



**The Lost Decade
and
The (almost) Inevitable Rebound**

**Quarterly Market Comment
2Q-2008**

July, 2008

West Chester Capital

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The Lost Decade...

With the decade of the 2000s more than 85% over, it does not seem too hasty to label it the “Lost Decade” for legions of investors. Through the end of the second quarter of 2008, the S&P 500 is more than 12% below its close on December 30, 1999. While an investor in the S&P 500 would have collected a dividend yield of about 2% annually over that time, that still means a near zero return for investors in large cap stocks for the decade, so far.

Over the past century, large cap stocks have delivered a total annual return of about 10%, roughly half from appreciation and half from dividend income. During the 1990s, large cap stocks delivered an average annual total return of over 18%. For the last five years of the 1990s, large cap stocks delivered an average total return of more than 28%. With the perfect clarity of hindsight, these outsized returns were unsustainable. It is increasingly evident that the well above average returns of the 1990s set the table for well below average returns for the bulk of the 2000s. There are other factors at work here for sure...but outsized returns set the stage for undersized returns. So too do undersized returns set the stage for outsized returns.

Better Markets Ahead...The (almost) Inevitable Rebound

It is our belief that after we have collectively atoned for the excess returns of the 1990s by enduring the highly unsatisfactory returns of the 2000s, the stage will be set for a normal equity return environment. There is no reason to believe that U.S. equities have been permanently disadvantaged as an investment. The funny thing about averages is that the average return is rarely the return of any given period...sometimes well ahead of average, sometimes well behind. Moreover, the longer the period of deviation from the average, the longer and sharper the reversal is likely to be. So if outsized returns set the stage for unsatisfactory returns, this period is almost certainly setting the stage for better markets.

Without argument, there are significant and perhaps structural issues within the economy to address. Falling interest rates, which give equities a tailwind, are no more. The Federal Reserve has provided the stimulus it can with interest rates cuts, and with other issues like inflation looming, can no longer provide the fuel of falling interest rates to buoy the markets.

Commodities in general, and oil in particular, have enjoyed rising prices much like equities did during the second half of the 1990s. Unlike stocks and bonds which have an internal rate of return from earnings, dividends and interest, commodities are priced on pure supply and demand. While stocks and bonds are priced and maintain historical range relationships to their earnings, dividends and interest, commodities have no such relationship to inform investors about relative valuation.

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As such, commodities are infinitely more speculative in nature. After the unprecedented run-up in commodity prices of the past few years, it appears that many of the indicators of “bubble” conditions are present in these markets. Only with the perfect clarity of hindsight will the truth about the commodity markets be exposed, bubble or not. As always, bubbles are a function of the human condition, and will forever generate rationales for why these prices are not only justifiable, but only a way station to greater gains.

Bubble or Drubble?

Bubbles are only confirmed after they burst, but chasing markets and securities that have seen stratospheric price gains is a formula for disappointment and the permanent loss of capital. Unfortunately, it seems more and more likely that money is chasing commodity returns, while stocks are being sold to raise the cash to speculate in commodities. This too will probably end badly for those chasing the hot return markets, and dumping painfully cheap and attractive stocks. *Timeless Truth: as it is a mistake to chase euphoric markets, so too is it a mistake to sell into market panics.*

Dislocations in the real estate market are causing great pain among homeowners and institutional investors alike. The markets have endured the bursting of the tech bubble in the early 2000s, the bursting of the housing bubble in 2007, and the bursting of the commodity bubble may be right around the corner. Of the three speculative excesses of late, the housing bubble is the most frustrating and perhaps most destructive.

Pitching Tents Not an Option

People have no intrinsic need for technology stocks. Outside of what they consume in the form of oil, grains, or other basic components of the Western lifestyle, people have no intrinsic need to hold speculative positions in commodities. People do however, need a place to live. Rent or own, people need a roof over their heads. Moreover, real property has an intrinsic value. Land has an intrinsic value. Housing stock has an intrinsic value, whether determined by the market, or the real replacement cost of the bricks and mortar. There is a finite downside to the real estate market, not so for the capital markets (technically true--not practically). The complicating factor however, is leverage. While leverage tends to be limited or avoided in the capital markets by prudent investors, leverage is inherent in the real estate markets. Most investors put a maximum of 20% down on their property, for a debt to equity ratio of 4 to 1. Those homeowners who put little or nothing down, have little or no equity and an infinite debt to equity ratio. These folks are in the worst position as real estate prices decline, and are the most likely to walk as their equity vanishes. And as

