THORNHILL SECURITIES, INC.

THE LONG VIEW

A periodic review of research, topics and performance for long-term investors

October 2008

Asset Returns

Sep 30, 2008	YTD	2007	2006	10 Year	20 Year
Domestic stocks					
Large	-19.9	5.2	15.8	5.9	11.8
Large Value	-18.7	-0.7	22.5	7.7	12.8
Large Growth	-19.4	11.5	8.9	3.8	10.7
Small	-9.7	-1.8	18.3	7.1	11.3
Small Value	-3.5	-10.2	23.4	9.1	13.3
Small Growth	-15.0	6.9	13.2	4.3	8.8
Micro Cap	-13.3	-5.2	16.2	10.6	13.5
International stocks					
Large	-26.9	10.0	25.8	9.0	7.8
Large Value	-28.2	4.2	30.3	11.1	9.8
Large Growth	-26.2	15.0	21.8	6.8	5.7
Small	-26.8	5.7	24.9	17.6	-
Small Value	-27.7	3.0	28.4	20.1	-
Emerg. Mtks.	-31.1	33.2	31.4	14.9	-
EM Value	-35.6	45.6	37.9	21.7	-
EM Small	-39.1	38.0	37.3	21.3	-
Sectors					
U.S. REITs	1.2	-17.8	35.5	11.1	11.1
Energy	-19.5	36.8	18.0	11.5	12.0
Bonds					
Short Term	1.5	4.7	4.8	3.5	4.5
Five Year	0.4	5.2	3.9	6.2	7.5
Long Bond	4.2	9.2	1.7	7.3	9.3
Total Market	0.7	7.0	4.3	6.0	7.6
Other					
Inflation	-	4.1	2.5	2.7	3.1
Comm. RE	-	15.9	16.6	12.9	8.8
Residential RE	-	0.9	5.6	6.7	5.0
Hedge Funds	-	14.1	13.0	8.4	-
Commodities	-	16.7	-7.3	3.9	4.9

SOURCES:
Large Cap data is based on S&P 500 returns.
Large Value and Growth returns are based on Russell 1000 Value and Growth data.
Small Cap, Small Value & Small Growth are based on Russell 2000, R2000 Value and R2000 Growth data.
Micro Cap returns are based on the CRSP 9-10 index of the smallest publicly traded stocks.
Int'l Large, Large Value and Large Growth are based on MSCI's EAFE Indexes.
International Small & Small Value returns are based on small company data in developed markets from DFA.
Emerging Markets data is from MSCI's Emerging Market.
Emerging Market Value and Small Cap data is based on Indexes maintained by DFA.
REITs are based on the Wilshire REIT index.
Energy data is from S&P's energy index.
Short term bonds are represented by Lehman's index.
Five year bonds are five year treasury returns and long term bonds are 20 year treasuries.
Total Bond market is the Lehman Aggregate Index.
Other data comes from the Federal Reserve, National Association of Realtors, HFRI & the CRB.

Thornhill Securities, Inc.
336 South Congress, Suite 200
Austin, TX 78704

Written by Gabe Thornhill, CFA

Taking a Step Back

The last 12 months have been a tumultuous ride for investors. Through the end of September, 17 of 18 equity asset classes we track are down for the year. Given the dramatic declines of the first 10 days of October, all of those asset classes are now down 10-40% for the year. In this newsletter I want to review the current crisis, how it relates to previous bear markets, and what lessons we've learned.

Real Risk is Always Unexpected - "It's different this time"

At the heart of today's financial crisis are millions of mortgages, primarily from California, Florida, Arizona and Nevada, that borrowers cannot afford. Lenders made loans that only worked if home prices continued to appreciate. The loans were packaged into complex mortgage backed securities (MBS) which were sold to financial institutions and investors around the world. When the underlying mortgages started failing, investors were forced to realize their losses. In some cases the losses were real losses associated with the mortgages that failed, in other cases the complexity of MBSs made them difficult to value and trade. With no willing buyer for an MBS, its value would be "Marked to Market" at a severe discount. These bad loans have caused over $600 billion (to date) of losses and the demise of Fannie Mae, Freddie Mac, Lehman Brothers, AIG, Washington Mutual, Wachovia, and Bear Sterns. Other financial institutions have been driven to the edge of failure and more will likely fail. However, 1000 S&Ls failed during the 80's and the S&P 500 still delivered returns near its 80 year average.

This is an "unprecedented" situation and our government and financial institutions have been slow to react. Although many people felt home prices were too high, very few predicted the resulting devastation to our financial system. What is not "unprecedented" is the uniqueness of each crisis over the last 40 years; an oil embargo, double digit inflation and unemployment, Mexican economic collapses, S&L failures, foreign debt defaults, Asian Tiger meltdowns, and the tech bubble. Because the drivers are always different, it takes time to develop a new game plan. Mistakes will be made (i.e. Lehman bankruptcy), but the global economy and capitalism worked through each of the past problems with new and different solutions. Each crisis was accompanied by real fear about the future of our system and real stock market losses. In October 1974, following Nixon's resignation, the U.S. economy was mired in recession and the stock market was down over 40% from its previous highs. 51% of Americans surveyed by Gallup thought we were on the edge of a second Great Depression. Instead of a depression, the market more than doubled over the next five years.

