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FEBRUARY 2008 COMMENTS

FEBRUARY 2008 MARKET ACTIVITY (ending Friday, February 29)

During February, each of the major US stock market indexes (S&P 500, Dow Jones Industrials, NASDAQ Composite), declined for the fourth consecutive month. The declines were less than January, but still substantial.

Highest quality US Treasury bond prices continued to move higher, but other bonds, particularly municipals, declined in price, which is highly unusual in a time of declining interest rates.

International stock market indexes, both developed and emerging, posted gains.

Discussion of all these price changes appears throughout this month's Comments. (See page 2 for all monthly and YTD figures).

Over the past few months, dating back to November, the Investment Concepts section of the Monthly Comments focused first on the reported reasons for the significant November price declines, and then, in December, on actions that can be taken by investors during periods when prices show substantial changes. In our January Comments, we put the current declines in the historical context of other significant price declines, and then reviewed the many points of view regarding the reasons for the problems the likely prospects for their resolution.

For this month, we are going to discuss again the many issues confronting the economy and the markets, stemming from the continuation of financial and credit problems. We will then provide our point of view on where we are likely to go from here.

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Any recommendation contained in these Comments may not be suitable for all investors. Moreover, although the information contained herein has been obtained from sources believed to be reliable, its accuracy and completeness cannot be guaranteed.

COMMENTS: INDEX RESULTS for period ending FEBRUARY 2008

	YEAR	YEARS	YEARS	YEAR	YEAR	YTD	FEB
<u>STOCKS</u>	<u>1999</u>	<u>2000-02</u>	<u>2003-05</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2008</u>
Vanguard Total Stock Market Index Fund (1)	23.8%	(37.2%)	53.1%	15.5%	5.5%	(9.0)%	(2.9)%
Standard & Poor's (S&P) 500 Index (2)	19.6%	(40.1%)	41.9%	13.6%	3.5%	(9.4)%	(3.3)%
Vanguard S&P 500 Growth Index Fund (1)	28.8%	(48.4%)	41.8%	9.0%	12.6%	(9.2)%	(1.3)%
Vanguard S&P 500 Value Index Fund (1)	12.6%	(26.2)%	63.2%	22.1%	0.1%	(8.7)%	(3.6)%
Dow Jones Industrial Average Index (2)	25.2%	(27.5%)	28.5%	16.3%	6.4%	(7.5)%	(2.9)%
NASDAQ Composite Index (2)	85.6%	(67.2%)	65.2%	9.5%	9.8%	(14.4)%	(4.5)%
Vanguard Midcap US Index Fund (1)	25.0%	(18.3%)	83.9%	13.6%	6.0%	(8.6)%	(2.1)%
Vanguard Smallcap US Index Fund (1)	19.6%	(24.2%)	87.5%	15.6%	1.2%	(8.7)%	(2.5)%
Vanguard International Index Fund (EAFE) (1)	25.3%	(45.9%)	95.9%	26.6%	15.5%	(8.2)%	0.3%
Vanguard Emerging Markets Index Fund (1)	61.6%	(29.5%)	162.7%	29.4%	39.0%	(6.9)%	4.2%
Vanguard Real Estate Investment Trust Fund (1)	(0.4)%	47.5%	98.6%	35.1%	(16.5)%	(4.1)%	(3.8)%
 <u>BONDS</u>							
Vanguard Total Bond Market Index (1)	(0.8)%	30.4%	11.1%	4.2%	6.9%	1.9%	0.1%
Vanguard Intermediate Tax- Exempt Index Fund (1)	(2.9)%	23.7%	10.3%	4.4%	3.4%	(2.5)%	(4.1)%
Vanguard Short-term Bond Index (1)	2.1%	25.8%	6.5%	4.1%	7.2%	3.0%	1.0%
Vanguard Short Tax- Exempt Index Fund (1)	2.6%	13.8%	4.5%	3.2%	4.2%	0.7%	(0.4)%
Vanguard High-Yield Bond Fund (1); starting 2002	NA	1.7%	30.7%	8.2%	2.0%	(2.2)%	(1.5)%
Vanguard Inflation-Protected Bond Fund (1); starting 2001	NA	25.5%	20.0%	0.4%	11.6%	5.2%	1.3%

NOTE: Three-year results start with a base of 100, and after each year's % change, the result for that year creates a new base. So if at the end of the first year the index is up 10%, then the new base is 110%; and if down 10%, then the new base is 90%. NOTE also that a decline of 50% requires a gain of 100% to get back to the starting value, which explains why NASDAQ, down 67%, would require a gain of 200% to get back to its starting value.

