Third Quarter 2008

AT SMITH BARNEY

DIALOGUES

FINANCIAL STRATEGIES FOR DISCUSSION℠

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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).

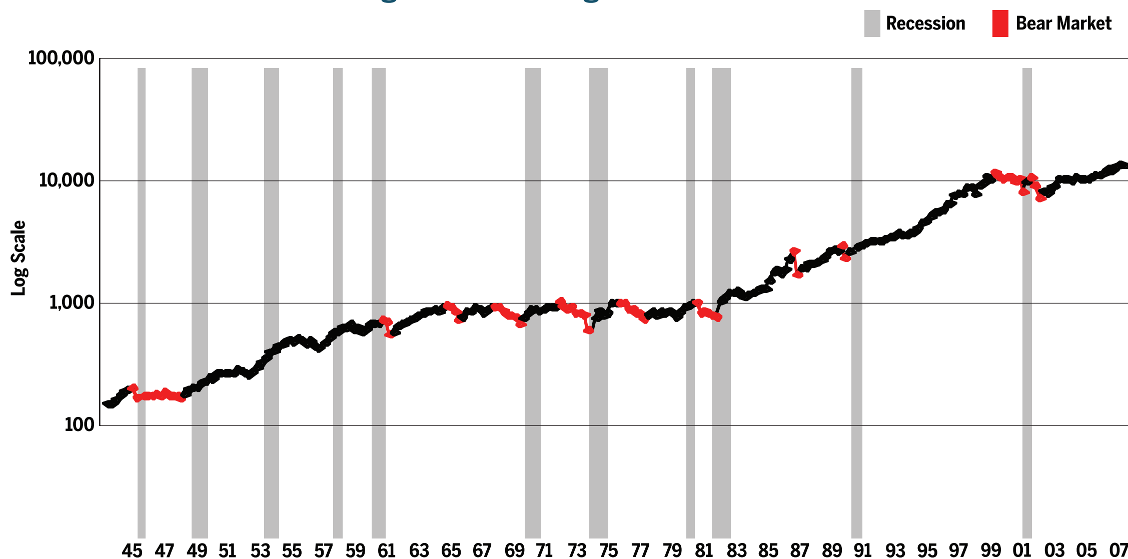
Those results may seem illogical, given that recessions usually *are* bad for corporate profits—and sometimes very bad. Commerce Department figures show that corporate earnings have fallen in all but two of the ten recessions since World War II—with an average annualized decline of almost 10%.

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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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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