



# SPINNAKER

SPINNAKER TRUST QUARTERLY NEWSLETTER

APRIL, 2009

## The Secret Formula: Money, Lots More Money, and Reform

At first glance, the first quarter of 2009 does not look very different from 2008. Significant investor uncertainty continues to dominate market action. Volatility in the markets continues at record levels. Major economic and financial news are in the headlines every day. The (new) President is juggling seemingly countless balls, and everyone is leery of Wall Street greed. Is anything new? Have we moved forward at all?

First, the numbers. The quarter ended on a positive note. In fact, during this quarter we experienced one of the biggest one-month market

rallies in decades. But coming after continued losses in January and February, the bottom line is still negative. The S&P 500 was down 10.9% for the quarter, after having been down 28% for the year in early March. International, mid-cap and small-cap markets are also negative for the year but have recovered from their lows. Emerging markets eked out a positive return for the year of +0.9%, with Brazil and China both having very good starts to the year.

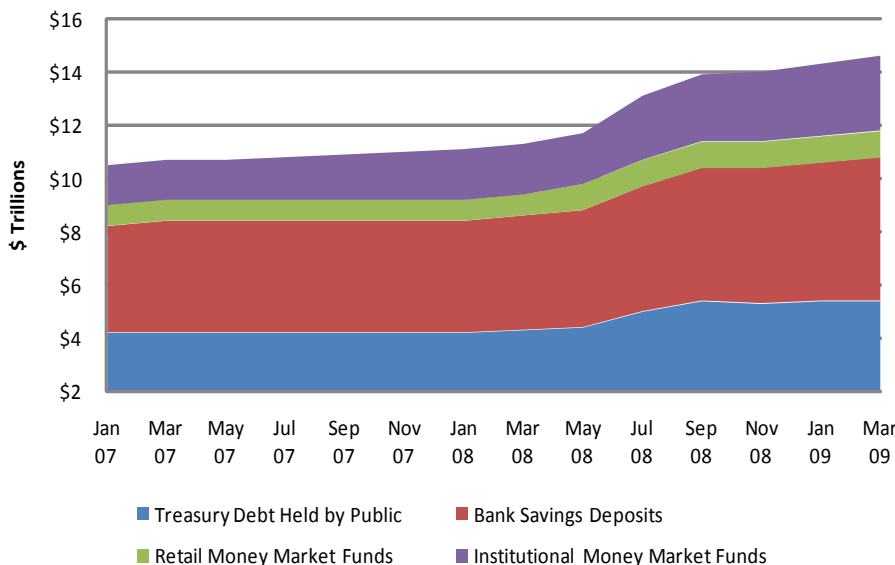
### *Better Late Than Never*

So is anything new? We alluded to a Wall Street category 5 hurricane in our third quarter newsletter last year. The Federal Reserve Bank

and Treasury Department were looking a bit like FEMA. They were slow to respond to this financial crisis, but they have taken some dramatic steps that may start to turn things around.

Federal Reserve Bank Chairman Bernanke showed his own will in mid-March, when the Fed's policy panel said it would purchase \$300 billion in Treasury debt, mostly maturing in two to ten years, starting immediately. The panel also decided to boost its purchases of mortgage-backed securities to a total of \$1.25 trillion from a previously announced \$500 billion, and its purchases of debt issued by Fannie Mae and Freddie Mac, the mortgage agencies, to a total of \$200 billion from \$100 billion.

### "Sideline Cash"



Source: Credit Suisse

When will marginal buyers emerge? We saw unprecedented mutual fund redemptions in the fourth quarter of 2008. Early figures show that the first quarter of 2009 also saw huge redemptions. As the chart indicates, Credit Suisse calculates that there is over \$14 trillion on the sidelines, the highest amount ever. Compared to a current total US equity market value of around \$9 trillion, that cash could have a huge impact if and when it is deployed.

