

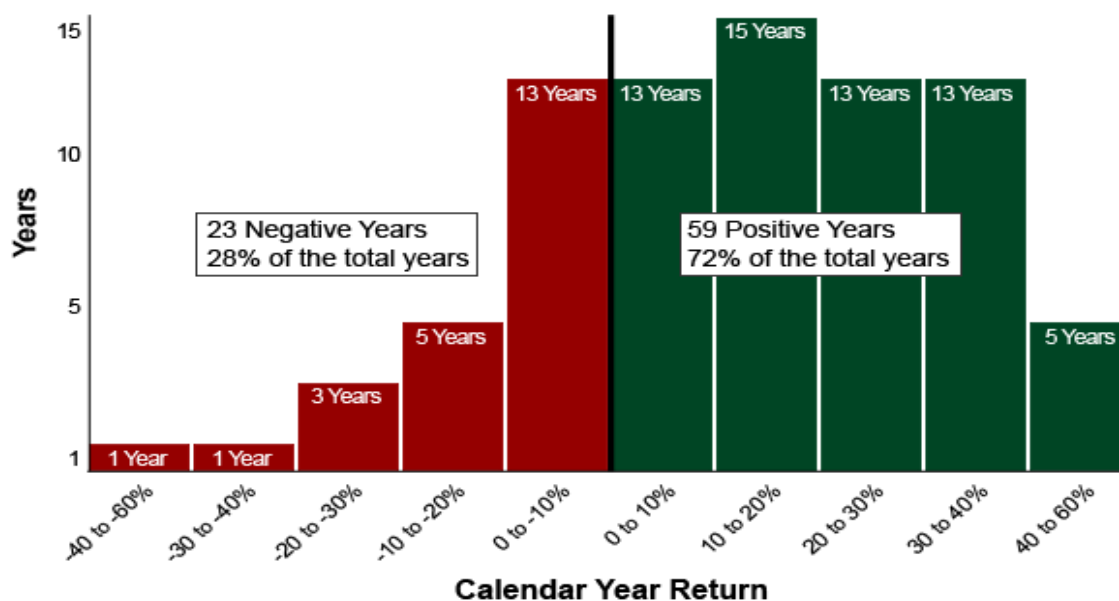
What Now?

One year ago, on October 9, 2007, the S&P 500 Index closed at an all-time high of 1,565. When the market closed on the one year anniversary of this date (October 9, 2008), the S&P 500 Index had fallen 41.9%. In fact, this broadly watched index of U.S. large capitalization stocks now sits at its lowest level since April, 2003, marking the twelfth bear market since 1929. Historically, bear markets have declined by an average of 32%. However, there have been three periods when market declines have been significantly worse. The Great Depression witnessed a record setting decline of 86%, the 1973-74 period of the Energy Crisis and Nixon Resignation included a down market of 48%, and the beginning of this decade inflicted a market fall of 49% soon after the tech bubble burst.

Given the speed at which the market has been moving with volatile swings up and down, it is futile to attempt to provide a meaningful snapshot on where things stand. As a result, we believe it is more constructive and helpful to examine as objectively as possible the following three questions: How does this current period compare with other periods of market turmoil? What factors led us to this current market environment? What should a long-term investor do?

First – How does this current period compare with other periods of market turmoil?

Most introductory presentations about investment management state that the average annual total return for the U.S. market has been approximately 10.3% from 1926 to 2007. However, it is often difficult to see that this so-called average annual return rarely transpires. For example, the Standard & Poor's 500 Index has only provided an annual return of between 0% and 20% in twenty-eight out of eighty-two of the calendar years between 1926 and 2007 – or approximately one-third of those years. The following chart illustrates this point:



Source: Ibbotson
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Perhaps even more insightful is the study of the range of best and worst periods since 1926. As shown below, investors who have remained invested in the stock market have historically experienced better results over longer periods, even in the worst markets.

