

THE SWEETWATER PERSPECTIVE

Our Views on Investing & the Economy

February 2008

2007 was a very difficult year for most investors and 2008 is off to a rough start. We underestimated the degree of problems emanating from the sub-prime loan meltdown. Unprecedented volatility and frustrating back and forth action have taken their toll on investor psychology and their holdings.

Before addressing 2008, let's take a look at what went right and wrong last year. Fortunately, for clients that were with us the entire year, we achieved a double digit return in 2007. Generally, our selection of asset classes and sector weightings put us ahead of the pack. Twelve months ago, we expected the US economy to slow and force the Federal Reserve to cut interest rates - this indeed happened. Our strategy was levered toward hopes of global economic expansion - this too happened. We avoided areas in the US economy that hurt investors the most - financial stocks, retailers, domestic real estate and small cap stocks. We also leaned toward sectors that derived much of their profits overseas such as oil service companies, industrial metals, infrastructure plays and agri-business, all helped by weakness in the US dollar.

Our message is that Sweetwater's endowment style investing strategy has historically had a low correlation to the US market over the long run. However, we're now experiencing an example of how this strategy can come into sync with the US market over short time periods when fear based sell-offs occur. In our view, there is little beyond diversification that a long-term investor can do to mitigate this, as some investors tend to throw the baby out with the bathwater. When this occurs, even historically low-correlated asset classes can move in similar fashion. However, over time, low-correlated asset classes will usually trade relatively independently. It is for this reason, that we remain committed to a globally diversified, multi-asset class strategy.

On Defense - We are currently positioned as defensively as any time in our firm's history. We have combed through every holding and considered the downside risk. We won't conclusively know if we are indeed in a recession for several months. *Our game plan is to evaluate every investment as if we are in a recession and to think in terms of the potential downside if things get worse.* Market environments like this have created tremendous opportunity in the past. Although the Fed

may have been late to the game, they now have the pedal to the metal regarding rate cuts. Why is this so important? Over the past 40 years, the average stock market return has been 21% at month twelve after the first rate cut. Don't underestimate the power of cheap money and an accommodative Fed. With interest rates at historically low levels (and maybe headed lower), *dividend and income paying investments are more important than ever.* We are slowly nibbling away at high income investments in periods of price weakness. This tactic has served us well in the past.

On a tactical note, an attractive storyline we continue to like is the growth in the agricultural industry. This is linked to the explosive growth of the, middle class in places like China, India and Russia. These countries are experiencing dynamic growth of their middle class. This newly empowered middle class will not only use more energy, but also consume more food. Increased demand for higher quality protein requires additional fertilizer, farm equipment, etc. This trend is furthered by demand for crop based alternative energy plays like biodiesel and ethanol (even if the economics of these is yet to be determined).

We've had a rough start this year, but one month's performance does not predict the whole year. We are working hard to research, discover and implement fresh investment themes. Investor Charles Carlson once wrote, "long-term investors get rich during bear markets - they just don't realize it until later."

P.S. Please feel free to send a copy of this letter to your family and friends. Also, if you know someone who has recently retired, please forward our information. Our business is built on referrals. ♦ © SFA 2008



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