

# Perspectives

on investing and other observations

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➤ TABLE I - TOTAL RETURN RESULTS FOR VARIOUS PERIODS

	4 <sup>th</sup> Qtr	3 <sup>rd</sup> Qtr	2 <sup>nd</sup> Qtr	1 <sup>st</sup> Qtr	1-Year	Annualized		
						10 Years to	20 Years Ending	
	2008	2008	2008	2008	2008	12/31/08	12/31/08	12/31/07
<b>Domestic Equity</b>								
Lipper Diversified Equity Funds Average	-23.10%	-9.91%	0.14%	-10.56%	-37.34%	0.57%	7.79%	11.23%
Dow Jones Industrials Daily Reinvested	-18.39	-3.71	-6.85	-7.00	-31.93	1.66	9.88	12.85
Lipper S&P 500 Funds Index	-21.95	-8.40	-2.75	-9.51	-37.08	-1.64	N.A.	N.A.
Lipper Large-Cap Core Funds Index	-22.16	-9.38	-1.44	-9.49	-37.07	-1.90	7.38	10.62
Russell <sup>®</sup> 1000 Growth Index	-22.79	-12.33	1.25	-10.18	-38.44	-4.27	7.43	10.66
Russell <sup>®</sup> 1000 Value Index	-22.18	-6.11	-5.31	-8.72	-36.85	1.36	9.07	12.77
Lipper Mid-Cap Core Funds Index	-25.87	-10.86	2.66	-9.38	-38.53	3.20	9.22	N.A.
Lipper Small-Cap Core Funds Index	-25.49	-7.01	2.37	-9.19	-35.59	4.06	N.A.	N.A.
Russell <sup>®</sup> 2000 Growth Index	-27.45	-6.99	4.47	-12.83	-38.54	-0.76	5.21	8.81
Russell <sup>®</sup> 2000 Value Index	-24.89	4.96	-3.55	-6.53	-28.92	6.11	9.96	13.30
<b>International Equity</b>								
MSCI EAFE + Canada IX ND	-21.15	-20.67	-1.17	-8.69	-43.56	1.18	3.36	7.67
Lipper International Funds Index	-21.12	-19.56	-1.90	-9.42	-43.62	2.14	5.68	9.55
<b>Fixed Income</b>								
Lipper Inter-Investment Grade Funds Index	-0.30	-3.47	-1.09	0.11	-4.71	4.24	6.25	N.A.
Lipper Sh-Investment Grade Funds Index	-2.07	-2.48	-0.27	0.15	-4.61	3.23	5.15	N.A.
Barclay's Intermediate Govt/Credit	4.84	-1.19	0.14	3.00	5.08	5.43	6.96	7.04

SOURCE: LIPPER, INC.

## YEAR IN REVIEW

In January of 2000, we thought investment returns would be more modest in the future than in the prior two decades. The damage in 2008 has been significant, as outlined in Table I above. Today, twenty-year annualized equity returns are about 3 percentage points lower than the 12/31/07 twenty-year returns. Compare the last two columns on the right above. To put this into monetary terms, \$1 million invested in the Lipper Multi-Cap Core (equity) Index 21 years ago grew to almost \$8.4 million at the end of 2007. After the declines of 2008, the value dropped to about \$5.1 million – a 39% loss. Individuals and institutions (pensions, college endowments, and foundations that benefit all types of activities) are now contemplating how significant reductions in portfolio values may affect future plans, budgets, spending and gifting. Fixed income investments, however, maintained their long-term rates of return. A diversified investor that owned a combination of equity, fixed income and money funds suffered far less portfolio damage over the last year, albeit still a meaningful amount. The cost to an investor of historically smaller returns (as is expected) from fixed income investments is acceptable when the consistency of return is considered (also, as expected). In addition, annual rebalancing augments returns. At some point, we may increase equities in portfolios where the allocation is significantly under target; the level to which is determined by the specific client situation.

