Tillar-Wenstrup
Advisors, LLC

Newsletter
1st Quarter 2008

A Difficult Quarter and Hopefully Near a Market Bottom

The stock market in first quarter of the new year was very volatile in reaction to serious problems in mortgage and financial issues. The stock market sell-off was very broad-Growth/Value, Small-Cap/Large-Cap, US/International - all styles fell somewhere in the range of high single-digits to low double-digits. Financial stocks performed much worse. Although we are never happy with negative returns, our portfolios declined much less than the benchmarks. More importantly, although volatility is unlikely to go away completely, there are many reasons to be optimistic about the future.

While uncomfortable, difficult markets eventually lead to opportunity. A year ago when the credit crisis began to erupt in earnest we began to speculate about how much damage could be done. At the end of May 2007, Financial stocks represented 21.3% of the S&P 500 index. We thought it could drop to as low as 15%. On March 17th during the collapse of Bear Stearns, Financials had fallen all the way to 16.2% of the S&P 500. This represented a decline of almost 38% and over $1.1 trillion. These are massive losses and could signal that most, if not all, of the damage has been done.

This is not to say that everything is rosy. We have consistently warned that the fall-out from the housing and debt bubbles will take years, not months, to work through, and all the recent data reinforce this belief. Unwinding of years of excess leverage could keep pressure on financial markets. New risks are forming: growing protectionism sentiment in Washington, weakening jobs market, and accelerating inflation.

Offsetting these risks are several positive factors. Many aspects of the world economy are strong. The commodity and agricultural economies are experiencing boom times. Despite U.S. problems the emerging economies remain robust and growing adding new global consumers every day. While the U.S. is still a major influence on the world economic scene, our importance has declined. According to the IMF, the U.S. share of world imports fell to 14% last year from over 20% in 2000, while the import share of the developing countries grew to 40.6% from 33%. During 2007, the developing countries produced over 52% of global growth. Last year consumer spending of the world's 17 largest emerging-market countries was equal to 65% of U.S. consumer spending. Clearly our problems will not be the death knell to the emerging markets that some commentators claim it will be.

In contrast to the U.S. consumer, Corporate America's balance sheets (with the exception of the financial companies) are as good as they have ever been. According to Standard & Poor's, the total cash held by companies in its industrial index exceeded $600 billion, up from $203 billion in 1998. Moreover, U.S. companies used only 11.7% of their cash flow to service debt in the third quarter, according to Economy.com. Better still these companies remained relatively lean during the good times decreasing the need for drastic layoffs like we experienced earlier this decade in the aftermath of the technology bubble.

The silver lining to downturns is that they create a lot of value. We know from experience that the best buying opportunities occur during periods of stress like today. We are encouraged by the current combination of despondent investors, attractive equity-market valuations, a deflated credit and housing bubble, and plenty of cash (with trillions dollars in sovereign wealth funds and corporate coffers).

We have transitioned from a market that was driven by liquidity to a market that is now driven by fundamentals. The trillions of dollars sitting on the sidelines in cash and equivalents will not be satiated with meager returns for very long.

And while it may still be early in the economic slowdown, remember the market traditionally bottoms well before the economy does. Market strategist Steven Leuthold recently stated "if it's an 11-month recession we would see a market bottom in May or June. " While it is difficult to predict a market bottom, long-term investors should be well rewarded from these levels.

Preserve in Difficult Markets – Outperform in the Long Term

Steve Wenstrup and Jim Tillar, CFA

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