

October 2, 2008

Dear Clients and Friends:

We are living in challenging times of late as we work off the excesses and transgressions of a global economy that for too long had easy access to buying power. This buying power over moderate time periods is known as credit, while over shorter time periods is more commonly referred to as liquidity (a topic I will return to momentarily). There is little doubt that a prolonged period of very low interest rates in the U.S. combined with the anticipation of a burgeoning western-style consumer class in Asia, the ease with which capital could be borrowed, and the political mandate to make home ownership available to virtually every American blended to create a period of unbridled and unchecked leveraged investing and financial engineering here and around the world over the last 6 years.

Following the collapse of the technology bubble in 2000 and the terrorist tragedy in 2001, Alan Greenspan (former Chairman of the Federal Reserve Bank) followed a monetary policy that allowed for the baton to be passed from a bubble in technology stocks to a bubble in housing and secondarily financial assets which were able to rapidly inflate as a result of easy credit and limited oversight in new markets. Led by the United States, the global economy entered into a prolonged period of re-flation, a phenomenon which manifested itself in the form of asset price inflation for housing and commodities and banks divining new revenue streams through advisory services and financial products that carved up these rapidly increasing assets, pooled the pieces, and resold them to buyers around the world eager to participate in these new and seemingly profitable investment vehicles. These buyers were not only buying pools of assets that were inherently more risky than their underlying credit ratings might have suggested, but in many cases were using borrowed money to finance their purchases. Without becoming too granular, we were trying to create something from nothing. And as is often the case in good times, no one really wanted to blow the whistle. Bank executives were not interested in evaluating risk in these hyperbolic growth areas and instead focused on chasing deals for fear of being left behind. Home buyers were seeking liberal financing offers even if it meant buying more house than they could really afford and lenders were lending under the assumption that a rising tide would continue to rise. But as the venerable Warren Buffett once said, "It's only when the tide goes that you learn who's been swimming naked."

As noted in an internal strategy note dated 8/15/08. I wrote:

This stock market sell off is not over. Clearly the trend in the weakening US dollar has been broken and the sell off in gold, silver and oil is a reflection of the reversal of that trade. This mentality is precisely why bear market rallies can move with such ferocity and the air pockets they leave behind can be devastating once the music stops.

We will go to new lows in the equity markets by late October and we must use market strength to position for the next leg down. There are too many investors seeking to call a bottom at this juncture. We will see a bottom when jobless claims spike to 600K, real estate prices contract another 5-10 percent, and the volatility index (VIX) spikes above 30-32 in capitulation trading. In my opinion, such a move will take us to approximately 1130 on the SP 500, constituting a 28% decline peak to trough in that index.

On September 29, the SP 500 Index opened at 1209 and traded to a bottom of 1106 while the Dow Jones Industrial Average lost 777 points. On the same day, the volatility index (VIX) opened at 36 and spiked all the way to 48 as the broader markets swooned, losing approximately 9% in market capitalization in a single trading day.

Where do we go from here?

First, it is imperative that we pass The Economic Stabilization Act, a taxpayer investment and rescue package, immediately. The miss-perception that this is a Wall Street “bailout” is obscuring popular opinion. The rescue package is for the U.S. Economy not Wall Street. Ask executives and shareholders at Lehman Brothers and AIG and Bear Stearns and Washington Mutual and Fannie Mae and Freddie Mac and IndyMac Bank and Charlotte’s own Wachovia Bank if they feel as though the government has bailed them out. The answer would be a resounding no. But even in free markets, of which I am a staunch proponent, I believe the government must play a role in helping to manage laissez-faire policies which lead to extreme outcomes. In these instances, it is in the best interest of the people for the government to seek to engineer a soft landing as opposed to the crash landing a truly free market system would invoke. In such a scenario, everyone would lose and for longer.

Passage of this bill, which as I write has just passed the U.S. Senate by a 3:1 margin, is an important first step in helping to restore confidence to the financial system and liquidity to the credit markets. The House of Representatives will vote on the bill this Friday afternoon, and I encourage you to hold your Representative accountable for an affirmative vote. Passage of this bill would mean that businesses large and small have a better chance of borrowing money to meet payroll obligations and working capital commitments. It means that banks may stop hoarding cash and begin lending again for car loans, student loans, home loans and business loans. It means that companies have a better chance of holding on to employees and homeowners have some time to stave off foreclosure.

