

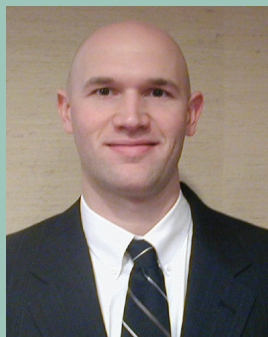
## 2008 Fourth Quarter Market Review

### Executive Summary

Written by:



Rick Vollaro, CPA  
Senior Analyst, Partner



Carl Noble, CFA  
Portfolio Analyst

•The fourth quarter of 2008 began in utter disarray as financial markets around the world were collapsing in unison. After gradually increasing in intensity throughout 2008, the current bear market, which started in October 2007, transformed into a full-fledged crash as the quarter commenced.

•The U.S. Federal Reserve (The Fed) steadily increased its monetary efforts during the past year in an attempt to halt the financial crisis, and stepped up its activities considerably in the fourth quarter. The Fed increasingly focused on using their balance sheet to battle the deflationary evils of the current recession, which is otherwise known as “quantitative easing” by central bankers and economists.

•Pinnacle Advisory Group managed accounts suffered losses during the fourth quarter in what turned out to be a painful year for investors. Early in the quarter, Pinnacle began to gradually increase risk in portfolios back to a more neutral level, which turned out to be a well-timed adjustment that helped returns as the market rallied toward the end of the quarter. The U.S. equity allocation in portfolios is roughly “sector neutral” to the S&P 500, meaning that current sector weights are close to the sectors weights of the S&P 500.

•Our latest outlook is that the economy is in a severe recession and will remain extremely weak through year-end, with risks still tilted to the downside and the possibility that this could stretch into 2010. The macro

environment appears to be lining up for a furious war between the forces of deflation and reflation. Due to ongoing economic dislocations, extreme volatility should be expected and the market may very well trade in a wide range that could extend from the current cyclical trough of 740 to as much as the previous highs around 1,500 on the S&P 500.

•At present, our model allocations are positioned at slightly below neutral volatility, which we feel is appropriate given the risks to both sides of the forecast. There may be additional upside due to the tremendous amount of reflation in the works combined with the oversold nature of the markets. Should we get an extension of the rally off the lows, we will treat any surge in the markets as a cyclical rally within the ongoing bear market, and in the absence of improved fundamentals, our current plan is to use the rally to reduce volatility in portfolios as it plays out.

•The tide is certainly out at the moment as investors deal with the declines in asset values, awful economic data, and the highly negative news flow. The road to recovery will no doubt be bumpy and investors should expect many twist and turns along the way. Our investment strategy will have to be more nimble than ever before; ready to adjust to a variety of possible scenarios that have very different implications. Ultimately, we believe that the tide will come back in, even if the water is hard to see from the shore at the moment.

## Fourth Quarter Review

The fourth quarter of 2008 began in utter disarray as financial markets around the world were collapsing in unison. After gradually increasing in intensity throughout 2008, the current bear market, which started in October 2007, transformed into a full-fledged crash as the quarter commenced. In hindsight, it was apparent that allowing Lehman Brothers to fail on September 15, 2008 was a painful miscalculation that caused credit markets to cease functioning and economies around the world to crumble. The forward-looking nature of financial markets quickly came to a realization that future earnings would be severely damaged, causing risk assets to be indiscriminately punished across the board. Along the way, government authorities scrambled to come up with policies to save the system, but their patchwork approach only seemed to confuse markets and exacerbate the downturn in progress.

Index	4th Quarter	2008
S&P 500	-21.94%	-36.99%
Russell 2000	-26.12%	-33.80%
MSCI EAFE	-19.92%	-43.07%
Dow Jones/AIG Commodity Index	-30.12%	-36.61%
Lehman Aggregate Bond Index	+4.57%	+5.24%
3-Month T-bills	+0.022%	+2.05%

By mid-November, investors were awestruck and paralyzed by the carnage. Amazingly, stocks managed to erase a decade's worth of gains as the S&P 500 Index sunk to an intraday low of 740 on November 20, 2008, which was the lowest since 1997. Thankfully, that day marked at least a short-term bottom, and stocks rallied

by more than 20% by year-end. But overall, 2008 will disappointingly go down as the worst year for the S&P 500 since 1937. By the end of the quarter, an exhausted investment community was left to grapple with a myriad of questions regarding the shorter and longer-term prospects for economies and financial markets in 2009.

