Second Quarter 2008

DIALOGUES

FINANCIAL STRATEGIES FOR DISCUSSION℠

At Smith Barney, wealth management is defined by understanding you better—gaining deeper insight into your and your family's needs, goals and values. By looking at your whole financial picture, we can help you develop sound investment strategies. Let's continue working together to optimize your portfolio potential.

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Looking Beyond Short-Term Volatility

Whether you get your news from the papers, television or the Internet, you know how quickly the financial markets can change. Some days are euphoric (a key economic report may bolster consumer confidence or a company reports better-than-expected earnings for the quarter, igniting market indexes). Other days, however, aren't as sunny—and some of them may be downright unnerving. So what are some of the possibilities when an inevitable downturn occurs in the market?

An important piece of advice to keep in mind during a market slide is one you've no doubt heard before: Do not overreact. Even though your instincts may be telling you to try to protect your investments by switching to a more conservative approach or to liquidate your positions in hopes of buying them back at lower prices when the worst is over (an approach known as "timing" the market), it's important to keep your emotions in check—and your eyes on the long-term horizon. History tells us that over the long run the stock market can be quite resilient. From wars to natural disasters to economic meltdowns, the market has seen it all—and over time has shown remarkable capacity to bounce back.

While it's not always easy to maintain long-term perspective, overreacting to events as they unfold may compound the damage—and you may end up selling at the bottom or missing part or all of a subsequent market recovery. To help protect against short-term volatility and the anxiety it may create, together, we can help develop a diversified investment plan that reflects your long-term goals and tolerance for risk. By reviewing the investment plan on a periodic basis, we can try to alter it as needs change. At Smith Barney, our primary focus is ensuring that your wealth continues to work hard for you day in and day out.

Past performance is no guarantee of future results. Diversification does not ensure against loss.

By the Smith Barney Division of Citigroup Global Markets Inc.

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Recessions and Bear Markets:

The Connection Isn't as Close as You Might Think

Recent economic and capital markets developments have contributed to a surge in stock-market volatility, leading some investors to worry that the odds of a recession have risen—along with the risk of a significant market downturn.

Many investors are nervous because they assume an economic recession would lead to a decline in corporate profits, which would likely push stock prices down.

It may sound like a plausible assumption. However, it also could be wrong. The historical record suggests the link between recessions and bear markets is not a tight one. Over the past 11 recessions (as defined by the National Bureau of Economic Research, a nonprofit research group) the Standard & Poor's 500 Index posted an average annualized return of 12.1%—a percentage point and a half *higher* than the index's 81-year annualized return. All told, market returns have been positive in seven of the past 11 recessions (see table below).

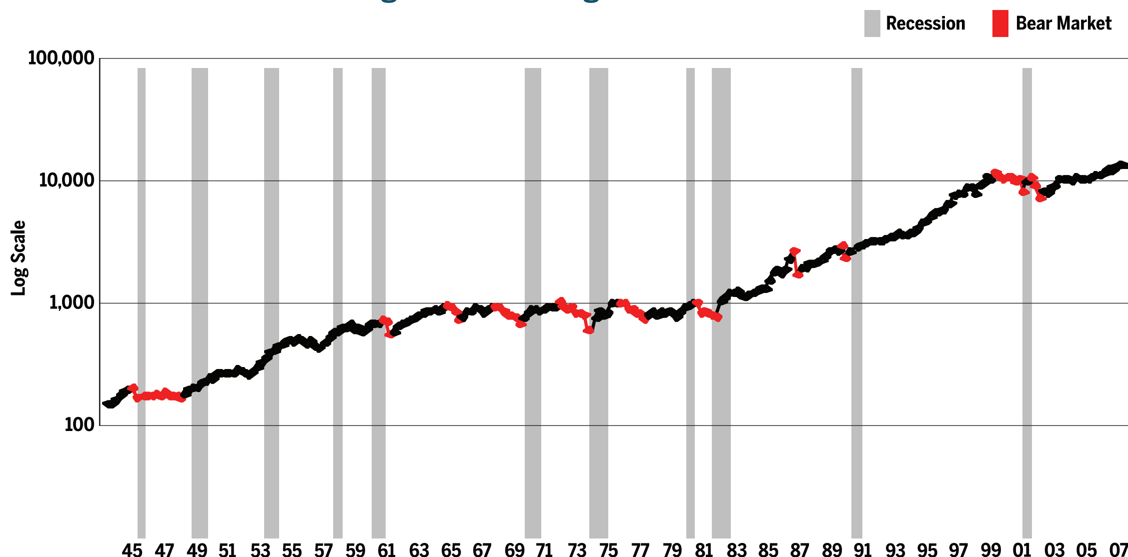
Those results may seem illogical, given that recessions usually *are* bad for corporate profits—and sometimes very bad. Commerce Department figures show that corporate earnings have fallen in all but two of the ten recessions since World War II—with an average annualized decline of almost 10%.