Secretary of the Treasury Geithner settled on a strategy that the markets seem to like. In simplest terms, Treasury is using loan guarantees and \$100 billion in remaining TARP money to create a more liquid market for 'toxic' financial assets. These include those infamous mortgage securities, as well as various loans that may be nonperforming. The idea is to create new buyers for those assets, perhaps leading to higher prices than now exist in an illiquid market, and thus help banks gradually clean up their balance sheets.

Finally, at the end of March, the administration unveiled an overhaul of the financial system designed to impose greater regulation on major players like hedge funds. The administration's proposal, which will require congressional approval, would represent a major expansion of federal authority over the financial system. It would impose tougher standards on financial institutions judged to be so big that their failure would represent a risk to the entire system. It also would extend federal regulations for the first time to all trading in financial derivatives, exotic financial instruments such as credit default swaps, that were blamed for much of the damage in the meltdown. The administration also wants larger hedge funds to be required to register with the Securities and Exchange Commission.

None of this will be easy to execute and there are no guarantees it will work. The banking system is changing and the market is working to understand how. The new system will likely be smaller and more risk averse, but more stable. A more stable system should boost confidence. However, until we see a meaningful recov-

ery in the banking sector, we will remain fairly defensive by being overweight in the healthcare and energy sectors and significantly underweight in the financial sector for our clients.

### *Will there be an E in P/E ratios?*

The chart on the opposite page shows the S&P 500 price and earnings over the past 17 years. Most investors buy stock in hopes that the company's earnings and, therefore, the value of the stock will go up. No doubt, S&P 500 earnings have been steadier than S&P 500 prices. The tech bubble of the late 1990's shows prices getting way ahead of earnings. (As a point of reference, you may recall that you could buy a share of Cisco Systems at 190x earnings in March of 2000. Today Cisco trades at a more reasonable 13x earnings.) Currently, while earnings have dropped significantly, prices have dropped even more. This may mean that there is some value in the market and that stocks are cheap. We will see what first quarter earnings look like over the course of the next few weeks.

Incremental positive news from the banking sector is starting to surface. Wells Fargo and Citigroup both claim to have made money in the first two months of 2009, and Deutsche Bank and Credit Suisse are reporting strong starts to 2009 and forecasting profitability this year.

There will be surprises, both positive and negative, and the market will continue to be volatile through this period. But as this chart indicates, there could be room for continued price improvements if there aren't too many disappointing earnings announcements.