## *“Quantitative Easing”*

Amidst a barrage of notable developments during the quarter, an important shift in fiscal and monetary policy is of particular interest for investors. The U.S. Federal Reserve, which has been steadily increasing its monetary efforts during the past year in an attempt to halt the financial crisis, stepped up its activities considerably in the fourth quarter. They had already reduced short-term interest rates, which is their primary monetary tool, from 5.25% in September 2007 to 2% entering the quarter. After lowering the rate to 1% in October, they announced following their meeting on December 12 that rates would fall again to a range of between 0% - 0.25%, meaning that they had effectively fired their last monetary bullet. Or had they? Actually, short-term interest rates are only one tool at the Fed's disposal. Fed officials were well aware of the dwindling capacity to reduce rates, so they've been increasingly focused on using their balance sheet to battle the deflationary evils of the current recession, which is otherwise known as “quantitative easing” by central bankers and economists.

The Fed's balance sheet is its assets and liabilities, similar to a regular corporation. Under normal circumstances, the asset side consists almost entirely of risk-free government debt (T-bonds, T-bills, etc) that it uses to help manage the money supply in the economy. However, as the current crisis has deepened, they've reduced their government debt holdings through an alphabet soup of various lending facilities designed to help support financial institutions, while accepting non-government, and thus riskier, debt as collateral for those loans. In effect, due to the shutdown of the credit markets, the Fed has had to step in and exercise its ability to be the “lender of last resort.”

More recently, the Fed has been rapidly expanding the size of its balance sheet so that it can provide even more assistance to markets. Indeed, the Fed's assets have increased by a staggering \$1.2 trillion (yes, with a “T”) since September, to more than \$2 trillion total. Of the increase, more than half has been attributed to quantitative easing. You might be wondering, “Where does all this money come from?” Well, the Fed is granted the unique authority to “print” money. But in the modern age, that process doesn't involve a printing press and stacks of

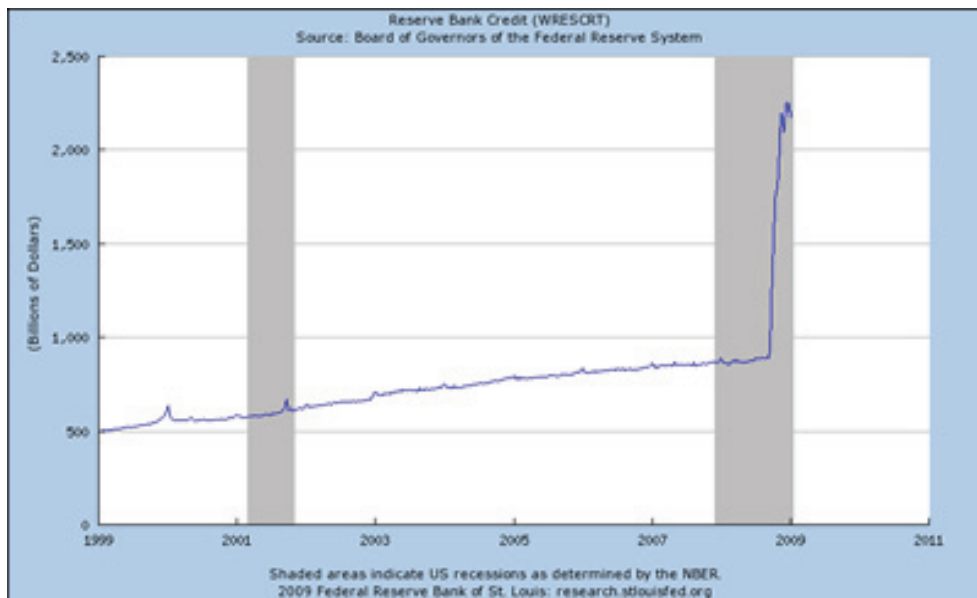


Chart 1 Reserve Bank Credit

dollar bills; rather, they make direct electronic credits to their own accounts.