Standard financial theory teaches that the price of a stock should reflect the stream of earnings it is expected to produce. So, all else being equal, lower earnings should mean lower equity valuations and negative returns.

But all things are seldom equal. Other factors frequently influence stock prices, even during recessions. These forces can include:

- **Inflation.** Rapid price increases may create uncertainty about the quality of corporate earnings—and the real value of future earnings. This uncertainty can push down stock prices. Conversely, if an economic slump slows inflation, stock prices might rise, or at least not fall as much as they would have fallen otherwise.
- **Interest rates.** The Fed typically reacts to a recession by quickly lowering short-term interest rates. Long-term bond yields often also decline. Lower rates increase the relative attractiveness of equities, which can help offset lower earnings.
- **Noneconomic shocks.** Unexpected bad news, such as a war or terrorist attack, can drive stock prices down, worsening the impact of a recession. Good news like tax cuts, peace deals or mergers can drive prices higher, despite a recession.
- **Investor psychology.** Sometimes markets rise and fall for reasons that seem to have little or nothing to do with economic fundamentals. The 1987 bear market, for example, occurred at a time when economic growth was accelerating. It's also important to understand that financial markets tend to be *forward looking*. That is to say, prices are usually influenced by what investors expect to happen, not what has already happened.

Dow Jones Industrial Average: 1945 through 2007



Source: Consulting Group, Dow Jones, National Bureau of Economic Research

For most investors, the wisest course is to develop a long-term investment strategy and stick to it, even during market corrections and economic downturns.

Periods before a recession often see a spike in market volatility, as investors react to rising uncertainty about the direction of earnings. In seven of the last ten recessions, profits also peaked before the economy did, giving investors additional reason to be cautious. By the same token, however, the market often hits bottom and starts to recover before the economy does—as investors begin to anticipate a rebound in earnings.

No Crystal Ball

While the stock market is forward looking, it isn't psychic. Many economic slumps widely anticipated by investors—and reflected in stock prices—have never materialized, or as the Wall Street joke goes: The stock market has correctly predicted ten of the last five recessions.

This unsteady relationship is illustrated by the chart to the left, which shows the rise of the Dow Jones Industrial Average since the end of World War II. (This is shown on a log scale, meaning the vertical axis is based on percentage gains, not points.) The gray bars in the background show the past 11 recessions and the red line segments mark the past ten bear markets, defined as a drop of 20% or more from a previous market peak.

As can be seen, bear markets and recessions often have occurred in close proximity to each other—but there are exceptions. Of the ten postwar bear markets, four occurred entirely during periods of economic expansion, while another (1946 to 1949) began at the end of one recession and hit bottom in the middle of another. Four recessions (1953 to 1954, 1957 to 1958, 1960 and 1980) were not accompanied by bear markets at all, while the worst declines of the 2000 to 2002 bear market occurred *after* the recession had ended.

There also isn't any automatic connection between the depth and severity of a recession and the corresponding intensity of a bear market. The deep 1981 to 1982 recession, for example, was accompanied by a relatively mild bear market, perhaps because equity valuations were already depressed when the recession started. The brief 2001 recession, by contrast, took place in the middle of the deepest bear market since the Great Depression, probably because equity valuations were drastically inflated during the 1990s boom.