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most mortgages are packaged into securities and sold into the capital markets to third-party investors, the unprecedented decline in home prices has caused havoc, illiquidity and untold short term, and perhaps temporary loss of capital for the holders of these mortgage backed securities. However, walking is not an automatic for homeowners in a negative equity situation. There are attendant issues like, having a place to live, serious credit impairment, the nuisance of moving, and more. While negative equity is an unfortunate circumstance, is is not an automatic mortgage default trigger.

This pain is finite, however. It is also entirely possible that once the increasing foreclosures stabilize and reverse, the mortgage backed securities that have been written down so aggressively by so many major financial firms, may be written back up, reversing most of the paper losses taken in recent quarters. Time will tell. Yet with a population that grows by 1% annually, the U.S. has three million more people every year who need housing. Whatever the surplus of housing is now, it will be absorbed, construction will pick up again, and mortgages will be issued to hundreds of thousands of home-buyers every year. These are veritable certainties.

Price to Earnings Multiple Contraction

Concurrent with the sub-par returns of this decade has been an enormous contraction in the valuations of most companies. While prices of both individual securities and the broad markets were clearly overextended by the early 2000s, the inverse now appears to be true, for many quality large companies.

Company	Symbol	Early 2000s Peak PE Multiple	Current 2009 P/E Multiple	P/E Contraction
S&P 500	SPX	30x	13x	56%
Amer. Intl. Grp.	AIG	24x	5x	79%
United Health	UNH	24x	7x	70%
Pfizer	PFE	51x	7x	86%
Gen'l Electric	GE	40x	10x	75%
Cisco Systems	CSCO	60x	15x	75%
Home Depot	HD	45x	15x	66%
Automatic Data	ADP	38x	19x	50%
Legg Mason	LM	27X	10x	63%
SEI Investments	SEIC	36x	17x	52%
Johnson & Johnson	JNJ	31x	14x	54%
Wal-Mart	WMT	39x	16x	59%
Best Buy	BBY	35x	11x	68%
Microsoft	MSFT	53x	13x	74%
Cardinal Health	CAH	32x	13x	59%

Interestingly, over the period from 2000 to now, the 10 year treasury rate has fallen from 6% to 4%. In a falling interest rate environment, the present value

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of financial assets should rise. In this case they should have risen by 50%, all things being equal. With this backdrop, the P/E contraction of these stocks is even more pronounced. Perversely, the lower these stocks go, the more attractive they become, yet the more suspect they appear to a hypersensitive, suspicious market. The financials are especially suspect because of their role in the mortgage markets. They were largely excluded from the table above due to the extreme adversity they have endured. Yet many quality companies have seen their relative valuations fall to attractive levels. And as P/E multiples have contracted dramatically, so too have dividend yields grown enormously.

Dividends are Cool Again

In a market that has gone sideways for the better part of a decade, it is now possible to hold a diversified equity portfolio that pays a dividend of 5% or more. In this market environment, where total returns have been essentially zero for eight plus years, dividend income is abundant, tangible and more appealing than ever. Also, high dividend yields are indicators of cheap or depressed stock prices. We are not making an argument that the market is going or should go back to the overextended prices of the late 1990s, only that today's prices present compelling return potential. Moral of the story—high prices lead to low returns, low prices lead to high returns. But you must have the fortitude to stay invested, especially when prevailing market conditions and sentiment are decidedly negative.

Behind Every Selloff is a Rebound

In the early 2000s, prices were unsustainably high. The inverse now appears to be true. Prices appear to be unsustainably low. If that is true, it is a uniquely opportune time to be invested. As ever, at market extremes, there is always a story to support the prevailing zeitgeist. Stocks are high because “we are in a new era” or other such nonsense. Today, stocks are low because “the other shoe is about to drop” or “recession is here” or “oil prices are killing us” or fill in the blank. The truth is, market extremes are rarely, or never, sustained. Many companies now appear to be at unsustainably low relative valuations. *Timeless Truth: every selloff creates the conditions for a rebound...the sharper the selloff, the sharper the eventual rebound.*

Ten Year Returns - Equal to the Worst Two Periods in Eighty Years

The charts below show the cumulative ten and eight year returns of the S&P 500. The chart assumes that the year would end where the market ended the second quarter. The chart reveals that as of now, the S&P 500 has endured the second worst ten year stretch in the eighty-five years of data examined going back to 1926. Only the ten-year period that includes the Great Depression of the 1930's has a lower return.