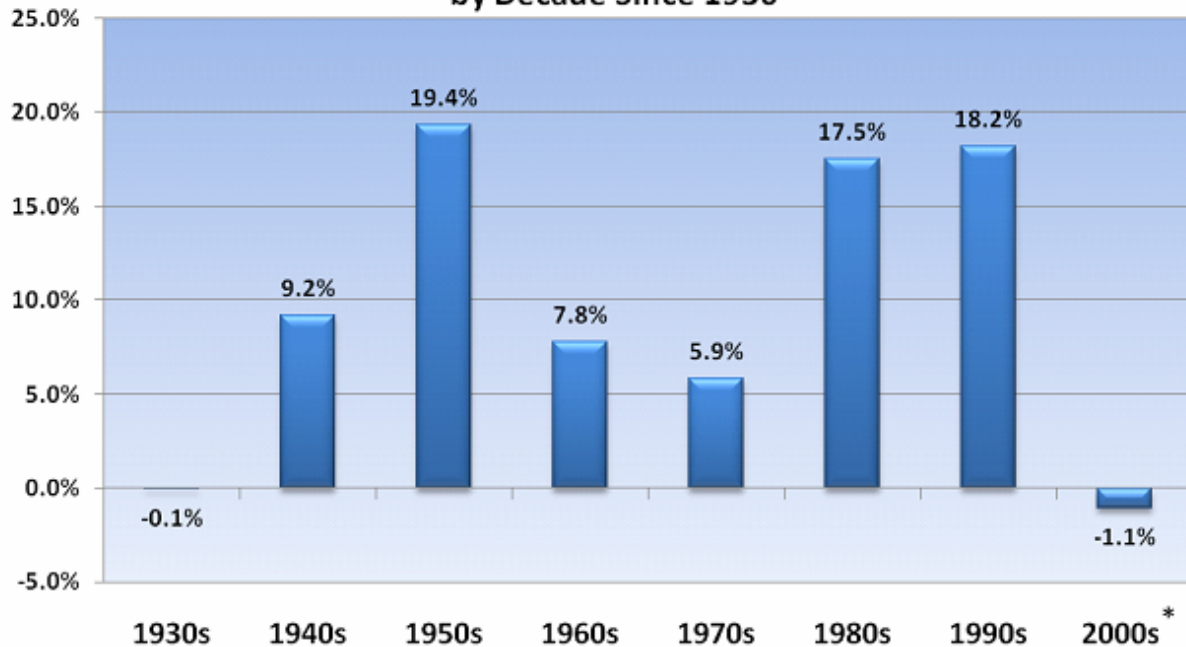
S&P 500 Index Cumulative Returns
Rolling Periods Starting In 1926

<u>Length of Period</u>	<u>Best Return of Period</u>	<u>Worst Return of Period</u>
1 Year	52.9% (1933)	- 43.9% (1931)
5 Years	251.1% (1995-99)	-50.1% (1928-1932)
7 Years	350.8% (1949-55)	-25.4% (1928-34)
10 Years	514.2% (1949-58)	-12.3% (1929-38)
15 Years	1,346.0% (1985-99)	4.9% (1929-43)
20 Years	2,584.0% (1980-99)	74.1% (1929-48)

Using the return data from this table, the downside of a long-term investor over a rolling ten-year period has been a cumulative -12.3% while the upside has rewarded a cumulative return of 514.2%. Although some may not want to take this risk, many would consider this trade off to be very advantageous for some portion of their investment portfolio.

While we believe rolling periods are very instructive, we understand that many people think about returns in terms of static periods such as decades. The same risk/reward trade off can be illustrated using this criteria. The only decade in the modern era that has failed to produce a positive return was the period of the Great Depression in the 1930s. During this historic decade, the S&P 500 Index narrowly missed positive territory by providing an annualized return of -0.1%. If we ended this current decade as of 9/30/08, this would be the second decade that would miss the positive territory mark. All other decades since 1930 have produced positive annualized returns as shown below:

**S&P 500 Index Annualized Performance
by Decade Since 1930**



*Through 9/30/2008

What factors led us to this current market environment?

Each new day substantial volumes are published by numerous financial media outlets – including newspapers, journals, online venues, and of course the talking heads of television. We understand that most of you receive an ample serving of these information updates, so we will not repeat the obvious headlines such as a recounting of the nationalization of Fannie and Freddie or the drama of the “Rescue Bill” signed into law recently. Both of these stories have received substantial coverage, and thus we will focus on other interesting developments. Beneath the headlines, we found the following circumstances noteworthy.

