

QUARTERLY UPDATE

Economic and Investment Management Perspectives

Extraordinary Times May Bring Extraordinary Opportunities

By Richard A. Weiss
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The recent, rapid succession of major financial failures (or near failures) has led to a severe liquidity crisis that is clogging the credit markets. At the same time, the landscape of the financial services industry is changing rapidly and will likely continue to do so for some time.

This has led to a virtual collapse in both consumer and investor confidence that will delay but, importantly, not deny an economic recovery. Additionally, this crisis in confidence has led to extreme pricing dislocations in the markets. The historic flight to quality has pushed many otherwise “safe” investments to extreme, and possibly even irrational, levels.

The most important thing to remember is that risk and return remain the key principles of successful investing, even during stressful times like these. However, the immediate risks and potential returns are magnified in the current environment, placing even more importance on investment discipline and valuation techniques. City National Asset Management’s quantitatively disciplined approach has proven especially effective in times like these, when market psychology dominates and volatility increases.

Polarization of Risk and Return

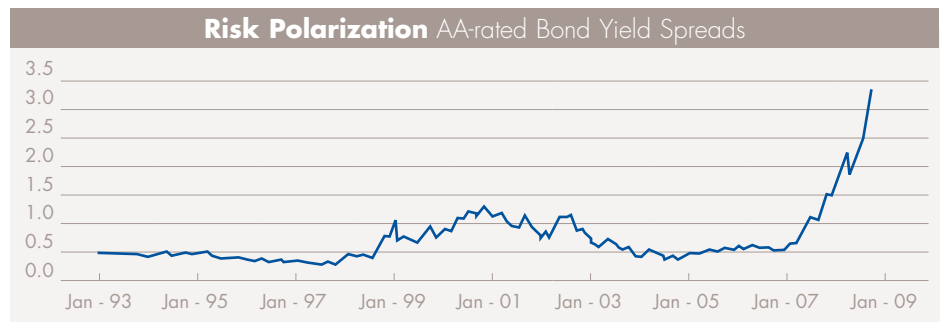
With consumer and investor confidence hitting all-time lows, panic has gripped the markets and is currently pushing the prices of many assets to unsustainable extremes. The typical risk/return spectrum has bifurcated into two camps: Low Risk and High Risk. There are few, if any, assets currently priced in the middle.

The graph below indicates one such example, the current yield spread on AA-rated bonds. Normally, AA-rated bonds offer about 0.5% more in yield than comparable maturity Treasury issues. In a typical recession, that spread may increase to 1%, reflecting a credit premium accorded the safer Treasury securities. However, we are now in an environment where those spreads have quintupled to more than 3% in just a few weeks.

This polarization of risk and return is being driven by panicky investors and severe illiquidity. It is, therefore, likely to be a temporary phenomenon, and one that can and should be exploited. Recognizing and capitalizing on these opportunities is the key to a successful investment strategy in the near/intermediate-term. Renowned investor Warren Buffett recently made two sizable investments (in Goldman Sachs and GE) that are prime examples of this strategy.

Our Current Asset Allocation Stance

It’s clear that the present economic downturn is going to be extended. It’s important to note, however, that the downturn in equities started more than a year ago and that we were well into the process/cycle before the recent crisis



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hit. The more recent consensus of economic forecasts has pushed back the trough by four to six months, at least until the first quarter of 2009, which thus delays our switch to a more aggressive investment posture.

Tips for Weathering Volatile Markets

By Roger Stinnett, CPA, CFP, CIMA

Tax & Financial Planning Manager

Today's highly volatile market environment reinforces the importance of financial planning. Having a financial plan in place can help keep you from over-reacting. Now is the perfect time to take a deep breath and re-commit to strategies that may improve your financial situation. Here are some tips on keeping your financial life safe and sane:

- **Don't Have a Knee-Jerk Reaction.** Don't liquidate your portfolio. There's a reason you had that portfolio strategy in place to begin with. The time many people forget their investing principles is the time they need them the most. Sometimes, the best reaction is no action, except to tighten your seatbelt.
- **Keep the Long-Term View.** No one has a crystal ball, but these volatile times eventually will pass. Sticking to your financial plan will help ensure that you are positioned to reap the benefits of taking a long-term view.
- **Keep Funding Your 401(k).** It's tempting to reduce the amount you are putting in or stop contributing all together. Instead, think of how you are buying more shares at a cheaper price and getting an "instant return" from your employer's match.
- **Rethink Your Expenses.** You can't control the markets, but you can control your spending. Make a list of five things you could eliminate or cut back. That could include: eating out less, a less costly winter vacation and cutting back on your cable TV channels and other entertainment, and perhaps dropping a phone line.
- **Retirement Accounts are the Last Resort.** Don't crack the nest egg. Keep it safe and try not to tap this money. Accessing these funds now might mean penalties and leave you short when it comes time for retirement.
- **Have a "Doomsday Fund."** Maintain an emergency cash fund. While you may not need it, this fund gives you the flexibility to act quickly in helping friends and family.
- **Consider Wealth Transfers.** The current high volatility, low interest rates and depressed asset values have provided the perfect opportunity for making wealth transfers. Quick action now may save significant estate and gift taxes.