With their newfound resources, the Fed has been pursuing a variety of strategies in an attempt to restart the flow of credit and thus economic activity – they’ve been making loans to needy financial institutions, guaranteeing the assets of large money center banks that are deemed “too big to fail,” and making sizable purchases of agency-backed mortgage securities in a bid to aid the housing market by bringing down mortgage rates. The immense size of their recent actions does seem to be having the desired effect, albeit at a much slower pace than intended. Some credit market relationships and spreads that had spiked to worrisome levels following Lehman’s demise have been restored to more reasonable levels.

The bottom line is that while the Fed has reached the limits of using traditional monetary stimulus involving adjusting short-term interest rates, it has signaled that it will continue to expand its balance sheet using unconventional and creative methods. The Fed is well aware of the risks of going too far and of possible “unintended consequences” of their actions. But they’re also acutely attuned to the enormity of current problems and have made their intentions clear to use their full arsenal in an attempt to resuscitate the financial system. Because they are such a powerful force with expanding

resources, investors must consider how these actions are likely to ultimately affect markets. For an in-depth discussion of Pinnacle’s views on this and other matters, please turn to the “Market Outlook” section of this report.

**Pinnacle**  
**Performance**  
**Analysis**

Pinnacle Advisory Group managed accounts suffered losses during the fourth quarter in what turned out to be a painful year

for investors. Early in the quarter, Pinnacle began to gradually increase risk in portfolios back to a more neutral level, which turned out to be a well-timed adjustment that helped returns as the market rallied toward the end of that period. We realize that the size of portfolio losses is concerning for investors, but we are nonetheless pleased that our tactical approach added significant value throughout the year as losses were far less than those in the broad stock market and respective benchmark portfolios.

Composite	4th Quarter Composite Return 9/30/08 to 12/31/08	Trailing 12-Month Composite Return 12/31/07 to 12/31/08
Dynamic Conservative Growth	-4.94%	-13.18%
Dynamic Moderate Growth	-7.32%	-16.77%
Dynamic Appreciation	-11.86%	-23.61%
Dynamic Ultra Appreciation	-14.78%	-28.57%

*Please see the last page of this report for important performance-related disclosures.*

## Fourth Quarter 2008 Market Review

At the individual security level, U.S. Treasury bonds posted the best performance during the quarter as investors fled riskier holdings. Other types of fixed income, including high grade corporate bonds and international government bonds, also performed well. Equities and alternative investments generally declined again, although gold was an exception as it posted a slightly positive return due to its “safe-haven” qualities. Defensive sectors, diversified international equity mutual funds, and eclectic managers held up the best, while cyclical sectors and diversified commodities declined the most.

### Quarterly Portfolio Activity

The fourth quarter marked a significant shift in portfolio tactics. Beginning January 2007 and throughout the majority of 2008, portfolio activity was largely defined by considerable reductions in equity weightings in an attempt to minimize the damage from the oncoming bear market. Towards the end of the third quarter, however, the depth of the market rout caused us to shift our focus to re-building risk exposure as we began to focus on the longer-term value opportunities that were emerging. New equity positions were added, which were largely funded by reductions in fixed income holdings.

The following table details the current asset mix across strategies:

Composite	Equities	Fixed Income	Alternatives
Dynamic Conservative Growth	29	54	17
Dynamic Moderate Growth	42	39	19
Dynamic Appreciation	61.75	19.5	18.75
Dynamic Ultra Appreciation	77.5	4.5	18

In anticipation of a significant rally, we purchased new positions in some areas of the market that experienced the worst declines (and which we’d previously been underweight), including the Financial, Consumer Discretionary, and Energy sectors. As a result, the U.S. equity allocation in portfolios is roughly “sector neutral” to the S&P 500, meaning that current sector weights are close to the sectors weights of the S&P 500 (although still with some different industry emphasis). Within the fixed income allocation, we continued to diversify into non-government sectors that offer tremendous value. Most notably, we purchased a High Yield exchange-traded fund after spreads to Treasuries of those bonds reached record-high levels. It’s the first time in several years that we’ve owned High Yield corporate bonds.

Please note that specific trades and securities vary by portfolio policy. For additional insight regarding portfolio transactions, please visit the “Current Interest” section of our website, or contact your advisor.