A Historic Watershed Period For Investment Banking: Of the five major independent investment banks that existed a year ago, only two – Goldman Sachs and Morgan Stanley – have been able to survive thus far. And even they have been forced to abandon their status as investment banks in favor of a more conservative bank holding company structure. Two others, 94 year-old Merrill Lynch and 86 year-old Bear Stearns which had both survived the Great Depression, were acquired by large banking institutions. Perhaps most disconcerting to the market, Lehman Brothers declared bankruptcy (see below). Just one of these might be considered a truly remarkable development. According to the Wall Street Journal, all five taken as a whole represent a watershed in the banking industry's biggest restructuring since the Great Depression. It will likely change the way business is conducted on Wall Street for years to come.

The Lehman Bankruptcy: Lehman Brothers Holdings Inc., recently the fourth-largest U.S. investment bank, succumbed to the subprime mortgage crisis it helped create in the biggest bankruptcy filing in history. The 158 year-old firm, which survived railroad bankruptcies of the 1800s, the Great Depression in the 1930s and the collapse of Long-Term Capital Management a decade ago, filed a Chapter 11 petition with U.S. Bankruptcy Court in Manhattan on 9/15/08. According to bankruptcy reports, Lehman had \$613 billion of debt on its balance sheet, approximately 25% of which was unsecured. As expected, the unsecured debt fell precipitously on the announcement of Lehman's bankruptcy. The reason the Lehman failure is so instructive is that it highlights how inter-connected seemingly disparate corners of the market have become. Though still going concerns, Goldman Sachs and Morgan Stanley were forced to reorganize and subject themselves to far greater regulatory oversight due to a lack of confidence in the investment banking industry stemming directly from Lehman. Events directly linked to the Lehman failure have dealt a blow to the financial sector in recent weeks resulting in a significant lack of confidence. Banks cannot ascertain to whom they should lend even among themselves, which plainly makes the prospect for lending outside the circle of financial institutions to the broader economy particularly dim. Though often overlooked in more pleasant times, confidence is perhaps the key ingredient in a well-functioning capitalist economy. Lack of confidence led to panic selling which in turn has driven the markets swiftly downward. Restoration of confidence is the goal of the government's bail-out proposal, as well as the key to preventing unexpected daisy-chain shockwaves from flowing from one area of the economy to another.

Money Market Funds: The shockwave requiring government intervention in the money market system, however, is something no one anticipated. Lehman's bankruptcy led to The Reserve Funds breaking the buck on one of its largest money market funds due to its Lehman holdings. This prominent money market fund held Lehman Brothers debt. It was the first time since 1994 that such a fund, which is supposed to be as safe as a bank account, had lost money. The loss was made worse due to a run by investors on the fund. Over two days, investors pulled more than half of their assets from the fund, once valued at \$64 billion. This started a ripple effect in the credit markets effectively shutting them down and thereby providing yet another blow to investor confidence. It is important to note that The Reserve Funds was a smaller, closely held enterprise without the financial resources of a larger financial institution that could make their investors whole.

Easy Access To Debt Led To Over Spending: After 9/11, interest rates were cut to historically low levels while lending standards across business and real estate (both residential and commercial) were dramatically relaxed. The end result was too much debt and too little cushion (equity) for protection from asset price declines. The subprime debt fallout has been one of the most visible results of this unsound policy.

De-leveraging and Forced Selling: This market downturn is different than most because it did not begin as a cyclical economic downturn. A significant de-leveraging process began in the financial markets approximately 13 months ago. This de-leveraging environment has forced asset prices down. When assets decline in value and there is excessive leverage, debt can exceed equity. Forced selling then occurs which further pushes prices lower. This cycle started with residential housing and has moved to commercial property as well as business loans. Many anticipate more pricing pressure in those markets and for corporate default rates to rise. The core of our financial problem, as Treasury Secretary Hank Paulson said in mid-September, is that these mortgage instruments are underpinned by real estate assets whose value keeps declining. Until home prices stabilize, no one knows how large the losses will be. “We’re basically at all-time lows for good credits,” Blackstone President Tony James said in a presentation in mid-September at a New York investor conference. “Because of capital pressures, and regulatory capital pressures in particular by the holders of the loans, they are forced sellers at well below intrinsic values.”