Conclusion

At this point, it's impossible to predict whether the current economic jitters eventually will lead to a recession—or how the stock market would react if they do. Much would depend on investor expectations about the seriousness of any downturn and their confidence in the long-term soundness of the U.S. and global economies.

Past performance is no guarantee of future results, but history suggests that recessions, like bear markets, are short-term corrections in a longer-term rising trend. Investors who have tried to second-guess the market—for example, by exiting the stock market when they thought a recession was at hand and jumping back into the market when they thought the economy had hit bottom—often have been disappointed.

For most investors, the wisest course is to develop a long-term investment strategy and stick to it, even during market corrections and economic downturns.

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S&P 500 INDEX: This world-renowned index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 focuses on the large-cap segment of the market, with over 80% coverage of U.S. equities, it is also viewed as a proxy for the total market.

Performance results include all cash and cash equivalents, are time weighted and annualized for time periods greater than one year and include realized and unrealized capital gains and losses and reinvestment of dividends, interest and other income. The volatility of the index used for comparison may be materially different from that of the manager performance shown. Indexes are not available for direct investment. Index returns consist of income and capital appreciation (or depreciation) and do not take into account fees, taxes or other charges. Such fees and charges would reduce performance.

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Coping with Volatile Markets

What Long-Term Investors Need to Know

Periodically, investors are given a sharp reminder that stock prices can go down as well as up—and can do both very quickly and with relatively little warning. These sudden market movements can raise doubts about the wisdom of a long-term commitment to equity investing.

Investors are often tempted to overreact in such situations. Their first instinct may be to sell holdings, particularly stocks that are highly susceptible to market moves. Or, they may try to "time" the market—liquidating positions in hopes of buying them back at cheaper prices when the worst is over. This is usually a mistake: Even professional money managers can't often guess the market's next move.

When markets turn volatile, it's more important than ever for investors to keep a clear head and a cool hand. The middle of a sudden correction—or an upswing—isn't the right time to be making impulsive emotional decisions about your portfolio. As the saying goes: Act in haste, repent at leisure.

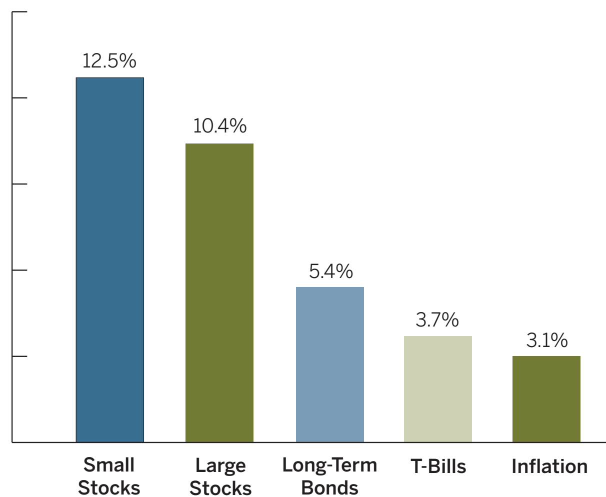
Risk and Reward

Short-term volatility is a fact of life in the stock market, a risk equity investors have to be prepared to accept. While diversification and prudent portfolio management may reduce this risk, it cannot be eliminated entirely. However, a review of more than eight decades of market history suggests long-term investors in U.S. stocks typically have been well rewarded for the risks they have taken—particularly when compared to supposedly "safe" investments such as government bonds and money market instruments. How well? Consider this:

- **A dollar invested in large-cap U.S. stocks** at the beginning of 1926 could have grown to almost $3,250 by the end of 2007, according to Ibbotson Associates.
- **By comparison, that same dollar invested in long-term Treasury bonds would have grown to only $77,** while $1 invested in short-term Treasury bills would have been worth just $20, according to Morningstar, a financial research firm.
- **The annualized return on large-cap stocks over the past 82 years has been just under 10.4%**—almost twice the average return on long-term U.S. government bonds, according to Ibbotson. T-bills, meanwhile, have barely kept ahead of inflation over that same period.

