WealthHealth
Personal Wealth Management

October 2008 Investment Review & Outlook

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Things have been changing so rapidly it is hard to write a market commentary without it being quickly outdated. So we will preface this by pointing out that there are two views expressed that may seem at odds, and both are connected by market valuations. The first is our view of the credit crisis and its impact on the overall economy. This is a predominantly negative view. The other is our view about the return outlook going forward, which has become increasingly positive, because the worse the markets get, the better the return outlook gets. It is important to balance these as you assess this environment.

The credit freeze that chilled the financial markets in early and mid-September this year was more alarming than anything we've experienced in our investment careers. The credit (lending) markets have been dysfunctional for months, but the risks to the broader economy significantly increased in September as credit markets came close to a standstill. The inability for businesses to access the short-term capital they've relied on for decades to fund their normal business operations threatens to severely damage the economy.

Index Returns

Through 09/30/2008

			Annualized Returns		
Index	**Quarter-To-Date**	**Year-To-Date**	**1-Year**	**2-Year**	**3-Year**
S&P 500	-8.37%	-19.29%	-21.98%	-4.68%	0.21%
Russell 1000	-9.35%	-19.50%	-22.10%	-4.57%	0.13%
Russell 2000	-1.11%	-10.38%	-14.48%	-1.98%	1.83%
MSCI EAFE	-20.56%	-29.26%	-30.50%	-6.84%	1.12%
Lehman Brothers Aggregate	-0.48%	0.64%	3.66%	4.39%	4.15%
Lehman Brothers Municipals	-3.21%	-3.19%	-1.86%	0.59%	1.86%
Dow Jones AIG Commodity	-27.70%	-8.01%	-3.66%	6.15%	1.90%
CSFB/Tremont Hedge Fund	-10.33%	-9.87%	-7.71%	3.60%	5.49%

The problems resulting from years of growth in the amount of debt relative to the size of the overall economy has now infected the global financial system. Financial institutions, hedge funds, and households are being forced to reduce debt (deleverage) at the same time, which is not only resulting in forced sales of investment assets, but is also reducing the amount of capital to the credit markets. Governments worldwide have taken numerous actions to help bring confidence back to the credit markets—which lie at the heart of the problem. But the problems won't be fixed quickly and confidence will likely come back only gradually.

But though the underlying economic problems are severe, our return expectations have become more positive. Remember, equity returns are not simply a function of the economy and its impact on corporate earnings; they are a function of the prices at which we can buy those securities. The steep declines in stocks have been very painful, but recent declines have taken us to levels where it is clear that fear and pessimism are taking over. Fear and pessimism are the drivers of good longer-term opportunities.

September saw an unprecedented reshaping of our financial industry amidst major turmoil in the credit markets.

The credit problems will contribute to further economic weakness. Additionally, despite the government's rescue package, significant risks remain.

Longer term, the size of the rescue package will have implications for interest rates, the dollar, and the regulatory environment. We are assessing these and will likely make portfolio adjustments in coming months that factor in this new environment.

Our longer-term return expectations for equities have improved a great deal with the recent sharp market declines. We also think significant opportunities are being created in other areas, and from current levels we are confident in our ability to identify them and earn good returns in coming years.

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Regardless of what one may believe about the greed and poor judgment that got us to this point, there is no question that the world needs a financial system that facilitates the workings of the economy. Businesses and banks rely on their ability to borrow so they can invest and grow and create new jobs, so they can bridge seasonal fluctuations in their revenues, and so they can support their day-to-day operations, including making payroll. And Main Street relies on its ability to borrow as well. Demand for a home, a car, or other long-term assets is dependent on borrowing ability. Without that, consumer demand and thus the global economy would be much smaller. A sudden and significant reduction in the availability of credit is happening, and if it continues it could result in significantly reduced demand for goods and services and a simultaneous loss of confidence on the part of businesses that would lead to waves of layoffs and less capital investment. This could create a significant shrinkage in the economy, which would have major negative fallout to businesses and individuals. Moreover, there is a risk that it could develop into a self-reinforcing cycle that would be hard to break.