- 1) Results for Vanguard funds include dividends and fund expenses but do not reflect PPA's advisory fee.
- 2) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

%	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q			
		<u>1999</u>					<u>2000</u>					<u>2001</u>			
S&P 500	4.1	7.6	(7.7)	15.6	2.0	(3.0)	(1.3)	(7.8)	(12.1)	4.8	(13.8)	8.1			
NASDAQ	14.6	10.0	0.0	61.0	12.4	(14.8)	(7.2)	(29.6)	(25.5)	12.9	(26.7)	18.3			
BONDS	0.0	(0.5)	0.4	(0.7)	2.4	1.5	3.1	4.3	3.2	0.8	4.3	0.0			
		<u>2002</u>					<u>2003</u>					<u>2004</u>			
S&P 500	0.0	(13.8)	(14.1)	4.5	(1.8)	12.8	2.2	13.2	1.3	1.3	(2.4)	8.8			
NASDAQ	(5.5)	(19.5)	(13.5)	7.0	2.5	19.2	12.1	16.2	(0.5)	2.7	(7.5)	13.9			
BONDS	0.0	2.8	3.6	1.8	0.9	2.7	0.2	0.2	2.7	(2.6)	3.1	1.0			
		<u>2005</u>					<u>2006</u>					<u>2007</u>			
S&P 500	(2.6)	0.9	3.1	1.6	3.7	(1.9)	5.2	6.6	0.2	5.8	1.6	(4.1)			
NASDAQ	(8.1)	2.6	4.4	2.5	6.1	(7.6)	3.9	7.1	0.3	7.5	4.0	(2.0)			
BONDS	(0.5)	3.0	(0.7)	0.6	(0.7)	(0.2)	3.8	1.3	1.4	(0.6)	2.9	3.2			
		<u>2008</u>					<u>2009</u>					<u>2010</u>			
S&P 500															
NASDAQ															
BONDS															

FEBRUARY 2008 COMMENTS

STOCK index prices for US stocks posted substantial declines again in February. The YTD declines for a number of the indexes were greater than the full year 2007 gains. However, international and emerging market indexes gained (see details in chart on page 2).

The broad-based US indexes of Total Stock Market, S&P 500, Dow Jones Industrials, and NASDAQ Composite have declined YTD in a range of -(7.5%) to -(14.4%). Emerging Markets, International, and REIT are also down YTD, but marginally less (see page 2).

BOND returns (price change plus interest) for the highest credit quality part of the bond market were positive for the month. But municipal bonds showed price declines, thereby increasing their yields, which would not be expected in a period of declining interest rates. Treasury Inflation Protected bonds, last year's big winner, continued its outperformance, but their real yields have been pushed to extremely low levels. The benchmark 10-year US Treasury yield closed at 3.53%, compared to January's 3.64%. (Bond returns for various time periods are set out on page 2).

ECONOMIC NEWS impacting this month's price movements is discussed starting on page 5, as part of the review of the many issues that continue to confront the economy and the financial markets.

From a longer-term standpoint, the major question now is whether the 2003-2007 recovery from the severe bear market of 2000-2002 is over, or whether stock prices can regain their long-term positive direction. Looking back over the full period from the 2000 highs to February 2008, the Dow Industrials are 5% higher, the S&P 500 13% lower, and the NASDAQ still a stunning 55% lower. Thus, the annualized returns for all three indexes since 2000 are far below their long-term average annualized returns. The mutual fund company Vanguard notes that from 1926 through 2005, in only six of 80 years did stock prices fall within 2%, up or down, of the long-term annual average return of plus 10.4%.