**Market Outlook** (note that this was written on January 14th with the S&P Index at (840)

Last quarter we wrote the following, “*Our current base case is that the global economy is decelerating at a rapid rate. Industrialized nations are most likely in recession, while emerging markets are rapidly slowing from their torrid growth pace of the past few years. The credit freeze has exacerbated the economic slowdown that was already in progress, with the odds that the U.S. economy will undergo a deep rather than a mild recession increasing steadily. We believe the war between inflation and deflation that characterized the markets just a quarter ago will be replaced by icy pockets of deflation emanating from deteriorating economic fundamentals across the globe. The good news is that valuation has improved markedly and stocks are extremely oversold again. The combination of global monetary and fiscal intervention, improved stock market valuations, oversold conditions, and strong technical support levels at the 2002 lows seem to support the notion that a material rally could soon materialize. However, due to the severity of the economic damage sustained during the credit crunch, we are not willing to commit to a view that the rally will represent the next cyclical bull market at this time. Therefore we are instituting a bifurcated approach*

*to portfolio positioning, where we begin to add volatility back to moderate through aggressive models in advance of the fundamentals, while maintaining more of a defensive posture within our conservative models.”*

Unfortunately, our macro forecast for the economy turned out to be right on target. During the quarter, the National Bureau of Economic Research (NBER) officially declared that the U.S. had fallen into recession during December 2007. While the NBER's declaration captured headlines, it wasn't really “news” to us since we'd been operating under the assumption that the economy was in recession for the balance of the year, based on the many economic fundamentals that we track that showed weakness. In fact, our fear of oncoming recession earlier in the year is what compelled us to rotate portfolios to be much more defensive than usual. But that's in the past. Entering 2009, the critical issue for investors is, now that the recession is a year old, how much longer will it take for it to run its course, and when should they begin investing for the next growth cycle?

*Our latest outlook is that the economy is in a severe recession and will remain extremely weak through year-end, with risks still tilted to the downside and the possibility that this could stretch into 2010. The macro environment appears to be lining up for a furious war between the forces of deflation and reflation. Deflationary pressures emanating from the housing depression, global recession, poorly functioning credit markets, and forced deleveragings have the upper hand at present. On the other side of the battle lines stand monetary and fiscal authorities from around the world that appear willing to commit trillions of dollars of stimulus to try and defend the system from the deflationary mindset that is showing tentative signs of taking hold.*

*Due to ongoing economic dislocations, extreme*

*volatility should be expected and the market may very well trade in a wide range that could extend from the current cyclical trough of 740 to as much as the previous highs around 1,500 on the S&P 500. Should we get an extension of the rally off the lows, we will treat any surge in the markets as a cyclical rally within the ongoing bear market, and in the absence of improved fundamentals, our current plan is to use the rally to reduce volatility in portfolios as it plays out. At present, our model allocations are positioned at slightly below neutral volatility, which we feel is appropriate given the risks to both sides of the forecast. It is important to note that in some respects we are currently navigating uncharted waters, and there is more risk to the outlook than usual due to the number of potentially high octane variables that are currently in play. In this environment we remain extremely vigilant in guarding against becoming entrenched in our stated view, and stand ready to quickly adjust if necessary based on incoming information.*

### Poor Fundamentals and Shifting Structural Winds

The economic backdrop is showing no signs of improvement. Leading indicators of growth and employment confirm that the economy is still reeling from the ripple effects of malfunctioning credit markets

Chart 2 from the Economic Cycle Research Institute



that are working their way through the system. Weak growth first affected the U.S. markets and the consumer, and there is no longer any debate about whether the world will catch a cold when the U.S. consumer sneezes. The world's leading economic indicators have all been dropping precipitously and at this point no region within the world economy has been spared.

At Pinnacle, there is a laundry list of economic data that we rigorously monitor in our attempt to assess the future direction of the economy. Unfortunately, the data is almost uniformly negative, with no signs of an imminent turnaround. While many market prognosticators argue that the economy will rebound around mid-year, we are far less certain that will be the case. In fact, even a cursory glance at a leading indicator created by the Economic Cycle Research Institute (ECRI), shown in Chart 2, might lead you to believe that the economy could actually get worse. With the economy under pressure, corporate earnings also seem likely to disappoint. Analysts have been slow to adjust to the economic contraction and are frantically revising their future estimates lower. In short, cyclical fundamentals still appear very poor at present, which is largely contributing to our view that we will experience continued bouts of volatility throughout the early part of 2009.