Most important, remain vigilant. Now may be a good time to make an appointment to revisit your financial plan and asset allocation with your Investment & Trust Consultant. ❖

The strategies presented in this document were not intended and cannot be used for the purpose of avoiding any tax penalties that may be imposed. The strategies were not written to support the promotion or marketing to another person any transaction or matter addressed. Before implementation, you should consult with your other advisors on the tax, accounting and legal implications of the proposed strategies based on your particular circumstances.

Extraordinary Times

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The Federal Reserve now seems more likely to reduce rates at the next few FOMC meetings, based on the probabilities implied by Fed Funds futures prices. Inflation, while still a concern at some point, has been relegated to backstage while central bankers around the world focus on fears surrounding a global recession.

Accordingly, we remain fairly defensively positioned and well diversified across large-cap stocks, the developed international markets, high-quality bonds, and certain conservatively oriented alternative investments where appropriate. We have been underweighted for some time in the riskier segments such as emerging market equities and bonds, junk bonds, venture capital and private equity.

Opportunities Abound

For those with the requisite tolerance for risk and suitable investment horizons, current market dislocations and pricing anomalies represent significant potential opportunities for abnormally superior investment returns.

When (not "if", but "when") liquidity returns to the marketplace, pricing will revert to fairer valuation levels, producing significant returns for those who bore the interim illiquidity risk. The important point to emphasize is that the basic tenets of risk and return remain intact, even in the current, extreme environment. *Valuation* becomes paramount in security selection in these times. Therefore, City National is maintaining its long-standing, quantitatively-disciplined approach to investing that has proven itself over the long term.

One Last Note

It is virtually impossible to open a financial publication or turn on the financial broadcast news without seeing a barrage of negative news on the economy: anemic growth, housing slump, rising unemployment, weaker dollar, bank failure, global recession, etc. It seems as if it weren't for bad news, we wouldn't have any news at all. The lopsided nature of the economic reports is extreme.

Contrast this with the situation a little over a year ago. Throughout the first quarter of 2007, an investor couldn't read an article or watch a financial news program that wasn't touting "excess liquidity" as the fuel for even higher market prices. There was only good news back then; the polar opposite of today's situation.

If nothing else, this amazing if not ridiculous pendulum swing in psychology from "greed" to "fear" over the last year should give investors solace. The rapid and extreme movement from one end of the spectrum to the other is bound to repeat itself – next time in our collective favor. ❖

Collapse in Equities Moves Us Closer to a Bottom

By Barbara Bruser, CFA
Director of Equities
City National Asset Management

Equity markets around the globe collapsed in the third quarter and particularly in September, roiled by the crisis in the credit markets and rising fears of a widespread contraction in economic activity. We are now officially in bear market territory, with global markets posting negative price returns for four consecutive quarters. Domestic markets have fared better than those abroad, which began their fall later but then dropped much farther. While this erosion in portfolio values is difficult to endure, the current widespread fear among investors is typical of the mood seen at major market bottoms. We may not be there yet, but we are closer than we were a month ago.

2008 TOTAL RETURNS

	Q3	YTD
S&P500	-8.9%	-20.6%
DJIA	-4.4%	-18.2%
NASDAQ	-8.8%	-21.1%
MSCI EAFE	-21.1%	-31.1%
Emerging Markets	-27.6%	-36.8%

Within the U.S. market, the pattern of returns shifted during the third quarter. Top performers were defensive sectors such as consumer staples (up 4%) and health care (virtually unchanged). These sectors also took over first place for year-to-date performance, replacing the commodity-sensitive sectors of energy and materials that had outperformed in the first half and for the last three years. High prices for materials and energy finally had an impact on demand, both in the U.S. and around the world. Stocks of commodity producers were the worst performers, falling more than 20% in the third quarter alone. It is interesting to note that despite all the concerns about financial services companies, this sector was actually one of the best performers in the third quarter, as well as in September. What this suggests is that real economic activity, not the “headline risk” of bankruptcies, remains the underpinnings of the equity markets.

A Shift in Equity Sector Strategy

During the third quarter and before the credit markets seized up, economic and market data began to suggest that the bottom of this

economic cycle was approaching. In anticipation of a recovery, we shifted our overall equity sector strategy from *defensive* to *neutral*. Within sectors, however, we are still hedging our bets. For example, home builders and auto companies are not part our consumer strategy and regional banks are not generally part of our financial services strategy.