However, going back further to the bull market that began in 1995, all three major indexes have remarkably similar average annual returns, all positive, ranging from 8.4% to 9.2%. (These returns are, however, below the 10.4% average annual return for stocks dating back to 1926.) As they converge, "regression to the mean," described by Swensen as "one of the most powerful influences in the world of finance" (pg. 154), seems apparent. But Vanguard's observation is also meaningful, since annual returns during the bull market were far higher than the long-term averages, and the eight year returns from 2000- 2007 have been far lower.

The moral: Stock returns are truly unpredictable and volatile in short time frames, and can be over long time periods as well, even with (so far) a fairly stable very-long-term average return. Key Questions: Your relevant time frame and tolerance for risk.

	<u>S&P 500 (1)</u>		<u>DOW (1)</u>		<u>NASDAQ (1)</u>	
1st Qtr 2000 High	1,527		11,723		5,048	
Year End 2000	1,320	(13)%	10,785	(8)%	2,470	(51)%
September 21, 2001 Low	965	(37)%	8,235	(30)%	1,425	(72)%
Year End 2001	1,148	(25)%	10,020	(17)%	1,950	(61)%
October 9, 2002 Low	777	(49)%	7,286	(38)%	1,114	(78)%
Year End 2002	880	(42)%	8,342	(29)%	1,336	(73)%
Year End 2005	1,248	(18)%	10,718	(9)%	2,205	(56)%
Year End 2007	1,468	(4)%	13,265	+13%	2,652	(47)%
February 29, 2008	1,331	(13)%	12,266	+5%	2,271	(55)%

Context: Prior Five-Year Gains in Bull Market of 1995 - 1999

	<u>S&P 500 (1)</u>	<u>DOW (1)</u>	<u>NASDAQ (1)</u>
End 1994	459	3,834	752
End 1999	<u>1,470</u>	<u>11,500</u>	<u>4,070</u>
Gain	1,011	7,666	3,318
Avg. Ann. % Gain: '95-'99; 5 years	26.2%	24.6%	40.2%
FEBRUARY 2008	1,331	12,266	2,271
Gain	872	8,432	1,519
Avg. Ann. % Gain: '95-2/08; 13.16 yrs	8.4%	9.2 %	8.8 %

1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's fees.

INVESTMENT CONCEPTS: CONTINUING ISSUES in the FINANCIAL MARKETS

The chart below, which we introduced with our November Comments, has been updated to reflect the extreme volatility (mostly negative) of the months since the summer of 2007.

	S&P 500	Change from YE06	Dow Jones Industrials	Change from YE06	NASDAQ	Change from YE06
YE 2006	1,418	-	12,463	-	2,415	-
7/19/07 High	1,553	9.5%	14,000	12.3%	2,720	12.6%
8/16/07 Low *	1,370	-3.4%	12,456	-0.1%	2,387	-1.2%
10/9/07 High	1,565	10.4%	14,165	13.7%	2,859	18.4%
12/31/07 Close	1,468	3.5%	13,265	6.4%	2,652	9.8%
1/22-23/08 Low *	1,270	-10.4%	11,635	-6.6%	2,202	-8.8%
1/31/08 Close	1,378	-2.8%	12,650	1.5%	2,390	-1.0%
2/29/08 Close	1,331	-6.1%	12,266	-1.6%	2,271	-6.0%

* Note - Lows from 8/16/07 and 1/22-23/08 are not closing prices, but daily ("intra-day") lows

Some key observations from the chart:

1) From the 10/9/07 highs to the 1/22-23/08 intra-day lows, the S&P 500 was down 19%, the Dow Industrials down 18%, and the NASDAQ Composite down 23%. Those are major declines in a very short time frame.

2) However, just a week or so later, the recovery from those lows was also dramatic, with the S&P 500 gaining back 8.5%, the Dow 8.7%, and the NASDAQ 8.5%. Whether these gains continue or not is of course unknown, but the sharp recovery in a very short time frame illustrates the dangers of exiting the stock market after a period of declines, on the assumption the declines will continue. While February's close was below January's, the indexes are still 3% to 5% above the January intra-day lows.

