



INVESTMENT MANAGEMENT UPDATE

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October 7, 2008

MARKET UPDATE & OBSERVATIONS

<u>Market Index Returns</u>	<u>3rd Qtr</u>	<u>1-Year</u>	<u>5-Year</u>
S&P 500 Index	-8.4%	-22.0%	5.2%
Russell 2000 Small Cap	-1.1%	-14.5%	8.1%
Foreign Stock Index - EAFE	-21.6%	-30.2%	11.1%
Taxable Bond Index	-3.7%	-2.5%	2.0%
Municipal Bond Index	-1.9%	-0.7%	1.9%

The 3rd Quarter of 2008 found both the U.S. and global economies in the crosshairs of several financial calamities that are largely attributable to the easy credit environment in 2003.

Unfortunately, some very prominent financial firms abused that credit by over-leveraging their balance sheets. This misuse of leverage ruined some century-old companies in less than five years. These casualties included: **Bear-Stearns; Washington Mutual Savings Bank; American International Group (AIG); Wachovia; and Lehman Brothers**, along with **Fannie Mae and Freddie Mac**.

These casualties have injected fear into investors, customers, lenders, regulators, and governments around the world, which has contributed to the world-wide credit crisis.

This fear has also been expressed by some clients as well. I think the best way to address this fear is to share our answers to some of the "Frequently-Asked Questions."

FREQUENTLY ASKED QUESTIONS

- **What strategies are you using to protect my portfolio?**

Our investment philosophy dictates that your **asset allocation** should provide much of this "protection."

For clients with **conservative allocations** and objectives, their modest exposure to stocks limits their losses in tumultuous times.

For clients with **balanced allocations**, declines in stock prices allows them to rebalance from their bond and cash holding by shifting funds into their stock holding at cheaper prices.

For clients with **aggressive objectives**, many of whom are young investors still building portfolios, the solution is to just keep saving and adding to portfolios, but again, now at cheaper prices.

This system works, although it doesn't avoid the pain of short-term declines within your equity allocations. But it takes patience to stick to your long-term objectives.

- **Where do you think the markets are going, both short-term and long-term?** First, a bit about forecasting. As I have said many times, we don't predict markets, and in fact, nobody can! Occasionally, some investors, managers and forecasters get lucky, at least temporarily. The bell-shaped curve of statistical probability dictates that a portion of the forecasters will be correct and a portion will be wrong. Over multiple market cycles, most of them will be some of both, as statistics would suggest.

Instead of "guessing" where the market is going, we depend on fundamental measures of valuation. Historically, P/E Ratios, Dividend Yields, Price-to-Book Ratios, and Earnings Growth have eventually determined appropriate values for equity securities.

However, there are economic cycles when valuations deviate from the fundamentals. We appear to be experiencing some of that right now. There are many solid, well-managed companies out there whose values have been excessively punished, much of it apparently by investor fear, sentiment and psychology. This creates bargains for long-term investors who have the patience to wait for values and fundamentals to again intersect.

- **But, you didn't answer my question! Where is the market going?** Again, we don't know and we don't try to make such predictions. We're investors, not guessers!
- **Should I sell-out now? Or, I should have sold out 2 weeks . . . or 2 months . . . or 2 quarters ago!**

Sit tight, as this too shall pass! Unless something has fundamentally changed in your long-term financial objectives, now is not the time to change strategies and reduce your equity allocation target. We prefer to do that when markets are expensive, not cheap! But again, they may still get cheaper, which will create an even more compelling case for increasing equity allocations.

For those clients who have regrets about not cashing out, I have posed the following question: "If you had done so, would you now be ready to reinvest those funds back into stocks since the equity markets are now cheaper?" The universal answer has been "No!" That means such decisions would have been based on investor psychology, not investment fundamentals.

• **What is causing all of this economic turmoil and decline in pricing of securities?**

The short answers are the long-standing drivers of most investment/financial decisions: “**Greed**” and “**Fear!**” Let’s look at some of the critical scenarios where greed and fear led to bad decisions:

- **Low Interest Rates**, which bottomed in mid-2003. Most observers attribute this trend to an over-zealous **Federal Reserve Board** that wanted to accelerate the recovery from the 2000-2002 recession.
 - **Homeowners** bought more house than they could afford (greed), or overpaid for a house they formerly could have afforded (greed), or used adjustable-rate loans because the current payment was lower (greed).
 - **Homeowners** re-financed mortgages to pay off credit cards, car loans and other consumer debt. Many of these were indulgences they couldn’t afford (greed) and now they can’t afford the higher, long-term mortgage payments.
 - **Relaxed Lending Standards**. Some blame Fannie Mae & Freddie Mac. Others blame all lenders. Others blame the system that disconnects the loan originators from the investors who eventually end up owning the loans. I think we all share some of this blame, including us as investors who bought bonds and stocks tied directly or indirectly to this part of our economy.
 - **Mark-to-Market Rules and Liquidity**. While I’m no expert in investment banking regulations, I understand that the lack of liquidity among many financial institutions combined with their reluctance (fear) to buy securities that are being re-priced in a downward spiraling market has exacerbated the spiral. But at some point, many of these securities will have real value with real collateral.
 - **Real Estate Investors** (greedy speculators?) who thought real estate prices would never drop, which were financed with leverage from (greedy) lenders, who sold the loans to (greedy) investment banks that financed these investments with leveraged funds.
 - **Stock & Bond Investors**. Ultimately, all investments are subject to the laws of supply and demand. As investors have been selling stocks and bonds, this increasing pressure forces prices lower. The real question is “Dom security prices reflect a company’s true value based on its ability to generate earnings or service the debt represented by that security?” Previously, we thought they were fairly valued or even cheap. But they got cheaper. Thus, we were greedy!
- One other point!** Remember that when someone sells an asset, whether its a stock, bond or house, there is always someone on the other side of the transaction. So, when a homebuyer or investor (over)pays, the seller receives that cash. The net cash effect is neutral, but everyone assumes that all similar assets are then worth that same price. Assets get priced based on the last transaction, not their underlying value.

MUTUAL FUND & ASSET ALLOCATION UPDATE

Portfolio Rebalancing

On October 9, 2008, we plan to rebalance many client portfolios to take advantage of the allocation adjustments in our portfolio models. We believe this is a prudent response to the economic turmoil and price declines of securities, particularly the stock market.

Mutual Fund Update

- **Mairs & Power Growth Fund**. You may recall that we added this large cap blend fund to our portfolios in April. Despite all the market turmoil, this fund provided a **positive return during the 3rd Quarter of +4.3%**.
- **Buffalo Small Cap** also turned in a positive return (+1.9%) during the quarter. During a conference call in late June, their managers declared that they had not seen such compelling values since the inception of the fund. Again, this supports the principle that sound investment strategy is based on analyzing fundamental security values, not forecasting markets.
- **Vanguard Value Index**. We were surprised that this index fund outperformed the S&P 500 during the quarter (-5.7% v. -8.4%), particularly since it has a high exposure to banks and financial stocks. But it also supports the benefits of our strategy to bifurcate this sector into separate value & growth components since **Vanguard Growth Index Fund** lost -12.0% in the quarter.
- Our international funds, **Templeton Institutional Foreign Equity** and **American Funds’ Capital World Growth & Income** provided our largest losses. Both lost **-15.2%** in the quarter. But they stayed ahead of the foreign index, which dropped **-21.6%** in the quarter. But remember, foreign funds were among the strongest performers the past several years. (To give you some additional perspective on the cyclicity of markets, the high-flying (and overpriced) Chinese market has declined nearly **-59%** in 2008.)
- One of our biggest disappointments has been the performance of **Dodge & Cox Stock Fund**. Among our model funds, it produced the largest 1-year loss, **-29.6%**. It was devastated by large financial holdings, including **Wachovia, Citigroup, AIG & Capital One**. But we are confident they’ll rebound from this setback. Their management team has extensive experience and a fine, long-term record of picking good stocks.
- On the bond side, **PIMCO Total Return & Vanguard GNMA** have continued to shine. Both produced top-quintile total returns the past year.
- However, **PIMCO High Yield** dropped over 10% in the quarter. Its income yield is now over 9% and we believe much of the sector risk is fully-reflected in its price. The yield spread over Treasury Notes is now about 600 bps. Therefore, we are planning to rebalance additional cash allocations back into the fund.

INDIVIDUAL SECURITIES MANAGEMENT

We have added several individual stocks to a number of our client accounts.

Nucor Corporation is one of the nation's leading steel producers. It is well-managed, innovative and the low-cost producer within its industry. We have followed it for many years, although it's been expensive until recently. Key valuation statistics include: a P/E of 6X, 4% dividend, A++ financial strength rating, and cash that nearly equals their total debt. After dropping from \$83 in May, we started buying shares around \$45 last month. Purchase prices have ranged from \$37 to \$53, but the stock has dropped with the rest of the market and is now priced around \$33.