Largest One Day Drop Ever For The Dow – September 29, 2008: On this day, the House of Representatives rejected a \$700 billion plan to rescue the financial system. In response, twenty-five stocks fell for each that rose on the New York Stock Exchange. The Dow Jones Industrial Average slid 778 points for its biggest point drop in its 112 year history. According to Bloomberg, over \$1.1 trillion in market value was erased from American equities. The S&P 500 Index tumbled 106 points, or 8.8%, its largest point loss since the 1987 crash. The MSCI World Index of 23 developed markets slid 6.9%, the most in 22 years. The Nasdaq Composite Index declined 199.61, or 9.1%. Since this day, volatility in the market place has risen dramatically. The VIX index, a measure of market volatility, reached an all-time high at the writing of this report on October 9th.

The Muni Market: The prices of municipal bonds have fallen as these high quality securities have been used by investors as a means to generate liquidity. Investment grade municipal bonds have experienced negligible default rates historically; however, they have recently suffered in price due mostly to the lack of demand for these securities. With the vanishing of many underwriters, dealers, and buyers in the municipal bond space, the lack of demand has led to price weakness. Accordingly, yields on municipals moved up a great deal during the past eight weeks causing the market value of existing municipal bonds to fall more than usual. The market for new municipal bond issues has reached a near standstill. As investors have flocked to the safety of U.S. Treasuries, the relative value of general obligation municipal bonds has never been greater.

T-Bills That Pay No Income: Treasury bonds have rallied as investors view them as a “safe-haven” investment when all other instruments remain in question. Demand has been so great for Treasury bills, on certain days, that the yield offered on those securities has been almost nothing. At one point during the day on 9/17/08, investors were willing to pay more for one-month Treasuries than they could expect to get back when the securities matured. Some investors, in essence, had decided that a small but known loss was better than the uncertainty connected to any other type of investment. In other words, investors were so afraid of losing money they were willing to accept no return in order to get their principal back. That is a sure sign of investor panic.

Wall Street’s Woes Reach Main Street As Unemployment Rises: U.S. payrolls plunged in September, signaling that the 13 month-old credit crisis on Wall Street is finally hitting home on Main Street. Employers cut more jobs during September than in any month over the past five years. In its last employment report before the presidential election, the Labor Department reported that the unemployment rate was 6.1 percent, a climb of 1.4 percentage points from a year before. The report also showed that hours worked – considered a good proxy for the state of the overall economy – matched the lowest level since records began in 1964.

Banks At The Center Of The Crisis: It is no secret that banks have been at the center of the recent crisis. The financial sector has often been referred to as the economy’s circulatory system. Historically, banks have been willing to put their capital at risk in the form of personal or business loans because they have confidence that doing so will yield a profit when enough borrowers repay principal and interest to more than offset any defaults. This borrowing power circulates through the economy as a key financing component for businesses and individuals alike. The recent lack of confidence in the economy and the financial markets has forced banking institutions to withdraw nearly all new credit from the system over the last several weeks, and this has

placed the economy in a severe credit and cash flow crunch. At the heart of all this activity, the seizing up of the global credit markets has made financial transactions almost non-existent and has the Federal Reserve working to encourage intra-bank lending at all costs. The U.S. and global economies require fluid financing to operate, so it is imperative the credit markets begin to operate more normally. One measure of the stress in the financial markets is the LIBOR rate, the interest rate that banks charge one another to lend to/from each other. LIBOR has risen dramatically over the last few weeks indicating higher yields have been required to sustain any interest in lending between banks. LIBOR is a key indicator of the fluidity of the financial system and today its levels are indicating that the markets are not functioning properly. The days of banks running with leverage at 30 or 40 to 1 are likely over. Several noteworthy financial institutions that took those risks have either failed or been absorbed by others. The SIVs, CDOs and other exotic creatures have been put back on balance sheets, losses have been taken, and new capital has been raised to absorb those losses. According to the Wall Street Journal, because of these developments, we should be moving to a sturdier banking system.

To conclude “What factors led to this current market turmoil”, one of our New York-based managers summarized today’s market environment as follows: “Asset values have fallen due to the continuing downturn in housing and the weaker economy. Credit has become less available (even short-term credit) and more expensive. Dislocations within the credit markets intensified in September, despite numerous efforts by global monetary authorities to ease pressures, with LIBOR rates doubling during the month, the commercial paper market noticeably contracting and high-yield and investment grade debt spreads widening to decade-wide highs. The ensuing credit turmoil triggered a number of ‘historic’ events. Most likely it will take additional capital and time for credit markets to return to something that approaches normal, in light of prevailing conditions today.”