In hindsight, we were probably early in this shift to sector neutral. However, as the credit markets open back up – and they will – we expect to see equity markets stabilize and a sector neutral stance will be viewed as a transition to a more economically sensitive portfolio strategy. The big question is how long the transition will take. While it is very tempting to look at the current market environment as unique, a little history can help put things into perspective.

Polarization of Investor Expectations

During times of great stress in the financial markets, risk aversion dominates investor behavior and the over-riding instinct is to sell. During periods of “irrational exuberance,” the desire for excess return dominates investor behavior and the instinct is to buy. The result is a polarization of expectations at both the top and bottom of every market cycle. The fear that is currently gripping the market is an expression of the risk polarization that usually accompanies market bottoms.

Over the last 65 years, the average bear market has lasted just under 18 months. The longest was three years. The most recent bear market ran two and one half years, ending on October 9, 2002, after which equities rallied for five years (to the day) and rose by 102%. Largely because of the conditions in the credit markets, we expect that the current bear market will run longer than usual and we do not anticipate a sharp recovery in stocks until well into 2009.

However, history also teaches us that if you wait until the recovery is certain, you will have missed the biggest opportunity for significant gains. We are not suggesting that investors increase their exposure to the equity markets at this time. We need some evidence that the solutions coming from Washington are restoring confidence in our capital markets and that business activity is also responding. However, adherence to investment disciplines is more important than ever during these market extremes. We continue to find opportunities in the equity markets and will use them to position our portfolios for the eventual recovery. ❖

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Bonds Remain Important Part of Investment Strategy

By Rod Olea

Director of Fixed Income
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The impact of the current credit crunch on the fixed income markets has been severe, with September being one of the worst performing months on record for fixed income assets other than U.S. Treasuries. The credit markets seized and investors flocked to the safety of Treasury bills, even at abnormally low yields. Most municipal bond portfolios and taxable (non-Treasury) bond portfolios had negative total returns of -1% to -3% during September. However, this massive flight to quality has eased as investors weigh the effects of the recently passed financial rescue plan and fixed income asset prices begin to normalize.

An area we are watching closely is overnight borrowing rates, specifically the Libor (London Interbank Offered Rate). Libor is a benchmark for the valuation of most money market instruments. Recent bank failures have made financial institutions wary of lending to each other, except at highly elevated rates. This caused a spike in Libor rates accompanied by sharply lower valuations for commercial paper and other short-term credit instruments. This, along with the collapse of Lehman Brothers and the failure of a major money market fund to maintain the critical \$1 a share level, precipitated a near-run on money market funds, which in turn led the U.S. Treasury to offer a guarantee program for these widely held vehicles. The Treasury's goal was to stem the outflow of funds from panicky money market fund shareholders into Treasury obligations. As we go to press, we hope that the worst of the credit and liquidity crisis tsunami is behind us. We may still experience some dislocations in the credit markets, but with the successful passage of the economic stabilization plan and the Treasury's Troubled Assets Relief Program (TARP), we believe investor confidence will gradually return to the markets as time passes.

Fixed Income Holdings Remain Vital

Despite the market dislocations during these challenging times, it's vital to keep in mind the purpose and benefits of fixed income assets to an investor's overall allocation mix. The role of bonds in a portfolio is to produce a steady (and sometimes

tax-advantaged) income flow while mitigating the volatility of other, riskier asset classes that are held primarily for capital appreciation. The bottom line is that our client's fixed income strategies are doing their job, even with the temporary gyrations in the bond markets.

Our taxable bond portfolios were already positioned for an economic slowdown with a higher quality orientation and underweight representation in corporate bonds. Even though our strategy avoided some of the declines seen elsewhere, all corporate bond valuations have been under pricing pressure recently. Our portfolios remain heavily weighted towards government securities, but as we see price opportunities we may add select corporate issuers that have weathered the financial storm.

Our Municipal Bond Strategies

The effects of the credit crunch also hit the municipal bond market, sidelining many new bond deals and increasing concerns that municipalities and agencies would not be able to efficiently access the credit markets. Cash crunches appeared at some states (including California) and municipalities. We anticipate that short-term markets will normalize in the months ahead.

Our municipal bond portfolios remain well positioned for this economic slowdown. We continue to focus on broadly diversified holdings and sectors such as general obligation issuers. These include states, cities and counties, as well as essential purpose revenue (water, sewer and power) agencies. We also hold pre-refunded issues – municipals secured with U.S. Government collateral. General obligation issuers have the ability to increase taxes when needed, and revenue bonds typically are secured with usage fees that are largely stable. Lastly, cities and counties typically have to run balanced budgets and therefore can and will reduce expenditures as needed. We have also increased our geographical diversification for our California and New York clients to include more national issues and thereby insulate portfolios against the declining tax receipts in those states. Our portfolios are well diversified, typically with no more than 3%-5% in any one issuer. ❖

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