Until late summer, this appeared to be a “normal bear market” addressing excesses and imbalances. However, as the fog began to clear and the extent of leverage and intermingled obligations became more apparent, the flight to safety and the urgency behind the need to reduce leverage produced the worst stock

market decline in seven decades. All asset classes, with the exception of U.S. Treasury bonds, suffered declines in the quarter that mirror those more often experienced over an entire bear market. The details of the unwinding of the leverage and the carnage this has begotten in the consumer and business sectors has been widely publicized; so we won't dwell on it here. However, conversations we've had with businesses, whether industrial, consumer, financial, domestic or foreign, resulted in an analogy to a light switch being turned off in September when the credit markets froze; confidence in basic institutions evaporated; business activity slowed to a crawl or ceased. The Dow Jones Wilshire 5000 Index lost \$10.4 trillion in market value from its peak in October 2007 to its low in November 2008 and was down \$8.4 trillion from the peak to the end of 2008. The average stock on the New York Stock Exchange declined 45%.

In October we contemplated the possibility of a year-end rally. We got the rally but from lower levels than we had anticipated. The rally from the November 20<sup>th</sup> lows to the end of the year approximates 20% for large-cap stocks, funds and indexes. We also indicated that small-caps might lead a recovery and they did, rising close to 30% in the last 27 trading days of the year.

Although few anticipated or were prepared for the events of 2008, many were not unprecedented. My first experience with financial duress was the bankruptcy of Penn Central, which briefly paralyzed the commercial paper market in 1970 and prompted then Federal Reserve Chairman Arthur Burns to use the Federal Reserve's balance sheet and open market operations to unfreeze credit markets. Easy credit, speculation, and panic led to the Dutch Tulip Bubble of 1636, the South Sea Bubble of 1720, the crashes of 1907, 1929 and 1987, etc. What is unprecedented about today's situation is a Fed funds rate near zero, though Japan has experienced this, and the magnitude of government intervention.

#### **INVESTORS LOATHE UNCERTAINTY**

Many tenets of the last thirty years are in question. Financial institutions and government sponsored enterprises thought to be basic parts of economic activity no longer exist or are fundamentally changed. Long standing rules, such as those surrounding short sales were suspended. Accounting practices have been questioned; however, the SEC did publish a lengthy report at year-end that reaffirmed fair value accounting, while acknowledging that some minor modifications may be needed. After several years of calm, volatility in the stock market reached levels not seen since 1987. In search of safety, money market fund assets ballooned to the point where they exceed those of equity assets, and investors flocked to FDIC insured certificates of deposit in spite of low interest rates and no liquidity. Briefly, Treasury bill yields were zero. Not until the Fed announcement on December 16<sup>th</sup> at its FMO meeting that "the focus of the committee's policy going forward will be to support the functioning of the financial markets and to stimulate the economy through open market operations and other measures ..." did credit markets begin to thaw. While the transition to a new Administration adds to the uncertainty, the Obama Administration has been leaking and announcing its fiscal policies, which include tax cuts and spending estimated at \$800 billion; what will be enacted by Congress is unknown.

#### **DEFLATION THEN INFLATION**

Deflation is most deleterious for debtors. The current environment has a whiff of deflation in the economy and lots of deflation in asset values. Inflation benefits debtors because debts are repaid with currency that buys less than when the debt was incurred. The huge expansion in money as the Federal Reserve uses its ability to create money - the Fed's balance sheet has grown from \$900 billion in late summer to over \$2.2 trillion - will likely produce inflation in the future. Foreign equity markets have declined as much or more than the U.S. equity market and their credit markets have also seized up. Fortunately, as a result, foreigners remain willing to hold U.S. government obligations. This helped the U.S. dollar recover a little in the fourth quarter and is evidence that the U.S. dollar is still regarded as the currency of safety.

The current environment is not productive for savers. Low interest rates do not entice saving nor reward those who save. In addition, in order to have access to capital; businesses will have to pay a higher price, if not in nominal terms, the price will be higher because less leverage will be tolerated. Consumers will also find borrowing more costly, not because mortgage rates are higher but because down payments will be. Any kind of borrowing will require more collateral. This is likely to be the case for the U.S. government as well in order to retain foreign investors.