What should a long-term investor do?

The late Sir John Templeton once remarked, “Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria.” The reverse could also be said of bear markets – they are born on euphoria, grow on denial, mature on panic and die on despair. And as often said by veterans on Wall Street, “They don’t ring a bell when the market hits the bottom.” So in this significant market decline, what is an investor to do?

History has shown that times of extreme fear and angst often represent the most compelling investment opportunities. However, during times of uncertainty, many investors are tempted to cash out and sit on the sidelines. Market timing decisions require making two decisions right – when to get out and when to get back in. History suggests that this is a very difficult strategy to execute successfully. Excesses in one direction have a tendency to lead to an opposite excess in the other direction. And the movement between these two can transpire at lightening speed. Equity recovery periods can be very sharp, especially after big downturns like the one we are currently experiencing. We are not making any predictions of a quick recovery. However, it is worthwhile to know that in the early ‘80s and ‘90s the market recoveries occurred in three to four months, respectively. Right now, most everyone is focusing on the negative factors, but sentiment can shift very quickly. There is considerable discomfort in getting through a bear market, but in the end, this one may prove to be a very constructive cleansing process that removes unhealthy excesses from the system and returns us to a more stable environment in the years to come.

We understand that repeating the refrains “Stay the course” and “Ride this storm out” may not be considered an “action plan”. Accordingly we believe it is important to know what is being done by the professional institutional managers we utilize. We have definitely been in active communications with each of our institutional portfolio managers. In addition, over the past few weeks, we have met face to face with several of our managers in New York and elsewhere to receive updated due diligence reports and to see firsthand how they are reacting to these turbulent times.

While our performance has generally been in line with the market benchmarks, it is important to note that in periods of market stress where liquidity is the driver of decisions, even stocks that have done well and that are fundamentally attractive often get punished. This can make the outperformance of a benchmark in the short-term more challenging. Conversely, it does set up opportunities for stock pickers to outperform the market in

selecting businesses that are going to be successful on a going forward basis, and that is what we believe our managers are doing. Our managers as a group have strong convictions that they are witnessing historic investment opportunities. In addition, the general characteristics that we focus on in our manager selection process give us confidence during this type of environment:

1. We only retain veteran professional money managers who have been through multiple down markets and survived in good shape. Most of our managers have been investing in their respective areas of expertise for over 20 years, and some have been around much longer. This provides a steady hand and time-tested experience in volatile markets.
2. Nine out of the eleven long-only managers we work with own their own businesses and have substantial personal assets invested alongside their clients thereby aligning their interests with their clients.
3. Each of our managers has a history of sticking with a disciplined philosophy and process that has worked well over time.

A few additional observations are worth mentioning:

The Fourth Quarter Of 2008: Although we are still in October, the fourth quarter of 2008 is currently on track to be the sixteenth quarter since 1925 when the stock market (as measured by the S&P 500 Index) has declined more than 15%. The previous fifteen quarters have averaged a loss of 21.9% with the second quarter of 1932 posting a loss of 38.0%. It is important to note in the six-month periods following these sharply negative quarters, the market has produced an average return of 15.9%, and has been positive in eleven out of these subsequent fifteen periods. The other four negative periods all occurred between 1929 and 1932. The eleven positive six-month periods averaged a rebound of 26.1%. While we have no basis for predicting the future, we obviously hope that history will repeat itself in this regard.

Historically High Level Of Cash: According to a recent report from the Federal Reserve Bank, a near-record amount of cash, money market funds and T-Bills exists today. In fact, according to one of our managers, the volume of cash and cash equivalents exceeds the value of the total market capitalization of the U.S. stock market today. In due time, much of this cash will return to the stock market and push prices upward. A strong case can be made to suggest stocks are cheap by historical standards. However, the real issue at hand is the lack of confidence in the economic and banking systems. As an example, the “TED spread” (the difference between LIBOR rates and short-term U.S. Treasury rates) is nearly at unprecedented high levels. As noted above, this is the result of banks being very uncomfortable lending money to other banks and to certain types of customers. Although painful, we believe such an environment will be remedied in the near term which will help set the stage for more favorable equity performance going forward.

