KEATING INVESTMENT COUNSELORS, INC.
REGISTERED INVESTMENT ADVISORS FOR INDIVIDUALS, RETIREMENT PLANS, TRUSTS AND FOUNDATIONS

Investment Strategy
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Financially, 2008 was one of the most eventful and troubling periods in our nation's history. Continuing problems in the housing market and the failures of several large financial institutions caused the sudden evaporation of confidence in the financial system as we entered the fourth quarter. Unemployment continued to rise, reaching 7.2% in December, the highest level in 16 years, with further increases expected. With the official declaration that the recession began in December 2007, speculation now turns to the likely length of the downturn and the factors that will bring the economy back onto a growth path. Based on previous recessions of this magnitude, recovery will likely be prolonged as governments focus on thawing credit markets and developing plans for large infrastructure projects and tax cuts, with the goal of adding new jobs to support sustainable economic growth.

Virtually all asset prices were caught in the downward spiral in the last four months of the year, including stocks, bonds (with the exception of Treasuries), real estate, and commodities. The U.S. stock market (S&P 500) declined 38.5%, the European market (Euro 350) declined 46%, Japan (Nikkei 225) declined 42%, China (CSEX) declined 65%, and emerging markets declined more than 50%. In this liquidity crisis the common denominator has been that leveraged owners, including hedge funds and private equity, began to sell indiscriminately to meet immediate calls for more collateral or client withdrawals. As a result, stocks of some of the best companies in the world came under ferocious short-term selling pressure regardless of their fundamental merits like superior earnings, dividends, brands, and patents.

We have seen this selling pattern before during the 1973-1974, 1981-1982, 1990-1991 and 2001-2002 bear markets, with the same indiscriminate selling of high quality companies. However, these companies were also the ones whose stock prices recovered first. In fact, since these same high quality companies are currently owned in client portfolios, and, while down for the year, the portfolios were generally down substantially less than the 38.5% of the S&P 500.

Periods of economic contraction, like expansions, do not last forever. Inevitably, economic growth is followed by excesses that lead to economic slowdown and contraction. These excesses have to be cleaned up and, as they are, conditions eventually begin to improve and the next period of expansion begins. Recessions are not pleasant for anyone, but as investors we should not overreact since recessions build the foundation for the next economic expansion. What most investors fail to realize is that the stock market is one of the best leading indicators of the economy. Typically stocks turn down about six months before a recession begins and turn up about five months before it ends. Although economic news, particularly unemployment, will continue to be negative for

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some time, the historical record shows the stock market has gained an average of 46% within twelve months of making its bear market low.

Despite the continuing struggles of the economy, there are a number of signs indicating that the economic low point may occur by the middle of 2009. The extreme volatility in October and November from forced liquidations has begun to subside. Also, credit markets have shown signs of thawing, as credit spreads have narrowed and several major corporate bond offerings have been successfully sold. Importantly, throughout December, as additional negative news was released, both the market and individual stocks stopped going down and often went up, indicating that perhaps the market had already fully discounted the "bad news." This is not to say that the bad news or additional selling is over, but the market appears to be anticipating the end of the current recession and could be poised for a significant recovery in the near future.

The government is continuing its effort to revive economic growth with significant stimulus already in the pipeline and more in the works. The Federal Reserve has reduced short term interest rates to 0.25% and during the past 13 weeks the money supply has been increased at a 14% annual rate. The Fed has also expanded its balance sheet by over $8 trillion by backing up deposits and creating a market for asset backed securities. There is also credible evidence that a 4.5% mortgage rate is being targeted. Given declines in home prices and mortgage rates, home ownership is more affordable than at any point in the past 15 years. Additional stimulus will come from the incoming Obama administration, which has been preparing a stimulus package with the goal of creating jobs through massive infrastructure investment. In addition, plans are being developed to slow the foreclosure "freight train" with more targeted federal programs and by giving bankruptcy judges the flexibility to rewrite mortgages.

What does this mean for investors? Market disruptions create opportunities for disciplined investors, as the stock price of a company can get dramatically out of sync with its long-term value. Although the economy is weak and its near-term course highly uncertain, equity valuations already reflect the type of severe and protracted recessions experienced in 1973-1974 and 1981-1982. With $8.85 trillion being held in cash, bank deposits, and money market funds, the question is not whether, but when, this money will begin to flow into stocks and bonds. In fact, the dollars held in money market funds alone is equal to 42% of the value of the S&P 500. The only comparable times with such a significant amount of money sitting on the sidelines were January 1991 and October 2002. These two instances were just after the bottom of bear markets and at the beginning of multi-year bull markets.

Given this backdrop, we have been investing accumulated cash balances, focusing on owning the highest quality companies in historically less cyclical sectors, notably

Consumer Staples, Healthcare, and Telecom. Companies we have targeted in these sectors include Coca-Cola, Johnson & Johnson, Philip Morris International, Procter & Gamble, Stryker, and AT&T. We have also started to invest in companies in extremely discounted sectors that have strong balance sheets and consistent execution which should enable them to improve their market position during the downturn. These include Aflac, BB&T, U.S. Bancorp, and IBM.

Even in difficult market conditions, these companies have proven their ability to make rational decisions that increase long-term value for shareholders. The large, high quality companies we own are largely self funding and have the size and ability to thrive in a troubled marketplace while their weaker competitors struggle to keep pace. These companies have the flexibility to continue to improve their operations while competitors must slash costs and delay capital expenditure plans. The best companies will also be able to purchase weaker competitors at discounted valuations that have not been seen in many years.

While we remain cautious and deliberate in our approach, we continue to keep our eyes focused on the longer term horizon of our clients' continuing needs. By design, our investment philosophy and implementation is less volatile on the downside while participating fully in the long term rewards of equity investing. Our client portfolios are custom managed to meet each individual's needs, with special emphasis on capital preservation, income, tax minimization, low turnover, and transparency. As many hedge funds investors now know, the lack of transparency and liquidity is not in investors' best interest, but serves to benefit fund management. This contrasts with our tailored approach, which offers daily full transparency where positions and strategies can be more closely dovetailed with other investments to optimize your overall objectives.

Although we have been going through a period of extreme risk aversion and volatility, we are confident that the current market is offering investment opportunities only witnessed every few decades. We believe this is an investor's chance to build a 'wish list' portfolio that should grow consistently over the next decade while producing higher dividends and lower risk than the market averages. We will continue to position our client portfolios to take advantage of these opportunities.

Truly yours,

Keating Investment Counselors, Inc.