We have added to our holdings of **General Electric**. Due to losses in its GE Capital division, its price has dropped to the low \$20's. We like its 6% dividend and solid financials. Also, Warren Buffett recent bought \$3 billion of preferred stock and an option to buy \$3 billion of common at \$22.25 for five years.

THE OUTLOOK FOR SELECTED ECONOMIC ISSUES

Although there are many important economic factors, the ones I see dominating the overall outlook include:

- **The Credit Crunch** - We hear about the lack of available credit. However, I would suggest: "Wasn't it the loose credit standards that largely contributed to the mess we are in." I believe we are in for a permanent return to stronger credit constraints and lending standards, which will force consumers to spend less, hopefully save more, and lower expectations for boosting standards of living, at least until time passes and we forget this lesson learned.
- **Interest rates** - They are again approaching record lows, which may give some borrowers a second opportunity to refinance their debt. Unfortunately, the ones in the most trouble have already lost their equity.
- **Real Estate Prices** - The bubble that burst will likely not re-inflate. Homeowners and lenders keep asking when prices will go back up, but they've got it wrong. They've merely retreated back to the more-justifiable levels seen before the pre-2003 real estate bubble.
- **Oil & Commodity Prices**. As I mentioned in prior Updates, periods of excess virtually always regress back to the mean. So I'm not surprised by recent declines in commodity prices. But given that food and gasoline, along with monthly housing costs, are the most prevalent consumer expenses, these declines have the most to offer suffering consumers.
- **The Federal Government Bailout Legislation**. While we generally disfavor government intervention into commercial markets, the increase in FDIC limits to \$250,000 should enhance bank liquidity without requiring an actual cash infusion from FDIC. At least for now!. Also, the government may even make money on its purchase of distressed mortgage assets. It will be interesting having another bidder at the table with a \$700 billion checkbook.

MONEY MARKET FUND UPDATE

The Money Market Fund used by The Trust Company for daily sweep of clients' cash is invested through **Kansas State Bank of Manhattan**. This fund provides FDIC-Insured deposit protection up to \$250,000 for each individual client. If a client's account exceeds \$250,000, Kansas State Bank provides complete deposit protection through the CDARS Program and pledged collateral consisting of U.S. Government securities. We monitor the adequacy of the collateral protection daily. The combination of these deposit protection programs provides the maximum protection for client deposits.

CAUTION: For those Trust Company clients who have personal deposit accounts at Kansas State Bank, the combined total of your personal and Trust Company deposits may overlap and exceed the FDIC Insurance limits. **Therefore, we suggest that you confer with us regarding your combined FDIC-Insured deposit protection if you have a personal checking, savings or C.D. account at Kansas State Bank of Manhattan.**

A TRIBUTE TO SIR JOHN TEMPLETON

We were saddened by the death in July of Sir John Templeton at age 95. As the founder of the Templeton Funds, his investing principles, applied over 70 years, still make up the core of sound, prudent portfolio management.

His principles included the benefits of global investing, fundamental valuation and patience. But his most recognized principle was investing on the basis of "**Maximum Pessimism**." He was always asked where the outlook is good, but that was the wrong question. According to Templeton, investors should ask "Where is the outlook most miserable?" That's what makes investing so difficult and the reward for successfully betting against the crowd so compelling. Sir John, you will be missed!

PLEASE JOIN US TO CELEBRATE THE SEASON



Autumn Open House

800 Poyntz Avenue

November 5th & 6th Noon – 6:00 pm

November 7th Noon – 7:00 pm

Please stop by for:

- Cookies, coffee, cider and other Goodies
- An Introduction to our Staff, both new & old
- Tours of our New Building