Today’s Environment Is Much Different Than The 1930s: A recent *USA Today*/Gallup poll showed that one-third of Americans believes the country is in a *depression*. Make no mistake, the U.S. economy most assuredly has encountered clear and present danger, but it is helpful to put some of the recent emotionally-charged headlines to the iron test of empirical fact. Doing so indicates that references to a depression are either misinformed or exceptionally premature. As we have mentioned before, the technical definition of a recession is two consecutive quarters of negative GDP growth. We have not, as of yet, experienced our first negative GDP quarter. While economists have never defined an exact delineation of what constitutes a depression, most Americans would surely equate a depression with the economic climate of the 1930’s. In that time, GDP shrank in excess of 30% from 1929-1933, rebounded for a couple of years, and shrank another 18% in 1937-1938. Unemployment ran as high as 25% during this time period, and many of those with jobs were employed more so in form than in substance. Currently, unemployment is slightly above 6%. Perhaps the wave of bank failures we have recently experienced harkens back to the days of the Great Depression, but examined objectively the economy is currently in much better shape than was the economy of the 1930’s. Furthermore, most economists believe that the Great Depression was significantly exacerbated by faulty monetary policies in effect at that time as well as a non-responsive Congress. Today economists have a far more advanced understanding of tactics to alleviate economic stress now than they did then.

Ignore Market Predictions – both Rosy Outlooks and Doom and Gloom Reports: As recently reported in *The New York Times*, when all the experts and forecasters agree – very likely something else is going to happen. Every January a host of market prognosticators makes annual predictions about how the market will perform in that calendar year. Of the leading Wall Street firms who announce their predictions, it is rare that more than one or two of the predictions prove to be reasonably close to the actual market performance. However, this practice is repeated each January and the financial media always seems to bask in the glow of the insight. Many on Wall Street anticipated that the economy would enter into recessionary times during 2008, but the overwhelming consensus was that it would be mild and short-lived. In January, Goldman Chief Economist Jan Hatzius predicted a recession during 2008 for the U.S. and predicted the S&P 500 Index would be down during the first six months but end the year up 6 percent. Separately, Goldman Chief Investment Strategist Abby Joseph Cohen predicted the U.S. economy would rebound in mid-2008, although the first few months would be bumpy. Ms. Cohen stated that she remained bullish and predicted the S&P 500 would hit 1,675 by the end of 2008, a gain of 14.5 percent (excluding dividends). The S&P 500 Index currently resides below 900. We have tremendous respect for the market veterans of Goldman Sachs, but we remain dismayed by how much credence is given to market prognostications.

We will only know well after the fact when the market ultimately reached its nadir. The prevalence of fear and the dislocations we are seeing across a variety of asset classes suggest we may be getting close. With this in mind, we believe the following practical steps are prudent:

1. Sufficient cash and income should be reserved to provide for anticipated spending needs over the next several years.
2. For taxable investors with a fixed income allocation, high quality municipal bond holdings should be maintained. They are offering historically attractive returns relative to U.S. Treasuries or similarly rated credits. Currently, municipal bonds yield in excess of 100% of Treasuries – a rare circumstance given their tax-exempt nature.
3. Investors should adhere to their asset allocations through these trying times, assuming their asset mix continues to be prudent based on their long-term needs and objectives. Our portfolio managers are constantly evaluating and upgrading portfolio holdings in light of the markets. Over the long term, remaining invested at points like these should pay a handsome reward.
4. Clients should challenge the above recommendations relative to the proverbial “sleep well” test. Going through a turbulent market when stocks seem to be falling daily, and given the information age in which we live where the news is constantly trying to grab our attention, an investor should not put their emotional or physical well being at risk despite what others may deem appropriate for them. In the end, an investor’s peace of mind is a very worthy objective.

Based on our continued belief in the benefits of prudent diversification through specialized managers, we continue to adhere to the time-tested practice of weathering negative periods with a commitment to stay the course. The fundamental investment tenets that underpin the allocations we espouse were constructed for bad times as well as good. That is why we are comfortable staying with a prudent long-term investment allocation in the current environment. However, we understand the uncertainty and anguish that such volatile markets can bring, and we encourage you to let us know of any concerns you may have. Please do not hesitate to contact us.

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