### *Diversification (still) matters*

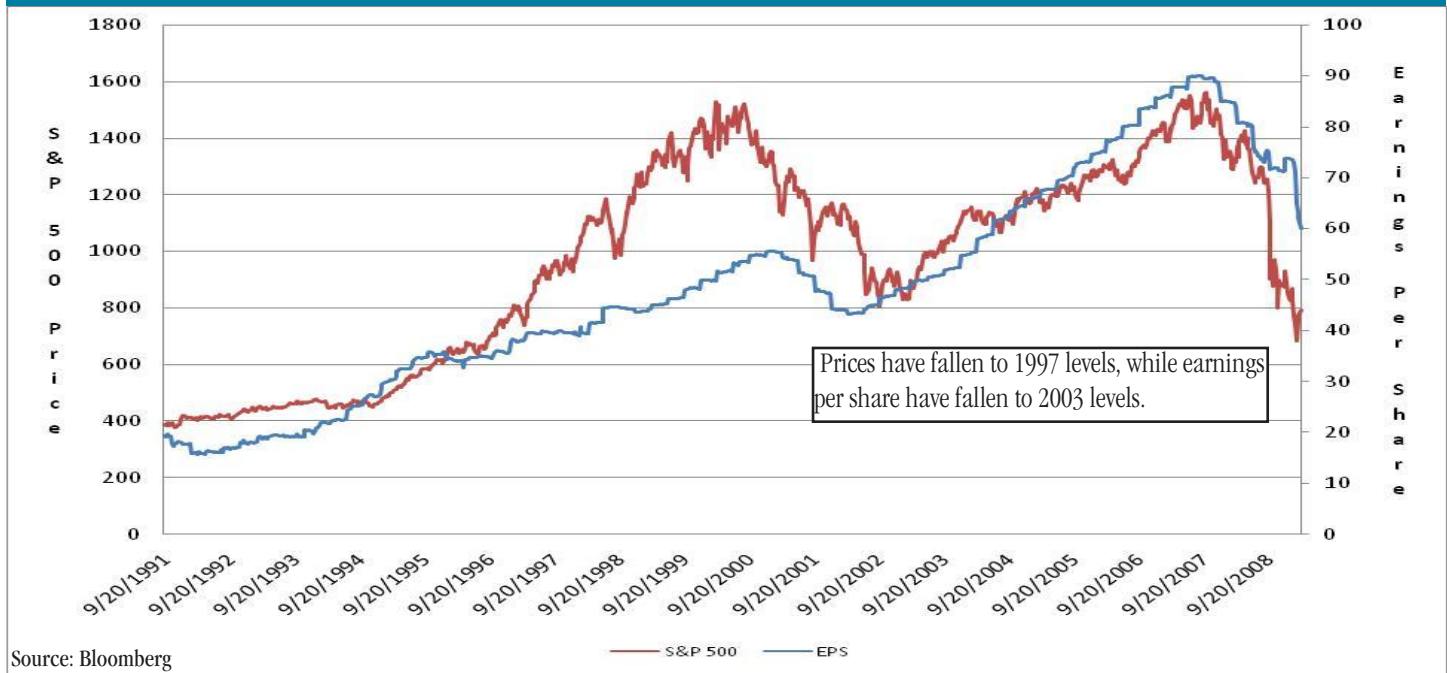
While the benefits of diversification might not be realized in a particular year (2008 comes to mind), the long-term value of this approach is most important. It used to be that owning some large-cap and small-cap stocks was a diversified portfolio. Then international stocks were an option. Emerging markets, precious metals, other commodities and high yield (junk) bonds are also now readily available. Hedge funds and venture capital are out there as well. And let's not forget cash and bonds. There is a place for all of these asset classes in some portfolios and most of these in all portfolios. Our client portfolios have become more and more diversified over the years.

At Spinnaker Trust we believe that diversification is a key building block to every financial plan, and we will continue to look for opportunities to diversify portfolios. Currently, we are considering adding to portfolios a basket of REITs (real estate investment trusts), and perhaps a very small allocation to a broad basket of commodities portfolios.

### *Conclusion*

Equity markets continue to bounce between fears of further economic weakness and the hope for bank stabilization and that the worst of the financial losses are over. The scope of the government initiatives increases the chances of eventual success. While we remain defensively positioned, we will carefully watch as events unfold to assess whether portfolio changes are warranted.

## S&P 500: Price vs Earning Per Share



## The Stimulus Bill

On February 17, 2009, President Obama signed the American Recovery and Reinvestment Act of 2009, a much touted and carefully scrutinized economic stimulus bill. The media has focused intently on those provisions of the Act which have the potential to benefit the greatest number of citizens. These include provisions providing a credit to first time home buyers, the "Making Work Pay Credit," which will add money to the paychecks of most Americans and the credits for the purchase of energy efficient cars. All of these provisions are valuable, and it is the hope that they will encourage the purchase of homes and cars and enable people to spend the money they save with all of these tax credits on other things, thereby stimulating the economy.

There are countless provisions in the Act, but it is worth focusing on a couple of the less talked about provisions which benefit individuals and business owners.

### *Exclusion on Gain from Qualified Small Business Stock*

Prior to the new tax Act, in order to encourage investment in small businesses, the Internal Revenue Code allowed individuals to exclude 50% of the gain from the sale of qualified small business stock held at least five years.