Risk and Return are Related

Up until late last year, we had a remarkable period of low volatility in the equity markets. From the lows in 2002 and 2003 until 2007, most asset classes

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showed steady upward movement with very few periods of volatility. The most popular measure of market volatility, the VIX, was at all time lows. The same measure is now hitting all time highs. Neither the highs nor the lows are sustainable for long periods. However, risk and return are related and equity investors have endured many bear markets, but ultimately been rewarded with higher real returns than bond or cash investors.

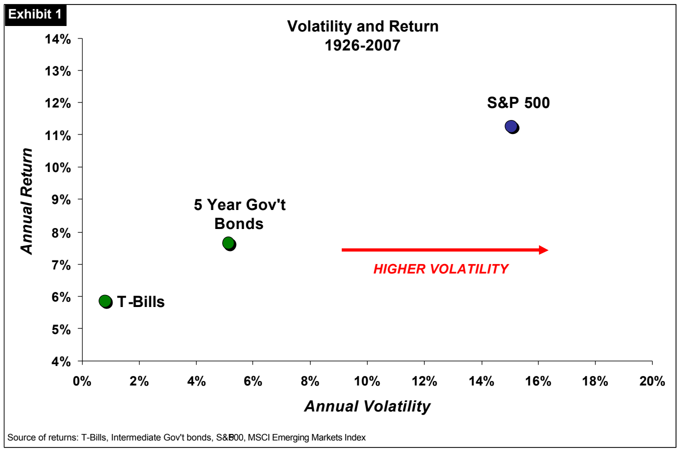
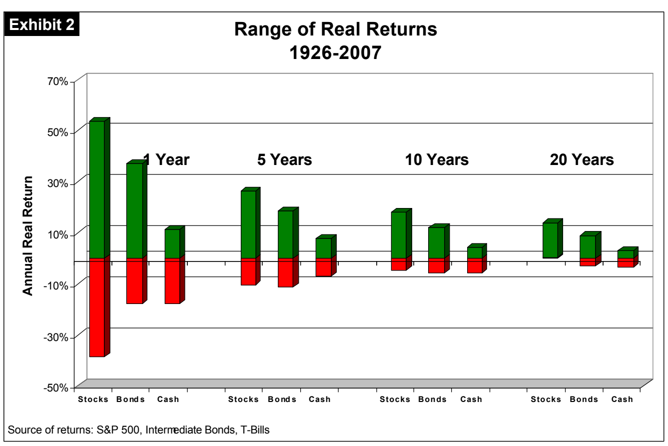
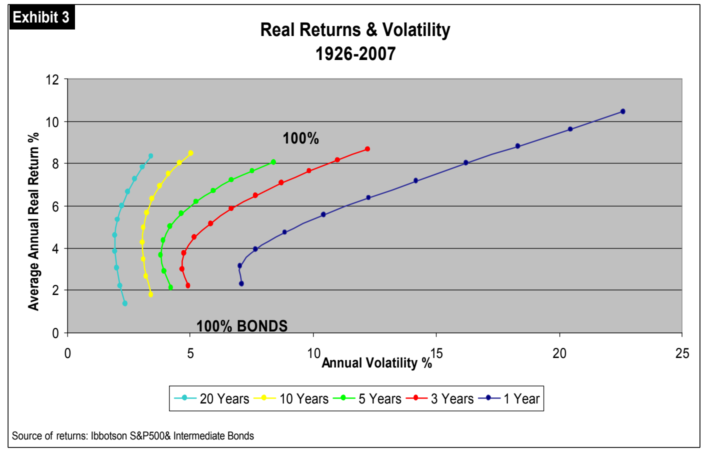


Exhibit 1 shows the volatility and returns for cash (approximated by T-Bills), intermediate government bonds, and the S&P 500. To get the higher returns associated with equities, investors must endure substantially higher annual volatility than cash or bonds. Since 1970, the stock market has declined 25% on four different occasions. However, $1,000 invested in the S&P500 in 1970 would have grown to $56,500 over the next 38 years. The same investment in T-Bills would have grown to $8,500.



A Long Term View Changes Perspective

While recent market declines have been brutal, taking a longer term view can add perspective. Exhibit 2 shows the range of returns over different holding periods going back to 1926. Over that time, there have been at least four declines of 40% in stock prices. However, over a five year holding period, the worst inflation adjusted decline for stocks was actually less than the worst real bond decline (stocks down 10%, bonds down 11%). Additionally, it was only a little worse than the worst five year period for holding cash, a 7% real loss. There were twice as many periods of negative real returns for bonds and cash compared to stocks. Exhibit 3 shows return and volatility for different holding periods for portfolios of large stocks and bonds. As the holding period increases, the volatility of returns declines.



Herd Mentality

I've talked about herding in a previous newsletter, however, it's never more evident than on the way down. Since I've been covering stocks I can think of multiple examples in the investment world, including:

"This time it's different."
"House prices always go up."
"Amazon will destroy Walmart."
"Internet companies can grow 50% annually."
"The dollar will continue to appreciate/depreciate for the foreseeable future."
"This could be the end of our financial system as we know it."
"Oil is going to $200."
"The Japanese/Chinese will dominate the world economy."

When everyone is running to the door in a market meltdown, a lot of good companies get trampled and indexes suffer steep declines. When things settle down, investors reassess their options and realize the value of long term stock ownership. Typically, the biggest increases in stock prices are immediately after the biggest declines.

Conclusion

I'm perpetually optimistic about our system of capitalism and the ability of our nation and its people to adapt to problems and opportunities. Over time, that ability enables companies to generate services and products that benefit customers and generate wealth for their investors, both in the U.S. and in countries around the world.

Gabe Thornhill