But let me be clear, this bill is by no means a panacea. Its approval should restore some confidence in the near term and provide more liquidity in the intermediate term. Why is this so important? Think of it this way. If the sprinkler system in your garden is turned off for a period of time in the summer (lets say on account of a watering ban), your lawn and plantings would begin to wither. After several days, they would dry out and turn brown. After a couple of weeks, the newer plantings would die. Beyond that, the lawn would die. If, however, the sprinkler can be turned back on in time, the lawn might rejuvenate rather quickly, greening again even. The newer plantings would be lost and many of the mature landscape may not recover. Perhaps some of the most venerable plants (think Lehman Brothers, Bear Stearns and AIG) in your garden would die. But the lawn could be saved. However, if the sprinkler is not turned back on in timely manner, the plantings will die and the lawn will die. In such a scenario one would have

to wait an entire season (cycle) to replant. In this example, the garden is our economy and the sprinkler is “liquidity”. By re-opening the spigot in time, we will not be able to save the garden, but we might be able to save the lawn and some of the plants.

State of the Markets and the Market Discount

It is difficult to see the U.S. economy recovering anytime soon. The headwinds facing the economy with or without a “rescue plan” remain formidable. Credit will remain difficult to access for consumers and businesses for several more quarters. Businesses will be forced to cut costs wherever possible which will lead to further job cuts and increased unemployment, and home prices will continue to come down in order to relieve inventories and clear the housing market.

Given that we continue to view the U.S. housing market as the key driver to economic recovery, our Analyst Brian Smyth did some work on housing inventories and has drawn the following conclusions:

Between 1995 and 2005, approximately 2 million excess homes were built in the US, as a result of a myriad of now well-documented reasons: speculation, flipping, second-home investment demand and first-time sub prime buyers, all of which was facilitated by low interest rates.

Today, we are entering the third year of an unwind of this excess inventory. Housing starts are now down to an annualized rate of 900,000 per year, well below the normalized 1.5 million annual rate needed to meet the US’s growing demographics (and well below the 2.3 million annualized rate reached in January 2006). If this pace of housing starts continues, we can expect the excess housing inventories to be sold off sometime in late 2009 or early 2010. If the number of housing starts continues to fall, we can expect the market to clear somewhat earlier. In the meantime, we can expect continued housing price declines for another 12-18 months, when a bottom is likely to occur.

If we further assume that the stock market will anticipate this bottom by some six to nine months, we can expect stocks to begin to recover in the middle of 2009. That leaves us with six to nine months from here in which to remain defensive (with high levels of cash), while the banks and markets further adjust to this housing correction.

Given that we are investors and not economists, we seek to discount the future status and trend of the economy such that we are able to participate in market movements that reconcile the present with the future. In addition to gauging the housing market, we look at other metrics including levels of Unemployment and Consumer Confidence. Interestingly, while the bottoms in all of these data generally occur well after a market bottom, Consumer confidence is historically one of the most coincident with only a two month lag, and Unemployment of the least coincident with a nine month lag. By point of reference, July 2008 marked the lowest level of consumer confidence since 1980 and the share of respondents planning to increase capital spending was the lowest percentage since 1975.

So does this mean we are at the bottom of the market? In our opinion there remain far too many headwinds, and far too much uncertainty to argue that point very vigorously. However, we do believe that the risks for systemic financial crisis would be further reduced with the enactment of this Congressional bill. Furthermore, forced liquidation in many stocks around the world have created huge corrections and in many cases present very attractive entry points. We believe the valuation on many energy, infrastructure, industrial and utility stocks, particularly with leverage to Asia, are pricing in a total and complete reversal of urban migration and industrialization trends around the world. We view this sell off as a symptom of the credit crisis and asset de-leveraging more than a lasting trend.

Even so, it is our intent to continue to proceed with caution. Our investment portfolios currently hold approximately 20% in cash, which gives us dry powder to continue to invest opportunistically in this challenging market. We will also continue to raise cash, particularly into market strength, until such time as we believe the major threats to the market have been alleviated, and we gain some confidence that the market may begin to discount economic recovery in the future.

Thank you and as always please call, email or come by to speak with us in person.

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