In order to be eligible for the exclusion, the small business stock must have been acquired by the taxpayer at its original issue, for money, for property other than stock or as compensation for services. When the stock is issued, the gross assets of the company cannot exceed \$50 million. Also, the company must use at least 80% of the value of its assets in the active conduct of a qualified trade or business.

The new Act increases the exclusion to 75% for stock acquired after February 17, 2009 (the date of enactment), and before January 1, 2011. Essentially, this benefits taxpayers making such investments, including those made through pri-

vate equity funds, such as the Spinnaker Private Equity Fund II, in 2009 and 2010. Obviously, the hope is that this increased exclusion on the sale of stock acquired during 2009 and 2010 will encourage additional investment into small businesses around the country.

### *Removal of Cap on Residential Alternative Energy Credit*

Much attention has been given to the credits available in the new tax Act to taxpayers buying energy efficient cars. There are, however, other very valuable tax credits in the new Act designed to reduce our dependence on foreign oil and promote the increased use of alternative energy.

Prior to the passage of the new law, taxpayers received a nonrefundable personal tax credit equal to 30% of the cost of eligible solar water heaters, solar electricity equipment, fuel cell plants, wind energy property and qualified geothermal heat pumps installed in their homes.

MARKET DATA: 2009, 2008, 2007

<i>Index</i>		<i>3/31/09</i>	<i>2008</i>	<i>2007</i>
<b>S&amp;P 500</b>	<i>U.S. Large-Capitalization Stocks</i>	-10.9%	-37.0%	5.5%
<b>S&amp;P 400</b>	<i>U.S. Mid-Cap Stocks</i>	-9.2%	-36.2%	8.0%
<b>S&amp;P 600</b>	<i>U.S. Small-Cap Stocks</i>	-17.2%	-31.1%	-0.3%
<b>Russell 1000</b>	<i>U.S. Large and Mid-Cap</i>	-11.1%	-37.6%	5.8%
<b>Russell 1000 Growth</b>	<i>Growth stocks broken out</i>	-4.6%	-38.4%	11.8%
<b>Russell 1000 Value</b>	<i>Value stocks broken out</i>	-17.6%	-36.8%	-0.2%
<b>MSCI EAFE Index</b>	<i>Established International Markets</i>	-14.6%	-45.1%	8.6%
<b>MSCI Emerging Markets</b>	<i>Developing International Markets</i>	1.0%	-54.4%	36.9%
		<b>3/31/09</b>	<b>12/31/08</b>	<b>12/31/07</b>
<b>90 day T-Bill</b>	<i>Short-Term Interest Rate</i>	0.20%	0.08%	3.25%
<b>10 Year US Treasury Rate</b>	<i>Longer-Term Interest Rate</i>	2.82%	2.21%	3.91%
<b>VIX Index</b>	<i>Risk measurement</i>	44	40	23
<b>Corporate Bond Spread</b>	<i>Risk measurement</i>	466 bps	570 bps	197 bps
<b>TIPS Spread</b>	<i>Inflation expectations</i>	133 bps	17 bps	233 bps

Unfortunately, except for the credit for solar electricity (PV) equipment, the credits all had relatively low caps: \$2,000 for solar water heaters and geothermal pumps, \$500 for each half kilowatt of electric capacity generated by a wind turbine up to a \$4,000 maximum and \$500 for each half kilowatt of electric capacity generated from fuel cell plants. These caps greatly limited the use of the credits as 30% of the cost of installing most of these systems far exceeded the credit caps.

The new act removes the caps on solar water heaters, geothermal pumps and wind turbines for equipment placed into service from 2009 through 2016. These credits make it much more economical for taxpayers to consider installing these sorts of alternative energy systems, which would have the

dual effect of reducing our dependence on foreign oil and stimulating alternative energy businesses.

### **Conclusion**

These are just two of the provisions of the new tax Act aimed at assisting current business owners, reducing our energy footprint and encouraging new investment. The Act contains many more provisions, and time will tell if they have the desired effect.



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