Equities have not only outperformed over the long run, they've done better over most shorter-run periods as well. Large-cap U.S. stocks (as represented by the S&P 500 Index) have delivered higher returns than either T-bills or Treasury bonds in 36 of the past 62 years—or about 58% of the time, according to data from Ibbotson and Smith Barney. The same data shows that since 1945, stocks have outperformed bills and bonds in 43 out of 58 rolling five-year periods (or more than 74% of the time) in 44 out of 53 rolling ten-year periods (more than 83% of the time) and in every 20-year rolling period.

Annualized Returns: 1925 through 2007



Past performance is not a guarantee of future results.

Source: Citi Smith Barney, Ibbotson Associates/Morningstar. Please see important disclaimers at the end of this report.

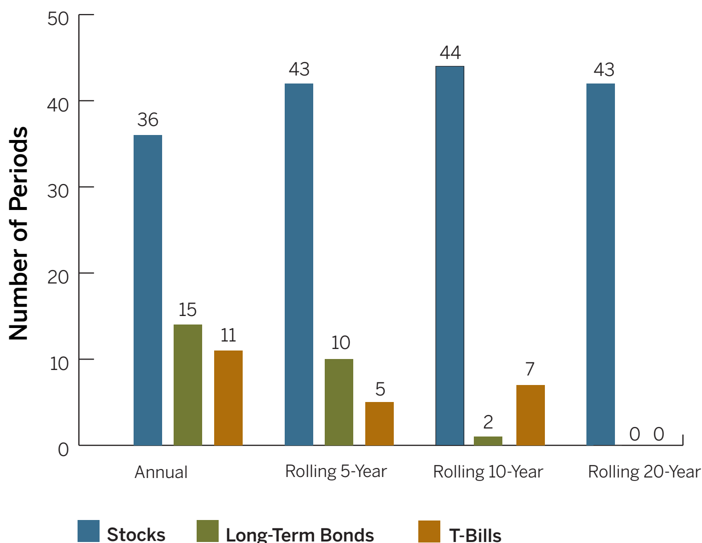
> **Equities have not only outperformed over the long run, they've done better over most shorter-run periods as well.**

The Odds Favor the Long-Term Investor

On a monthly or quarterly basis, stocks historically have been more volatile than bonds, T-bills and most other fixed-income assets. The market has also experienced deep and prolonged downturns, such as the 49% decline seen during the 2000 – 2002 bear market. However, these events have been less common than many investors might think:

- Returns on the S&P 500 have been positive in 59 of the past 82 years—or almost 72% of the time.
- During that same period, there have been only ten years in which the market lost more than 10%, and only five years in which it lost more than 20%.
- On the other hand, returns have been greater than 10% in 47 of the past 82 years, and greater than 20% in 31 of those years—or almost two years in every five.

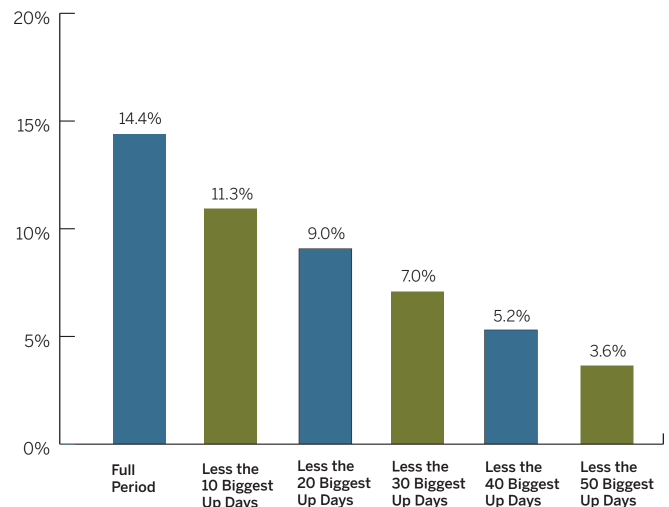
Top-Performing Asset Class 12/31/45 through 12/31/07



Past performance is not a guarantee of future results.

Source: Citi Smith Barney, Ibbotson Associates/Morningstar. Please see important disclaimers at the end of this report.

Annualized Increase in the S&P 500: 1980 through 2007 Net of Dividends



Past performance is not a guarantee of future results.