Trust Company Mutual Fund Model Performance					Market Index & Sector Performance				
Returns to September 30, 2008	3rd Qtr	1-Year	3-Year	5-Year	Stock Market	3rd Qtr	1-Year	3-Year	5-Year
Aggressive Growth	-8.9%	-22.2%	-0.1%	5.7%	S&P 500 Index	-8.4%	-22.0%	0.2%	5.2%
Aggressive Growth / Tax-Ltd	-8.7%	-22.1%	N/A	N/A	Dow Jones Indust.Avg	-3.7%	-19.9%	N/A	5.6%
Growth	-8.0%	-19.1%	0.4%	5.3%	Russell 2000 Small Cap	-1.1%	-14.5%	N/A	8.1%
Growth / Tax-Limited	-7.5%	-18.8%	0.3%	5.1%	Foreign Stock Index	-21.6%	-30.2%	N/A	11.1%
Balanced Growth	-7.3%	-16.4%	0.7%	4.8%	Science & Tech Funds	-15.3%	-29.0%	N/A	3.0%
Balanced Growth / Tax-Ltd	-6.8%	-16.3%	0.4%	4.4%	Bond Market				
Balanced Income	-5.9%	-11.6%	1.5%	4.1%	Govt / Corp 5-Year	-3.7%	-2.5%	1.6%	2.0%
Balanced Income / Tax-Ltd	-5.3%	-11.8%	0.9%	3.6%	Mortgage Bond Index	-0.8%	2.5%	N/A	3.2%
Conservative Income	-4.9%	-8.0%	2.0%	3.5%	5-Year Muni Index	-1.9%	-0.7%	1.5%	1.9%
Conservative Income / Tax-Ltd	-4.5%	-8.7%	N/A	N/A	T-Bill Index	0.4%	2.4%	4.1%	3.2%

Trust Company Fund Performance & Comparative Rankings (A = Best; E = Worst)

STOCK FUNDS	3rd Qtr	1-Year	3-Year	5-Year	10-Year	Expense Ratio
Dodge & Cox Stock Fund	-12.1%	-29.6% - E	-3.3%	5.4% - C	8.9%	0.5%
Goldman-Sachs Structured Large-Value - Inst'l	-8.2%	-25.5% - C	-2.6%	6.0% - C	N/A	0.6%
Mutual Beacon Fund - Z	-7.5%	-23.5% - C	0.0%	6.7% - B	8.5%	0.8%
Vanguard Value Index- Inst'l	-5.7%	-24.4% - C	0.1%	6.9% - B	4.8%	0.1%
Davis New York Venture	-9.9%	-22.0% - C	0.2%	6.9% - A	6.5%	0.6%
Mairs & Power Growth	4.3%	-12.3% - A	3.7%	7.7% - A	9.9%	0.7%
Growth Fund of America - F	-15.0%	-22.9% - B	0.8%	7.0% - B	8.5%	0.6%
Vanguard Growth Index - Signal	-12.0%	-18.9% - A	0.9%	4.4% - B	1.6%	0.1%
Ariel Appreciation	-4.0%	-20.5% - B	-2.1%	3.6% - E	7.6%	1.1%
Fidelity Low-Priced Stock	-12.2%	-21.8% - C	-0.1%	8.2% - C	11.8%	1.0%
Buffalo Small Cap	1.9%	-20.6% - D	-0.1%	7.8% - C	14.8%	1.0%
Capital World Growth & Income - A	-15.2%	-23.5% - B	4.7%	11.6% - A	10.5%	0.7%
Templeton Institutional Foreign Equity	-15.2%	-26.4% - A	4.8%	12.5% - A	8.4%	0.8%
BOND FUNDS	3rd Qtr	1-Year	3-Year	5-Year	10-Year	Expense Ratio
PIMCO High Yield - Institutional	-10.7%	-12.0% - D	0.3%	3.8% - C	4.5%	0.5%
PIMCO Total Return - Institutional	-2.1%	3.8% - A	4.4%	4.3% - A	5.8%	0.4%
Vanguard GNMA Fund - Admiral Shares	1.7%	6.6% - A	5.3%	4.6% - A	5.5%	0.1%
Vanguard Intermediate Tax-Exempt - Admiral	-2.2%	-0.3% - C	2.3%	2.5% - A	3.8%	0.1%
Vanguard High-Yield Tax-Exempt - Admiral	-4.2%	-4.0% - C	1.2%	2.7% - A	3.8%	0.1%

Explanatory Notes: This chart reports independent, comparative performance data and rankings assembled by the Investment Staff of The Trust Company of Manhattan. Sources for this information include: Morningstar, Lipper and the Wall Street Journal. The fund performance figures are provided by Morningstar and Lipper. The letter rankings or "grades" for 1-Year and 5-Year Performance are assigned by the Wall Street Journal. These rankings are based on the WSJ-assigned sector for the fund, which may not necessarily correspond to the fund's objective as defined by its own prospectus, or the sector to which we have assigned the fund within The Trust Company's Model Portfolios. However, we believe this format provides the fairest and most effective method of displaying fund performance comparisons.