Planning & Investment News
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2009

A TRAIN WRECK

Following are newsletter excerpts from one of the many services we subscribe to which help us with your investing decisions. We can only hope that their statement "For investors 2008 was a once-in-a-lifetime train wreck" is indeed true; that a year like 2008 only occurs at most once in a lifetime. To say that investing was a challenge in 2008, especially the last three months of the year, is a major understatement. As shown in the box below, fourth quarter investment returns were beyond atrocious in almost all investments. We all too well realize the pain associated with the drop in investment values.

We believe we must be cautious as we structure investment portfolios going forward. Maybe a seasonal analogy is a good way to look at a worst case scenario. We are in winter. The hard question is whether we are just entering, are in the middle, or leaving this spartan season. Winter is not only a time for protecting; it is also a time to prepare for spring. To not prepare for the eventual spring creates a bleak future. This thinking brings to mind Ecclesiastes 3 (*For everything there is a season*….)

It is with this mindset that we are structuring portfolios. We may miss some return if indeed spring's return is imminent. But we think the prospect of prolonged winter makes a conservative stance prudent. We are adding bonds to most portfolios to not only reduce risk, but and maybe more important, we like their return potential with respect to risk (as compared to equities). We will get through this. We look forward to working with you in a much better, and hopefully warmer, 2009.

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Excerpts from
Advisor Intelligence
Monthly Commentary - January 2009

For investors 2008 was a once-in-a-lifetime train wreck. The year was arguably the most painful in modern investment history (it was the worst year for the stock market since 1931)….

Clearly we are in the midst of a severe recession. Beyond that we also now believe it is not just possible, but likely, that we will experience several years of economic growth that is below the historical trend as consumers adjust to a new reality in which they finally have to pay down debt and increase savings (and thus spend less than in the past). We and others have been wondering since the late 1980s when the growth in household debt would have to slow or reverse. It has taken another 20 years since, but it is now clear that the time has come.

If the environment plays out as we believe it could, it may take a number of years after the recession ends for corporate earnings growth to return to its long-term trend, and the recession itself could last through 2009 or even into 2010. This has implications for stock market returns and investment decisions.

December Benchmark Returns (Preliminary)

	Dec	4Q	2008
Large-Cap Benchmarks			
Vanguard 500 Index	1.1%	-21.9%	-37.0%
Russell 1000 iShares	1.6%	-22.4%	-37.6%
Russell 1000 Growth iShares	1.8%	-22.8%	-38.5%
Russell 1000 Value iShares	1.4%	-22.1%	-36.8%
Mid-Cap Benchmarks			
Russell Midcap iShares	4.3%	-27.2%	-41.4%
Russell Midcap Growth iShares	3.7%	-27.4%	-44.4%
Russell Midcap Value iShares	4.9%	-27.1%	-38.4%
Small-Cap Benchmarks			
Russell 2000 iShares	5.9%	-26.0%	-33.7%
Russell 2000 Growth iShares	5.5%	-27.3%	-38.4%
Russell 2000 Value iShares	6.3%	-24.7%	-28.7%
Other Equity Benchmarks			
Vanguard Total Int'l Stock Index	8.2%	-21.0%	-44.1%
Vanguard Emerging Mkt Stock Index	8.3%	-27.8%	-52.8%
Vanguard REIT Index	17.4%	-38.2%	-37.0%
Bond and Money Market Benchmarks			
Vanguard Prime Money Mkt	0.2%	0.6%	2.8%
Barclays 7-10 Year Treasury iShares	5.1%	12.2%	18.0%
Vanguard Total Bond Mkt Index	3.3%	4.4%	5.1%
Barclays Credit Bond iShares	6.9%	4.9%	-2.1%
Merrill Lynch High-Yield Bonds	7.6%	-17.5%	-26.2%
Citigroup World Govt. Bond Index	7.1%	8.8%	10.9%
JPMorgan ELMI +	3.3%	-6.8%	-3.8%
Other Benchmarks			
DJ-AIGCI (Commodity Futures)	-4.5%	-30.0%	-35.6%
Gold Bullion (GC, COMEX)	8.3%	1.1%	5.8%

Historical comparisons are sometimes helpful. There have been two extreme economic and investment environments in the last 80 years—the 1930s, and the 1970s/early 1980s. By the late 1930s the economy was still in a weakened state with unemployment well above 10%. Moreover, Hitler's Germany was ominously flexing its muscles, annexing Austria in March of 1938. In the early 1980s inflation was sky high, interest rates were in the teens, and we suffered from back–to-back recessions with unemployment exceeding 10%. In both periods investor confidence was crushed after lengthy periods during which returns were dismal and because of a continuation of negative headlines. But as it turned out, both periods presented a great opportunity for long-term investors to buy stocks. This may be a similar time. These experiences reflect the tension that investors face—when risk seems greatest it is usually a good time to invest and when risk is an afterthought investors are likely to be disappointed with their returns going forward.