As was stated in January's Comments: "The current declines seem to have been triggered by a chain of events that started with an overheated, overpriced housing market. The high prices for homes gave rise to mortgages that proved too high relative to the underlying value of the homes, and whose interest rates started out low but had provisions for rapid increases. With housing prices declining, refinancing those mortgages was not possible, and so many defaulted."

“The investors who owned these mortgages (not the initiating banks, but entities that invested in the mortgages) wound up with major losses. Because many of these entities were banks, they began to tighten credit standards and restrict loans. This in turn had an adverse impact on the overall economy, as consumer spending slowed with reduced availability of mortgage funds to finance living expenses.” This at least is the scenario being presented by much of the media in its explanation of the current problems.

We now present some of the more significant issues that continue to weigh negatively on the economy, and presumably on the markets. We will then turn to our views of where we are likely to go from here.

1) Continuing problems in the housing market. In its front page article headlined “Decline in Home Prices Accelerates” (2/27/08), the WSJ states that “The decline in US home prices accelerated in the fourth quarter, according to the two leading barometers, compounding two of the biggest threats facing the nation’s economy: faltering consumer spending and tight credit markets.” The article explains these negative impacts as follows: “Lower home prices threaten economic growth by making consumers feel less wealthy and thus less willing to spend. They also curtail homeowners’ ability to borrow against the value of their homes to finance other purchases. In addition, lower prices erode the value of the banks’ collateral, prompting them to tighten their lending standards, which further impairs economic growth.”

2) Higher inflation and slower economic growth. In another front page article, this one headlined “Fears of Stagflation Return as Price Increases Gain Pace” (2/21/08), the WSJ states that “The US faces an unwelcome combination of looming recession and persistent inflation that is reviving angst about “stagflation,” a condition not seen since the 1970s.... Inflation is rising... while the Federal Reserve disclosed its policymakers lowered their forecast for economic growth this year to between 1.3% and 2.0%, half a percentage point below the level of their previous forecast, in October. They (the Federal Reserve) blamed a further slowdown in housing prices, tighter lending standards, and higher oil prices.”

The article discusses the dilemma posed by “rising unemployment and inflation.... When the Fed wants to fight unemployment, it lowers interest rates. When it wants to damp inflation, it raises them. It’s impossible to do both at the same time.” While the article distinguishes between the extremely high rates of inflation and unemployment reached in the 1970s as compared to now, it does mention certain similarities, such as “surging commodity prices, including crude oil, which is now close in price to its 1980 inflation-adjusted high.”

A front page NY Times article, headlined “Gas Prices Soar, Posing a Threat to Family Budget” (2/27/08), states that “gasoline prices are suddenly rising quickly,... which could not come at a worse time for the economy. With growth slowing, energy increases that were once easily absorbed by consumers are now more likely to act as a drag on household budgets, leaving people with less money to spend elsewhere. These costs could worsen the nation’s economic woes, piling a fresh energy shock on top of the turmoil in credit and housing.” Other recent NY Times articles discuss stagflation (2/21/08, front page and C1).

A signed WSJ article by Martin Feldstein, Chairman of President Reagan's Council of Economic Advisers (2/20/08, A15), discusses the Fed's ability to impact the economic slowdown by lowering interest rates (as it is doing now). The article is not optimistic. It begins: "Although it is too soon to tell whether the US has entered a recession, there is mounting evidence that a recession has in fact begun. Key measures of economic activity stopped growing in December and January or actually began to decline. The collapse of house prices and the crisis in credit markets continue to depress the real economy."

The Feldstein article then compares the past three recessions of 1981, 1991, and 2001 to the present. "These past recessions were caused by deliberate Federal Reserve policy aimed at reversing a rise in inflation. In those cases, the Fed increased real interest rates until it saw the economic slowdown that it thought would move us back to price stability. It then reversed course, reducing the interest rates and bringing the recession to an end. In contrast, the inflation rate in 2006 and 2007 stayed at a relatively low level of less than 3%. A key cause of the present slowdown and potential recession was not a tightening of monetary policy but the bursting of the house price bubble after six years of exceptionally rapid house price increases. The Fed will therefore not be able to end the recession as it did previous ones by turning off a tight monetary policy....The principal cause for concern is the paralysis of the credit markets....The collapse of confidence in credit markets is now preventing that necessary extension of credit....The lack of confidence in asset prices also translates into a lack of confidence in the creditworthiness of other financial institutions....It is not clear what can bring back the confidence in asset prices that is needed for credit to flow again."