What is needed to help return the markets to normal?

The capital infusion into the banking system is necessary so that financial institutions can take their losses and recapitalize. Actions have been designed both to address the underlying fundamental problem and to help bring confidence back to the market. There have been some signs of improvement, but as said, it will likely be a gradual process. Risk still remains, but that risk has been significantly reduced. It is the credit market not the stock market that is the economic linchpin.

Credit default swaps (CDS) remain a wild card that will not be easily addressed in the short-term. This is an unregulated market where financial institutions and hedge funds sell insurance against credit defaults. The market is huge—estimated at roughly $60 trillion—and because it is unregulated it is hard for anyone to really understand the risks. The government bailouts of Bear Stearns and AIG occurred because they were a major CDS counterparty and their failure would have negatively impacted many financial institutions—potentially putting the entire financial system at risk. The CDS market is headed for regulation but how we get from here to there remains unknown. Our understanding is that the CDS market is shrinking as contracts are unwound. That is good, but it is still a large market that is already contributing to market volatility and risk aversion and it represents an unknown financial system risk.

The debt tailwind of previous years will become a headwind to economic growth as the consumer sector shrinks. This outlook is consistent with the experience of other credit busts in Japan, Sweden, and several other countries. Economic growth in those cases was subpar for eight to nine years. The U.S. is different but there are also many similarities.

There is also uncertainty about inflation. In the short run we are not concerned about a big inflation spike. The bigger inflation concern comes into play as we look out into the next cycle. The government stimulus that will be necessary to manage through the downturn does risk some inflationary pressure a few years out.

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Why are bonds performing so poorly?

There has been extreme flight to quality with huge demand for U.S. Treasury securities—especially Treasury bills. This demand has been so great that investors were willing to accept near 0% returns on short-term Treasury bills. This demand is at the expense of virtually anything else.

Some portions of the credit markets, such as tax-exempt bonds, have been hurt by the lack of buyers. This has meant higher borrowing costs for tax-exempt bond issuers. There may also be some worry about reduced tax and other revenues in an economic downturn harming the credits and triggering increased defaults. We believe that default losses could be higher than in a typical recession but that the market has more than priced that risk. However, with such poor liquidity it is hard to know how tax-exempt bonds will perform over the short term. Longer term we believe they are now priced somewhat attractively with yields over 5%.

The corporate bond market is also extremely stressed with liquidity drying up in favor of Treasuries. Investment-grade corporate bonds had their worst month ever in September and their worst quarter ever. With the possibility of a worse-than-normal recession, defaults could be higher than in a normal down cycle. So some shift down in pricing makes sense. However, again, the flight to Treasuries has sucked demand out of the corporate bond market and this has led to an imbalance of buyers and sellers, which has driven prices sharply lower (for example an ETF that tracks an intermediate, investment-grade corporate bond index was down 6.8%). We believe this will pass and that corporate bonds will perform well if we look out past this crisis period. The lowest-quality portion of the investment-grade bond universe is yielding close to 8%. Longer-term return potential looks reasonably attractive and could result in capturing the yield or perhaps better, but some short-term risk remains.

Strategy and Conclusion

We are in the midst of an extremely trying period, but while near-term risk remains high we are finally becoming more enthusiastic about potential future returns. The painful sell off in equities in recent weeks initially reflected investors' revised expectations about the level of economic weakness we will experience. But more recently the sell off has shown signs of increasing fear and pessimism mixed with indiscriminate selling of stocks and bonds as part of the deleveraging process. These two factors lead us to believe that significant longer-term opportunities have been created for disciplined, valuation-driven investors.

We already see several asset classes at levels where we believe we can earn good long-term returns going forward, even under conservative assumptions (e.g., corporate and municipal bonds discussed above). We are also encouraged that our managers are enthusiastic at the stock-picking level—one value manager with more than 30 years of experience reports that their portfolio is at its biggest-ever discount to their appraisal of business values. These asset class and stock-picking opportunities are a reminder that the returns we can capture for your portfolio in coming years are not limited to just the baseline of what the stock and bond markets give us.

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