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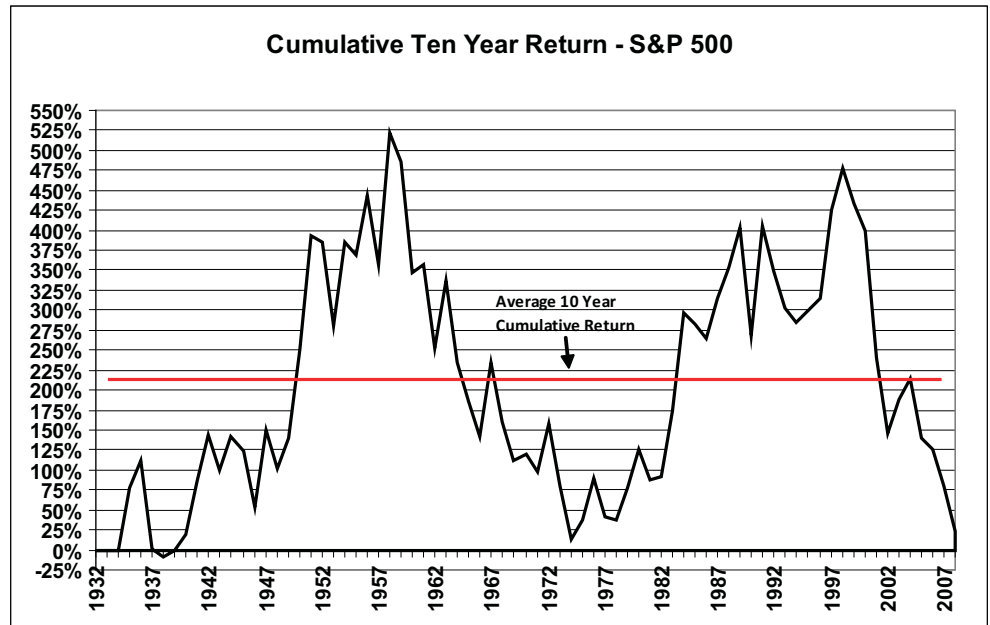
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This time period includes the Great Depression, a World War, the oil shocks and stagflation of the early 1970s, high inflation of the late 1970s and the high interest rates used to stifle inflation, and many other events and economic conditions.

The Coming Decade...The Sun Will Shine Again

Here is the good news...the market has a strong, perhaps inescapable tendency to rebound, regardless of the prevailing difficulties of the time.



The chart also shows how strong the market has been for extended periods of time after a lengthy down period. The ten year cumulative returns of the S&P 500 peaked at 525% in 1958 and 478% in 1998, with multiple peaks in the 300% to 400% range. The average ten year cumulative return of the market over the seventy-five ten year periods in the study was 212%. With a ten year cumulative return of the market now hovering barely above 10%, the market is well behind its historical average. We have every reason to believe that the market will stabilize, structural issues will be addressed, regulatory and governance bodies will do their jobs, and the significant asset bases of these companies will command the proper stewardship to generate adequate, normal returns.

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Valuation Case Study

Legg Mason is one of our portfolio companies. It is a pure money manager with close to \$1 trillion of assets under management in many asset classes and styles. One of their fixed income subsidiaries held mortgage backed securities that had to be written down. Legg Mason management did the right thing by making a payment to that portfolio to sustain the stable net asset value (NAV)

required by the product. This very day, an analyst somewhere out there in the world downgraded Legg Mason, because they were going to take an additional smaller charge this quarter to clean up the mess. Earnings for this quarter will be adversely impacted, true enough. For the record, Legg Mason is trading near \$40 per share, down from a peak of more than \$135 per share in 2006.