Credit markets are also very high on our watch list because they are the transmission mechanism for growth throughout the global economy. Malfunctioning credit markets have largely contributed to the global economy deteriorating from a run-of-the-mill recession to a much more severe recession. We believe that healthy and functioning credit markets are a prerequisite for the economy and financial markets to find solid footing, and recently tentative signs of improvement in some parts of the credit markets have emerged. Various market-based spreads that had widened considerably as fear spread across the financial landscape a few months ago have begun to settle back down in the wake of the growing government-led policy response.

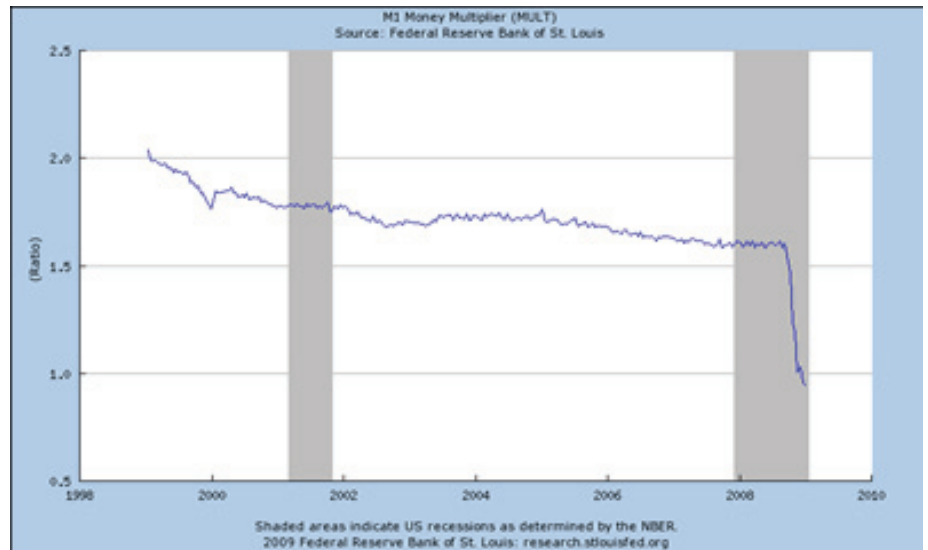
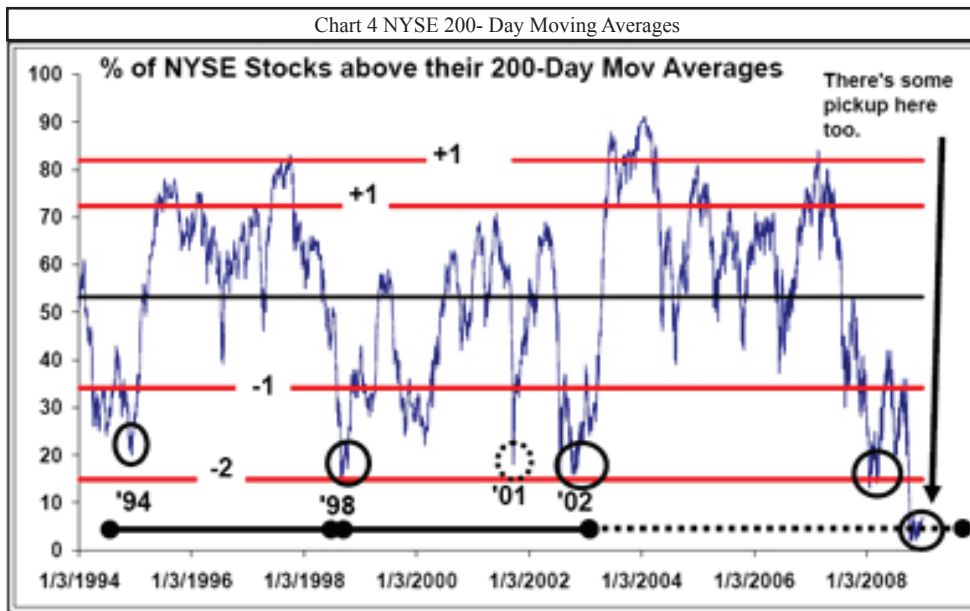