3) Declining value of the US dollar. In yet another WSJ front page article, headlined "Dollar's Dive Deepens as Oil Soars" (2/28/08), the interrelationship of various economic forces is discussed. "The latest impetus (for the declining value of the dollar) was data showing a softening US labor market, deepening turmoil in housing, and growth in 2007 slowing to the worst pace in five years. Fed Chairman Bernanke put more pressure on the dollar during Congressional testimony,...emphasizing gloomy prospects for the economy while pointing to the weak dollar as a rare bright spot helping exports, jobs and the trade deficit....The dollar's weakness adds upward pressure to the prices of commodities, most of which are trading in dollars. Commodities are soaring in value for a number of reasons, including that they have become cheaper for buyers who hold other currencies, which drives up demand."

A separate but related front page article in the same edition of the WSJ discusses the surge in commodity prices. "Few anticipated the strength of this latest run up in commodity prices. As 2007 ended, it appeared that a slowing global economy would ease demand for commodities. Instead, investors have diverted money into commodities, fleeing losses in the stock and bond markets. A weaker dollar, lower interest rates, and fears about inflation have added momentum to the rally."

Our View of Where We Go From Here

As the drumbeat of negative news continues, the large, always unanswered question is, where do we go from here? Should we have an expectation that stock prices are likely to recover, and from what levels, and when?

First we need to acknowledge that now, as during all periods of significant stock price declines, the problems are real and serious. Nonetheless, the long-term history of stock prices suggests that they are likely to recover. Long-term investment returns for stocks are not only positive, but substantially higher than the alternative liquid investments of bonds or cash, particularly when adjusted for the impacts of inflation. But while this may be true over lengthy past time periods, this position leaves two additional points to consider:

1) The time it takes for a price recovery to occur. One year may be manageable, but what if the period extends to five years, or ten years. This can create real problems for people anticipating normal investment returns. We need look no further than the current decade to see the US stock market, as measured by the S&P 500 index, lower today, eight years later, than it was at its highs in March 2000. (The price decline is 13%, excluding dividends).

2) History may not repeat, and there may not be any recovery. An example here is the Japanese stock market, which today remains more than 60% below its all time highs reached almost twenty years ago. Nick Taleb, whose books we have discussed in a number of prior Comments, discusses those "black swan" events that are totally unexpected, but occur with enough frequency to create real problems.

If the history of stock price recoveries is to repeat, the current problems need to be overcome. The likelihood of recovery, and its timing, depends in part on the general recuperative powers of the very large US economy, and in part on whether both business and government policies are able to work positively to solve the problems. (See articles about the efforts of business and government to find solutions; WSJ, front page, 2/28/08, and NYTimes, front page, 3/5/08). There are no assurances or certainties here, only the knowledge that prior periods with significant problems experienced stock price recoveries.

This idea should be kept in mind as we are presented with the daily negative news from the media, and as the markets are influenced in the short term by trading activity geared to make quick profits to justify the high risk and high fees that come with the activity. We believe our clients should try and avoid being caught up in the day-to-day price changes, and focus instead on their long-term financial objectives. For most people, some exposure to stocks is in order, given the long-term outperformance of stocks. But the degree of exposure varies for each person. Our most important job as investment advisor is to develop an appropriate amount of stock exposure for each client, based on their financial goals and their ability to withstand risk. Once this decision is made, we advise our clients to stay with their program, and not abandon it in the face of declining stock prices. We also suggest that they avoid efforts to time their buying and selling of stocks, trying to be in as prices rise and out as price decline. Most independent, academic opinion counsels against market timing. To conclude, we rely on the combination of an appropriate allocation to stocks, and the history of price recoveries, in advising clients to maintain their stock positions. Given the uncertainties the future holds, however, we tend toward caution in our stock allocation recommendations.



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