Investing is a Path to Success...Speculating is a Crapshoot

Here is the perspective of an investor, not a short term speculator. Legg Mason, absent these one time charges has normalized earnings power today of about \$5 per share. Looking out four years or so, Legg Mason is very likely to earn \$8 per share, as a result of market growth and asset gathering growth. Right now Legg Mason is trading at just above \$40, down recently almost 8% due to the aforementioned analysts negative report. At \$40, Legg Mason is trading at 8 times normalized earning power and 5 times the \$8 per share estimate of several years out. Most of the publicly traded pure asset managers trade in the 20 times earnings range...names like T. Rowe Price, Eaton Vance, or Affiliated Managers Group. To sell Legg Mason today is to sell it at the already very depressed multiple of 5 times 2013 earnings, and with very little downside risk.

On the other hand, to buy it or hold it today is to make a high probability, high potential return investment that has these possibilities: If Legg Mason can earn \$8 per share in 2013, and be awarded only 80% of the P/E multiple of its peers, it will trade at $\$8 \times 16 = \128 per share—a gain from today of 220% plus a 2% annual dividend yield for a total of about 230%. If it can earn the market multiple of its peers it could trade at $\$8 \times 20$ or \$160 per share for a 300% gain. This basic scenario lays out the potential of the long-term investment while exposing the short-term mentality that pervades much of Wall Street and its overpaid denizens. Wall Street cares little beyond this quarter or the next earnings report. Serious investors look farther down the river of time.

The bottom line is that the markets are mean reverting--that is they move back towards their long term averages. Returns that move too far from a historical norm generally move back toward the norm--as true for market averages as it is for batting averages. And as we can see from the experience of this decade, prices that went too far too fast in the 1990s led to a sustained period of underperformance. We think this protracted sell-off with unsustainably low valuations is setting the stage for a more normal return environment in the coming years.

Periodic Adversity

Since World War II, the S&P 500 has had twelve bear markets with a mean decline of 25%. That equates to approximately one out of every five years. We are now approaching a decline in the S&P 500 of close to 20%, the arbitrary indicator of a bear market. Coming on the heels of a sub-standard stretch

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of returns, it feels worse. And with the housing dislocation in the mix, it has driven many investors into despair, irrationality or both. But if history is any guide, and it certainly is, these bear market conditions will prevail 20% of the time. For more on handling adversity, please see our *“Handbook for Private Clients”* on the homepage of our website at www.wccadvisors.com.

Oil and Stocks

The broken record headline for the second quarter and much of 2008 has been...”stocks slump as oil hits record high.” Every day now, from multiple media outlets, the new high price of oil is trumpeted to the world. Feeding into the timeless and recurring irrationality of investors, every new high price encourages some of them to move money into the investment that is working right now. That money has to come from somewhere, and it increasingly appears to be coming from the stock market, which admittedly, is not working right now. It appears that stocks are being sold with irrational abandon..... stocks that with a little time, will almost certainly trade significantly higher. But they are not working right now. Yet this is typical investor behavior, chasing the hot fund, stock or asset class. This is almost always a counterproductive behavior.

There are numerous empirical studies to demonstrate the poor returns of investors who, on the constant lookout for the hot idea, move money into recently hot performing funds, stocks or asset classes, only to have missed most of the action, and suffer the pain when an overextended investment falls back to earth. It will ever be thus. More difficult to endure, and often appearing stubborn or foolish, is to stick to a proven strategy and discipline, even though it is performing poorly right now.

Bear Markets

Bear markets are an unavoidable aspect of prudent investing. Economic cycles are such that contractions in the economy are a recurring phenomenon. Whatever troubles exist in the economy and markets today, the capital markets and financial system has enormous resiliency, and with some competent management and oversight from regulators and officials, will recover. We don't like bear markets either. Yet we know that these episodes are inevitable. So we tough it out, right alongside you.

Value as Outcast

Recent market action has defied logic. Normally, large companies are a safe haven and those companies with low valuations are also considered defensive. For the large cap, low valuation sector to endure the quarter and half year it just has, is bizarre. In this unsettled market, low valuations and high dividend

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yields have come to be seen as distress signals. Historically, they have been just the opposite--opportunity signals--and they will be again.

The Data

Please examine the tables below. It details the absolute performance wreckage across the value styles of the equity markets for the second quarter of 2008. All figures are in percent.