Chart 3 Money Multiplier

However, significant hurdles remain before a full sense of normalcy is restored to credit markets. Indeed, banks have demonstrated an ongoing reluctance to make new loans, despite capital injections and other assistance designed to take away the systemic fear of insolvency that has gripped the banking system. The financial system appears to be caught in what is known as a “liquidity trap.” In other words, although there has been an enormous sum of money and credit extended to address problems at financial institutions, it is not finding its way to the beneficiaries that need it most. Ultimately, the capital injections are intended to flow through to consumers and businesses so that the gears of the economy can start to turn again. As chart three shows of the money multiplier is a vivid example of the degree to which the lending mechanism has broken down. The multiplier, which is an economic concept used to gauge the amount of extra money created through bank lending, is fairly stable over time, but recently spiked lower in dramatic fashion as lenders suddenly pulled back. Until there are tangible signs that banks are no longer hoarding funds and are beginning to lend again, the economy is unlikely to make much progress, and credit markets will remain dysfunctional. It is highly unlikely that we would position portfolios more aggressively until there is evidence that credit is flowing more smoothly.

### More Room to Rally

With the litany of negative fundamentals combined with important structural shifts taking place currently, it is fair to wonder if the rally off of the November 20, 2008 low can continue. There may be additional upside due to the tremendous amount of reflation in the works, combined with the oversold nature of the markets. The Fed and the Treasury have already made various pledges and guarantees worth several trillions of dollars in hopes of thawing credit markets and jump-



starting economic growth. In addition, the market is expecting a fiscal stimulus package in the near future that will likely amount to close to an additional trillion dollars on a variety of infrastructure projects, tax cuts, and other programs. It's obvious that the gravity of the current deflationary threat is clear to fiscal and monetary authorities, and they are doing their part to prevent such an outcome from occurring. If the stimulus has the desired effect, and credit markets can continue to heal, then there is a tremendous amount of cash on the sidelines that may scramble back in to risky assets since money market returns have fallen to miniscule levels.

Additionally, various measures of the internal state of the market itself are flashing bullish signals. After declining by more than 50% from top to bottom, there is a variety

of evidence that the market has become extraordinarily oversold. The percentage New York Stock Exchange stocks trading above their 200-day moving averages, shown in chart four, is one such "oversold indicator." It fell to a record low during the recent market rout, which clearly demonstrates the intense selling pressure in the market. Encouragingly, several major stock market bottoms in the past soon followed this indicator falling to a similar level, resulting in significant rallies as the selling eventually subsided. So, even if fresh lows are in store at some point in the future, which can't be ruled out, we believe the odds favor a rally first, if for no other reason than to "clear" the oversold readings.

### Summary

The tide is certainly out at the moment as investors deal with the declines in asset values, awful economic data, and the highly negative news flow. The recent rally has provided some relief, and while we are not convinced that the next long-term bull market is unfolding