Source: Citi Smith Barney

Many studies have suggested equity returns are actually higher than what the market's historical volatility otherwise would suggest. In other words, investors are demanding—and, on average, getting—unusually high returns to accept the risks associated with owning stocks. This extra return (sometimes known as the equity risk premium) is one of the reasons the stock market has proven so attractive for long-term capital accumulation.

The Risks of Market Timing

In theory, investors could boost returns even more by avoiding—or successfully timing—market volatility. However, as mentioned earlier, this is extraordinarily difficult. And the costs of being out of the market at the wrong time can be enormous.

From 1980 through December 2007—a period containing more than 7,000 trading days—an investor who missed the 50 biggest up days would also have sacrificed more than 75% of the increase in stock prices during that period—converting a 14.4% annualized rise into a gain of only 3.6%.

Of course, if an investor could figure out how to catch the biggest up days in the market, while missing the biggest down days, he or she could add, not subtract, from long-term performance. The problem is that the biggest up days often come immediately after the big down days. Jump out of the market after a big decline, and there's a good chance you'll miss at least part of the rebound.

The costs to long-term investors of putting money to work in the market at the wrong time—i.e. right before a market top—have been relatively small, at least over the long run.

On the other hand, the costs to long-term investors of putting money to work in the market at the wrong time—i.e., right before a market top—have been relatively small, at least over the long run. An investor who put $10,000 in large U.S. stocks at the tops of the last eight major bull markets could have had a portfolio worth more than $2.7 million by the end of 2007. By comparison, the same amounts invested in T-bills at the same times could have grown to roughly $503,000 over that same period.

Conclusions

Taking a long-term perspective on market volatility isn't always easy. However, overreacting to the latest market events can easily compound the damage, by forcing investors to sell at the bottom or miss all or part of a subsequent recovery. It can also lead them to forget the powerful long-term case for equity investing.

Investors can best protect themselves from short-term volatility by developing prudent, diversified investment strategies—ones that reflect their long-term goals and tolerance for risk. They can and should review these strategies periodically to see if they still match their financial needs. However, changes shouldn't be based on the latest dip or surge in the market—or fear of where the next one might lead. Because the most critical danger most investors face isn't the risk of short-term volatility, it's the risk of making decisions they will regret later.

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INDEX DEFINITION: The S&P 500 Index covers 400 industrial, 40 utility, 20 transportation and 40 financial companies of the U.S. markets (mostly NYSE issues). The index represents about 75% of NYSE market cap and 30% of NYSE issues. It is a capitalization-weighted index calculated on a total return basis with dividends reinvested.

There is no guarantee that any strategy will success as past performance is no guarantee of future results and investment results may vary. This information is intended for illustrative purposes only and does not necessarily represent the experience of other clients. The investment strategies presented are not appropriate for every investor. Each investor should review with their Financial Advisor the terms, conditions and risks involved with specific strategies.

Diversification does not guarantee a profit or protect against a loss.

Bonds are affected by a number of risks, including fluctuations in interest rates, credit risk and prepayment risk. In general, as prevailing interest rates rise, fixed income securities prices will fall. Bonds face credit risk if a decline in an issuer's credit rating, or creditworthiness, causes a bond's price to decline. High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues. Finally, bonds can be subject to prepayment risk. When interest rates fall, an issuer may choose to borrow money at a lower interest rate, while paying off its previously issued bonds. As a consequence, underlying bonds will lose the interest payments from the investment and will be forced to reinvest in a market where prevailing interest rates are lower than when the initial investment was made.

Understanding Our Behavioral Blind Spots

Making the Difficult Choices

Investment decisions are among the most important life choices a person can make. They may determine where your children will be able to go to college, when you'll be able to retire, or what kind of lifestyle you'll enjoy after you retire.

Unfortunately, these are also some of the most difficult choices a person can make. In order to make sound decisions, we need to be aware of our own psychological blind spots. These can lead us to make persistently poor financial choices—errors that over time can do significant damage to our portfolios.