2Q-2008									
Market Cap	Index	Pure Value	Value	Core Blend	Growth	Pure Growth	High	Low	Range
Large Cap	S&P 500	-13.25	-7.79	-2.73	2.05	1.23	2.05	-13.25	15.30
Mid Cap	S&P 400	-7.55	2.30	5.43	8.71	7.88	8.71	-7.55	16.26
Small Cap	S&P 600	-13.24	-2.45	0.40	3.47	-1.22	3.47	-13.24	16.71
Total Market	S&P 1500	-11.81	-6.77	-1.97	2.60	2.17	2.60	-11.81	14.41
Average		-11.46	-3.68	0.28	4.21	2.52	4.21	-11.46	15.67

For the year to date, the absolute performance figures are negative across the board, and again, the value and large cap subset of the investing universe got absolutely pummeled, on both an absolute and relative basis.

YTD-2008									
Market Cap	Index	Pure Value	Value	Core Blend	Growth	Pure Growth	High	Low	Range
Large Cap	S&P 500	-23.40	-16.07	-11.91	-8.07	-7.70	-7.70	-23.40	15.70
Mid Cap	S&P 400	-14.32	-6.53	-3.90	-1.12	-2.18	-1.12	-14.32	13.20
Small Cap	S&P 600	-15.38	-8.75	-7.09	-5.33	-10.56	-5.33	-15.38	10.05
Total Market	S&P 1500	-17.39	-14.99	-11.12	-7.45	-7.24	-7.24	-17.39	10.15
Average		-17.62	-11.59	-8.51	-5.49	-6.92	-5.49	-17.62	12.13

For the record, superior equity performance is strongly linked to value style exposures. That is, over time, equity portfolios that are overexposed to low valuation factors such as: low Price to Earnings, low Price to Book Value, or high Dividend Yield, have historically outperformed the broad market and portfolios tilted towards high growth companies. For the biggest and least expensive companies in the market to endure this drubbing is unthinkable. It is also a pure example of how perverse and extreme collective market behaviors can become, in the short term.

Our equity strategies all seek to put the long term advantage of valuation disciplines in your favor. While as core equity managers, we also seek growth factors in our disciplines, we have a strong bias towards the performance advantage and safety of low valuations. While this quarter and year to date have not been kind to these valuation factors, we firmly believe that they will prevail again, and perhaps very soon.

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Founded in 1994, West Chester Capital is a registered investment advisor managing \$150 million of client assets. Located in West Chester, Pennsylvania, West Chester Capital is a wholly owned subsidiary of AmeriServ Financial, a publicly held bank and trust company, headquartered in Johnstown, Pennsylvania. AmeriServ is a \$1 billion bank with a trust company administering \$1.8 billion in client assets.

West Chester Capital manages fiduciary quality portfolios and investment programs for individuals and institutions within a framework of openness, integrity, objectivity and rigorous client advocacy.

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Steady as She Goes

With these insights and market precedent as a guide, we will not waver from our discipline and conviction that a strong exposure to valuation factors is the single best path to superior absolute and relative equity performance. As detailed in the P/E Contraction table, the sell-off in large cap companies since 1999 has been dramatic. The compression of relative valuation is almost certainly overdone. As the market always does, it overshoots on both up markets and down markets. To abandon our discipline now would be imprudent.

Asset Allocation

As the tables above detail, there was a wide disparity in the performance of equity sub-sectors through the first half of the year. This performance disparity creates tactical re-balancing opportunities. The value to a client of an asset allocation and policy portfolio is fully realized during times of market volatility. As asset class and equity style performance deviates sharply during periods of market volatility, it presents the opportunity to shift portfolio exposure towards assets classes and equity styles that have underperformed on a relative or absolute basis. Doing so systematically removes the emotion and angst of increasing investment in poorly performing sectors. It is human nature to resist this, yet this is one of the most effective tools to earn adequate returns. The formal Investment Policy, Asset Allocation and Policy Portfolio are the foundations of prudent investing. Their primary function may be overriding these counterproductive human biases and behaviors.

Summary

Market conditions wax and wane. Volatility ebbs and flows. The range of individuals and entities participating in the capital markets is large, with a wide array of goals objectives, tolerances, agendas, knowledge and access to information. Recent volatility should confirm that the markets are not perfectly efficient. Storms always abate. This storm will be no different. Enduring declining markets is not pleasant. But it is inevitable in a serious investment program. After enduring this period of sub-standard market returns, there will come a period of normal or perhaps superior returns.

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