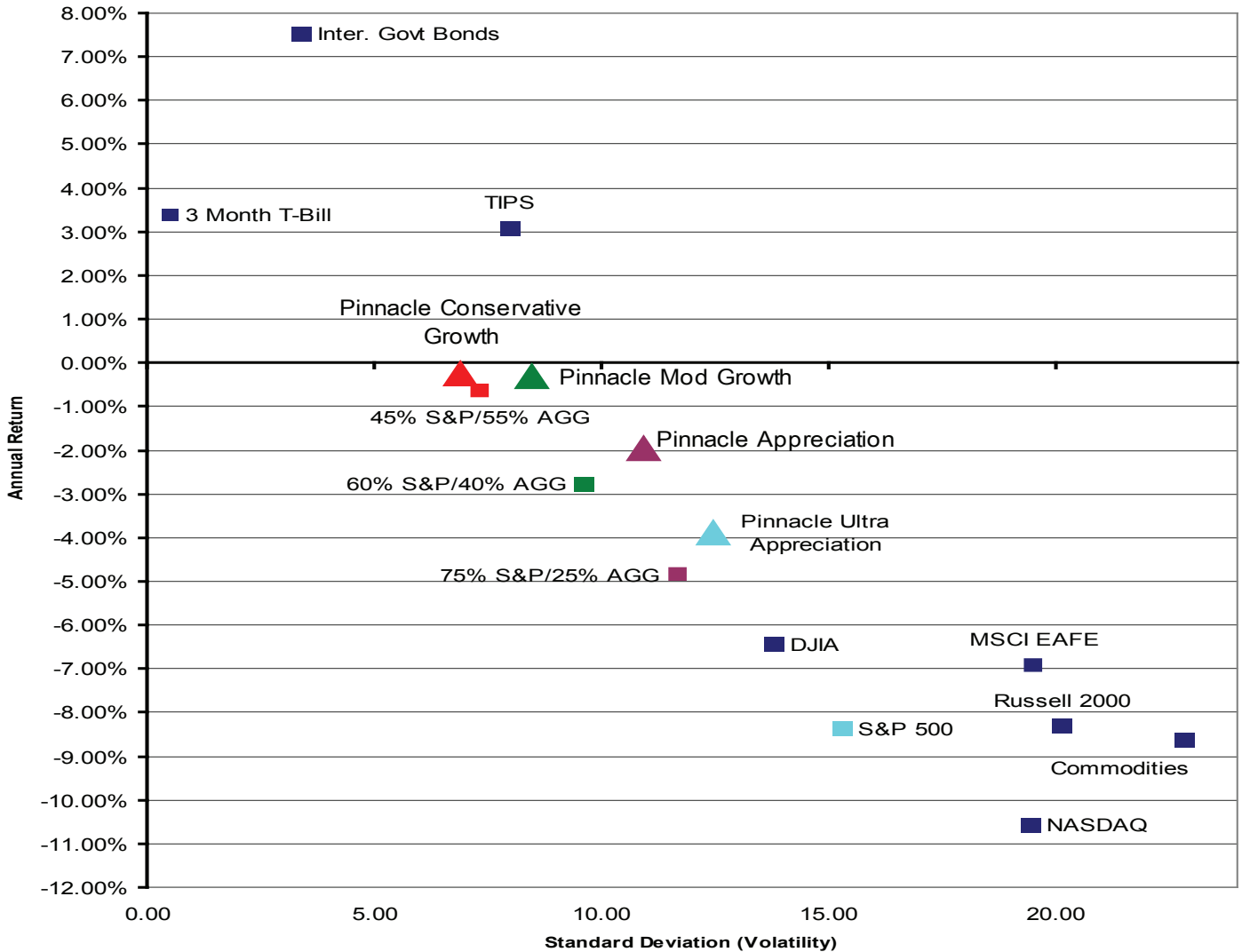
despite the gains, we are also aware of some positives that are slowly building behind the scenes. We have reached a point in the cycle where valuation has improved noticeably, lots of bad news is discounted, and policymakers are working overtime to do whatever is necessary to stop the bleeding in the financial system. The road to recovery will no doubt be bumpy and investors should expect many twist and turns along the way. Our investment strategy will have to be more nimble than ever before; ready to adjust to a variety of possible scenarios that have very different implications. Ultimately, we do believe that the tide will come back in, even if the water is hard to see from the shore at the moment.

*Note: Pinnacle's views are current as of the date of this communication and are subject to change as economic and market conditions dictate.*

# Fourth Quarter 2008 Market Review

3 Year Chart (12/31/05 - 12/31/08)

Pinnacle Composite Portfolios may be compared to a variety of asset classes, blends of asset classes, or mutual fund universes. This chart shows risk and return for four Pinnacle composites. Risk is expressed on the horizontal axis as standard deviation. A high standard deviation means a security is more volatile than a security with a low standard deviation.



Asset	Annual Return	St.Dev	Asset	Annual Return	St.Dev
3 Month T-Bill	3.41%	0.48	Pinnacle Dynamic Moderate Growth	-0.30%	8.46
Intermediate Govt Bonds	7.54%	3.37	75% S&P/25% AGG	-4.84%	11.69
TIPS	3.08%	8.00	Pinnacle Dynamic Appreciation	-1.94%	10.92
DJIA	-6.44%	13.78	Pinnacle Dynamic Ultra Appreciation	-3.89%	12.48
Pinnacle Dynamic Conservative	1.13%	5.69	S&P 500	-8.36%	15.29
Pinnacle Dynamic Con Growth	-0.23%	6.92	Commodities	-8.60%	22.82
45% S&P/55% AGG	-0.66%	7.35	Russell 2000	-8.29%	20.12
NASDAQ	-10.58%	19.42	MSCI EAFE Index	-6.92%	19.53
60% S&P/40% AGG	-2.75%	9.61			

**Intermediate Government Bonds** – An unmanaged index based on all publicly issued intermediate gov't debt with an avg maturity or 4 years.