<b>POSSIBILITIES AND PROBABILITIES</b>
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Historically, recessions and financial panics have been fought using monetary policy (lower interest rates and rapid monetary expansion) and fiscal policy (tax cuts and spending programs). With the interest rates the Fed controls near zero, the method the Fed is employing to lower longer-term interest rates is to purchase securities, such as mortgage securities, in the open market and to lend directly to institutions that heretofore did not have access to the Fed's balance sheet. However, the velocity of money (how often a dollar rolls through the system, which is partly affected by lending) has dropped, making monetary policy less effective. Rather than tax increases, the Obama Administration is proposing tax cuts for the middle class and tax rebates for those who pay no taxes. Businesses may also get checks if the rumored proposal to extend tax loss carry-backs is enacted. On the other hand, we believe that the Bush tax cuts that have sunset provisions are likely to expire as scheduled. An exception may be some compromise on estate taxes.

What if the process of de-leveraging results in continued low velocity of money and slow consumer spending? Higher savings (also the result of paying down debt) would be good but the adjustment process could be drawn out and delay any recovery. Government spending programs (energy efficiency, roads and bridges, upgraded schools and libraries) take a long time to have an effect, stretching out any recovery. Slow economic growth means lower tax receipts, adding to the deficit.

What if foreigners decided to spend their money at home rather than continue to finance our deficits? The chairman of China's sovereign wealth fund said that China had no plans for further investments in Western financial institutions, according to an article in the *New York Times* on December 3<sup>rd</sup>. Interest rates would increase and the dollar could fall. A falling dollar would make U.S. goods more attractive (a plus for U.S. global companies and exports), but would also make imported goods more expensive (a minus for consumers) and add to inflation. Savers could get higher returns. Debtors (the U.S. government included) would be able to repay debts with depreciated currency. However, capital could become more expensive, which we expect anyway.

The range of prognostications for earnings and stock index values is wide. Table II summarizes recent public forecasts from major Wall Street firms that were published at year-end in *Barron's and other sources*.

<b>Table II</b>		<u>Target S&amp;P 500 Index at year-end</u>	
<u>Est. S&amp;P 2009 EPS</u>	<u>Est. Median EPS</u>	<u>Range</u>	<u>Median</u>
\$40-\$92	\$60	600-1380	1020

Based on this data, from year-end 2008 the possible return for the S&P 500 is a loss of -33% to a gain of 53%. The median expectation is a gain of 13%, which would be a modest rebound based upon history. Since the end of WW II, the median gain after a quarter like the fourth quarter of 2008 has been 24.4% according to Ned Davis Research, Inc. For the decade to produce a 5% cumulative return, about on par with the 1970s and better than that of the 1930s, the S&P 500 would need to increase 71% this year. This is a reasonable range of possibilities. We believe the credit markets need to thaw for the recent stock market improvement to persist.

The probabilities are difficult to define. Therefore, we spend our time and efforts considering how to balance the risks and rewards of these possibilities.

We recognize the stock market may remain in a trading range for an extended period of time; however, that range is banded by the November lows and the October 2007 highs and allows meaningful moves in share prices, both up and down.

Some of the funds/managers with solid long-term performance records and extensive research discipline suffered above average losses in 2008. Recently Mike Lipper discussed the “winner’s curse” on his blog ([www.mikelipper.blogspot.com](http://www.mikelipper.blogspot.com)) noting that “...rarely do winners repeat three years in a row and even twice is difficult.” However, often after a bad year, long-term winners recover smartly. We have increased the focus of our discussions with equity funds/managers on their definition of portfolio companies’ value. Rather than price/earnings ratios and earnings growth, we are asking about valuation measures such as price to tangible book and cash flow since both of these measures avoid the pitfalls of accounting conventions. With bond managers we are discussing the credit research process as well as the trading and risk management procedures. Currently many investment grade corporate bonds are offering yields to maturity that resemble the long term return of equities and may present attractive opportunities.

We also believe that some of the huge hoard of cash will seep back into corporate bonds/funds, equities and equity funds. The amount of cash in money market funds is the largest percentage of total mutual fund assets since 1991. If investors are to rebuild their retirement nest eggs and personal balance sheets, if pension funds are to close funding gaps and foundations are to rebuild portfolios, they will invest in equities to generate returns that will help them do that. Fear is rampant now, but with time, greed will return.

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