We argue that we are in the midst of a secular or long-term bear market that started in 2000. That year the S&P 500 peaked on March 24 at 1527. After declining for several months it rebounded to almost the same level on September 1. After a devastating bear market in which the market declined by nearly 50% over almost three years, stocks ultimately clawed back to the year-2000 high and briefly and slightly exceeded it seven years later on October 9, 2007. But that high did not last, and in November of 2008 it broke through the low of the last bear market, falling to 752, a level first reached in 1997. Whether or not we have seen the bottom in this bear market is uncertain, but there is no arguing that the magnitude of the decline is among the worst of the last century. It is also arguable, based on a historical framework that stocks (and similarly pummeled asset classes) must now be discounting a great deal of economic damage to come. Are stocks

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cheap? Many metrics suggest that stocks should at least provide satisfactory returns going forward….

There is a mountain of cash sitting on the sidelines. In fact, since the advent of money market funds almost 30 years ago, money market assets relative to total stock market capitalization has never been higher. Some of that cash is likely to find its way into stocks and bonds at some point as investors become more willing (or realize the need) to take on more risk in order to earn higher returns than what they can get from holding cash. So this is another factor that can be viewed as a bullish indicator.

All of this evidence as it relates to the long-term potential in stocks is encouraging, but the near term is much less clear.

- Secular bear markets usually end at extreme levels of undervaluation. Most valuation measures suggest stocks are attractively priced now, but only one that we follow (price to free cash flow) puts stocks at the screaming buy levels seen in the 1930s or 1970s and early 1980s. The counter argument is that the 1930s economic collapse was much more severe than the current one is likely to be and that in the 1970s and early 1980s inflation and interest rates were much higher than they are now.
- Economic risk remains high. Policy makers have made it clear that they will do whatever it takes to support the economy, yet credit markets, though slightly improving, remain dysfunctional and the housing market remains highly stressed. And while a financial system collapse has been avoided, a newly realistic consumer, attempting to reduce debt and increase savings, could mean an economic retrenchment that lasts longer than the consensus expects. This could lead to an extended period of deflation, something that we are already getting a whiff of. In the near term, a significant deflation scare is not fully priced into the stock market.

Overall the evidence does not clearly suggest that stocks are at highly compelling valuation levels. It also doesn't make an iron-clad case that the stock market bottomed in late November after the S&P 500 hit its lowest level since 1997. While it is quite possible, maybe even probable, that we have seen the bottom, we can't be sure. Forced selling by hedge funds and others may not be quite done and more individual investors could simply give up if the market heads back down towards its prior low. Taking into account technical factors together with interest rate considerations and valuations at past secular bear market lows, a bottom somewhere in the 600s on the S&P is not out of the question (if that happened we believe a rebound off that bottom would probably be quick and significant). *Despite the near-term caution, the weight of the evidence overwhelmingly suggests, in our opinion, which investors are very unlikely to get hurt owning equities over the next five to 10 years and are likely to reap at least satisfactory returns.* That is a start and a justification for owning stocks with capital that is not needed in the near term.

We are prepared for volatile markets (though we think they will be less volatile than this past fall) and the possibility that many equity-type asset classes will experience wide performance swings with occasional strong rallies and subsequent sell-offs. Rallies could last for months with sizable returns, followed by sharp pullbacks. We have already seen a stock market rally of 18%, followed by a 25% decline, and a 21% rebound within the last few months. Sizable ups and downs in equity markets could play out over a period of a few years even as some equity markets stay within an overall trading range or move only marginally higher before beginning a new bull market. We don't know if this is what the next few years will look like, but we believe this to be a possible scenario because this is how other secular bear markets have petered out over time. Those possible opportunities, along with potentially solid returns from our fixed-income investments, could translate into an attractive investment environment as we wait for a new bull market.