**Lehman Aggregate Bond Index (AGG)** – An unmanaged, intermediate term, market-capitalization weighted index used to represent investment grade bonds being traded in the U.S. The index includes Treasury securities, Government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S.

**TIPS** - These are inflation-protected securities issued by the US Treasury.

**Dow Jones Industrial Average Index (DJIA)** - An unmanaged, price-weighted index of 30 widely held stocks traded on the NYSE. The 30 stocks in the Dow Jones Industrial Average are all major factors in their industries and their stocks are widely held by individuals and institutional investors.

**S&P 500** – An unmanaged, capitalization-weighted index composed of 500 widely held common stocks listed on the NYSE. This index provides a broad snapshot of the overall U.S. equity market . The index selects its companies based upon their market size, liquidity, and sector.

**S& 500 Total Return Index** – S&P 500 index including reinvestment of all dividends and distributions.

**AIG Commodity Index (Commodities)** - This rolling index is composed of futures contracts on 19 physical commodities.

It is designed to be a highly liquid and diversified benchmark for the commodity futures market.

**Russell 2000** – An unmanaged, market-capitalization weighted index that measures the performance of the 2,000 smallest companies in the Russell 3000 index.

**MSCI EAFE Index** - An unmanaged, market capitalization weighted index composed of stocks from 21 developed markets, but excludes those from the U.S. and Canada. The countries included in the index are located in Europe, Australia, Asia, and the Far East.

**NASDAQ** – An unmanaged, market-capitalization weighted index. The security types eligible for the index include domestic or foreign common stocks, ordinary shares, ADRs, shares of beneficial interest or limited partnership interests, and tracking stocks.

**45% S&P/55% AGG** – Comprised of the S&P 500 Total Return Index and Lehman Aggregate Bond Index.

**60% S&P/40% AGG** – Comprised of the S&P 500 Total Return Index and the Lehman Aggregate Bond Index.

**75% S&P/25% AGG** – Comprised of the S&P 500 Total Return Index and Lehman Aggregate Bond Index.

#### **Disclaimer**

Pinnacle Advisory Group, Inc. (hereinafter “Pinnacle”) is an investment advisor registered under the applicable provisions of the U.S. Securities and Exchange Commission (SEC).

#### **Pinnacle Dynamic Portfolios**

Any reference to “Pinnacle’s” portfolio volatility or portfolio performance is based on the actual performance of Pinnacle’s composite portfolio groups. There are five Pinnacle composite portfolios – Dynamic Conservative, Dynamic Conservative Growth, Dynamic Moderate Growth, Dynamic Appreciation, and Dynamic Ultra Appreciation – and each is managed within the constraints of a specific Investment Policy Statement. The composite portfolios are actively managed and the underlying securities and/or percentage holdings in each security can and do change as Pinnacle alters its market outlook based on a continuous evaluation of market and economic conditions. The composite portfolios typically own a diversified mix of no-load or load-waived mutual funds and exchange-traded funds that invest in U.S. and international equities, fixed income securities, and alternative investments such as commodities, real estate, and hedge-fund-like strategies. It is important to note that the returns and volatility shown are accurate representations of past performance, but are not necessarily predictive of future performance or volatility as market conditions can and do change. Returns are calculated using month-end portfolio values. Any and all return or volatility data for the composite portfolios are shown net of all Pinnacle fees and any other related fees (such as fund expense ratios or transaction/trading costs where applicable), include dividends and interest, and are size- and time-weighted. Policy composites include portfolios formerly categorized as “Stock” or “Mutual Fund,” which may have deviated slightly from target model weightings in the past. Policy composite returns may vary from individual Pinnacle client accounts due to deposits or withdrawals from the account, or other client-driven market timing or security selection issues. Pinnacle composite portfolios may be compared to various asset classes, blends of asset classes, indices, or mutual fund universes. The performance and volatility of these asset classes are for comparison purposes only and such performance can be materially different than a Pinnacle composite portfolio.