likely to be associated with severe and protracted economic downturns.

On the positive side, looking beyond the financial services institutions, corporate America came into this situation with strong balance sheets, high levels of productivity, and solid profit margins. For instance, the last 12-month earnings growth rate for the Russell 1000® Index excluding financial companies was 14.6% versus -32.9% for the Russell 1000® financial sector. Net income margins excluding financial companies remained at high levels relative to the past (+11.9%), while the financial sector margins declined from its June 2004 peak this decade of

17.6% to 9.2% currently. Energy and commodity prices have declined dramatically from their recently elevated levels, housing inventory is improving slightly and stocks prices are far from extended on a valuation basis.

Interestingly, August was actually a positive month in the U.S. stock market. Obviously, September erased all of the August gains, and then some. Still, as we begin implementing the newly signed TARP plan and make progress in valuing and removing the bad assets, it is not outside the realm of possibility that we could return to a market that focuses on the road to recovery, and the opportunities that exist here in the U.S. and throughout the world market. Certainly the recent events demonstrate how much can happen in a compressed timeframe. In the long term, we just might look back at this period as a tremendous opportunity. Accordingly, we remain steadfast in our belief that long-term investors should maintain a prudent, broad asset allocation with exposure to various asset classes.

Data source: FactSet

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