Chains of Thought

Traditional financial theory assumes all investment decisions are made rationally, based on the best available information. In theory, the result is an efficient market—one in which prices accurately reflect fundamentals, such as earnings and interest rates.

However, it's not always easy to reconcile financial theory with financial reality. Investors often appear determined to ignore the fundamentals, both in bidding stock prices up and slamming them back down again.

"In many important ways, real financial markets do not resemble the ones we would imagine if we only read finance textbooks," notes Richard Thaler, a professor at the University of Chicago and a leading behavioral finance researcher.

It's not that investors are totally irrational, Thaler and other researchers argue, but rather that their thinking can be influenced by mental biases. These quirks can lead them to make choices that appear intuitively correct, but produce poor performance:

- **Overconfidence.** Investors generally assume they know more than they actually do. They also tend to remember previous investment decisions in ways that exaggerate their own foresight. This can lead to overly aggressive trading and a reluctance to admit—and correct—mistakes.

> **Some studies have shown that the more investors know about the investment process, the less likely they are to be misled by behavioral biases.**

- **Mental Accounting.** Financial experts often advise investors to take their entire portfolio into account when making investment decisions. Yet, many investors unconsciously divide their wealth into separate pots. If they have a big gain, for example, they may think of it as essentially "free" money and take greater risks with it than they would with their "own" money.
- **Anchoring.** Logically, investors should always base their decisions on current prices and expectations, . Instead, they often become fixed on past events, such as the price they paid for a particular stock. Investors will often refuse to sell at a price lower than that—even when it makes more sense to accept their loss and invest their remaining money elsewhere.
- **Framing.** How people view a decision often depends on how their choices are presented. For example, in one study researchers asked participants how much they would be willing to pay to avoid a one-in-a-thousand chance of being killed. The average answer was $1,000. Participants were then asked how much they would demand to accept the same risk. This time, the answers ranged as high as $200,000. From an economic point of view, the two questions were identical, but subjects saw them very differently.
- **Loss Aversion.** In a completely rational market, the risk of loss and the possibility of gain should carry equal weight. However, on average investors place twice as much importance on avoiding a loss as they do on making a gain. In other words, to accept a 50% chance of losing $100, most people will demand at least a 50% chance of earning $200.

The Value of Advice

Are investors doomed to repeat these mistakes? Maybe not. Some studies have shown that the more investors know about the investment process, the less likely they are to be misled by behavioral biases.

This is one reason we encourage investors to develop prudent, long-term investment strategies that take into account their goals and tolerance for risk. While this doesn't guarantee investment success, it can at least reduce the risk of being led astray by behavioral blind spots. That's something even the smartest investor might want to keep in mind.

Smart Strategies for Investing in Any Market

Be Better Prepared to Preserve and Protect Your Portfolio

Headline news frequently highlights how quickly the financial markets can change. For some investors, this news precipitates a degree of uncertainty about the future, and possibly prompts them to look for a more conservative approach to help them preserve and protect their investments.

Investors are least likely to be permanently affected by current volatility if they keep their wits about them, as past experience has shown. Also, by adhering to a long-term investment strategy, they could be in a better position to benefit when the market recovers.

Meanwhile, here are some investment strategies that—when carefully applied—could help better prepare investors to respond to any major economic and investment trends that may affect portfolio performance.

- Periodically fine-tune the portfolio's asset allocation.
- Review equity positions.
- Take advantage of convertible securities.
- Consider the guaranteed income, tax benefits and death benefit guarantees of variable annuities.
- Rebalance the portfolio with fixed-income opportunities.
- Consider alternatives to cash.
- Set investment horizons globally.
- Establish a regular investment program, such as dollar cost averaging.

Some Helpful Reminders

- Now is not the time to ignore or abandon investment portfolios.
- The longer the time horizon, the less investors should be concerned about short-term market fluctuations.
- A diversified portfolio held for longer-time increments may help reduce the risk of losing money.

These strategies can work smartly to help cautious investors potentially take advantage of the changing financial marketplace.

Past performance is not a guarantee of future results. Diversification does not ensure against loss.

Dollar cost averaging does not guarantee a profit or protect against loss. Investors should consider their ability to sustain investments during periods of market downturns.

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