

# Q1 2009 Quarterly Investment Commentary



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Ah, Spring! With the weather improving, (and for baseball fans a new season starting!), spring means more outdoor activities, new green shoots (is that the plant speak or economy speak?), and hopefully a well-deserved end to the difficulties we have been facing in the markets and economic activity.

## First Quarter Market Performance

Stocks saw a significant one-month gain in March, but while it was a welcome respite from the battering in January and February, the first quarter still ended with a double-digit loss for U.S. equities. The large-cap S&P 500 surged by almost 9% in March, yet finished the first quarter with an -11% loss. For the quarter, value sharply underperformed growth, and smaller-caps generally did worse than larger-caps. The best performing U.S. equity style was large growth (Russell 1000 Growth), which lost “only” -4.2% for the quarter, while at the other extreme was small cap (Russell 2000), down -18.8%. Foreign developed market equities were similar to what we saw at home, with the EAFE International Index losing -13.9% for the quarter. In contrast, emerging markets equities had such a strong March that the emerging market stock index finished the quarter slightly in the black at +1.0%. Turning to bonds, the Barclays Capital Aggregate Bond Index was up 1.4% for March, bringing year-to-date results just positive at +0.1%. High-yield bonds had the best showing of any of the broad asset classes we track, with a gain of 5.3% for the opening quarter. On the other hand, REITs were beaten sharply lower as investors reacted negatively to deteriorating real estate fundamentals and debt rollover concerns, finishing the quarter down -32.1%.

March Benchmark Returns (Preliminary)			
Large-Cap Benchmarks	Mar	1Q	2009
Vanguard 500 Index	8.8%	-11.0%	-11.0%
Russell 1000 iShares	8.7%	-10.4%	-10.4%
Russell 1000 Growth iShares	8.9%	-4.2%	-4.2%
Russell 1000 Value iShares	8.5%	-16.7%	-16.7%
Mid-Cap Benchmarks			
Russell Midcap iShares	9.1%	-9.0%	-9.0%
Russell Midcap Growth iShares	9.5%	-3.4%	-3.4%
Russell Midcap Value iShares	8.7%	-14.6%	-14.6%
Small-Cap Benchmarks			
Russell 2000 iShares	8.9%	-14.9%	-14.9%
Russell 2000 Growth iShares	9.0%	-9.7%	-9.7%
Russell 2000 Value iShares	8.8%	-19.6%	-19.6%
Other Benchmarks			
Vanguard Total Int'l Stock Index	9.3%	-13.0%	-13.0%
Vanguard Emerging Mkt Stock Index	16.0%	0.1%	0.1%
Vanguard REIT Index	3.8%	-32.1%	-32.1%
Vanguard Total Bond Mkt Index	1.5%	0.3%	0.3%
Merrill Lynch High-Yield Bonds	3.4%	5.3%	5.3%
Citigroup World Govt. Bond Index	2.5%	-4.8%	-4.8%
JPMorgan ELMI +	3.8%	-3.9%	-3.9%
DJ-AIGCI (Commodity Futures)	3.6%	-6.3%	-6.3%

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## The Economy

While obviously not happy to see another down quarter, we are encouraged by recent early signs of a possible economic recovery and the March through early April market advance. We are not at all convinced that the recovery will be strong or that the markets won't retest March lows, but the completely negative news from January and February has at least been supplanted by some positive data points.

The fundamental problem, as we have discussed in previous commentaries, is that over the past several economic cycles U.S. households and the financial sector took on increasing amounts of debt relative to their income and assets in order to fund both consumption and investment. This trend was self-reinforcing as purchases with borrowed money both drove up asset prices (such as home values) and corporate profits, which supported even more borrowing. As a study by former Fed Chairman Greenspan pointed out, home mortgage equity withdrawals were increasing our economic growth rate by up to .5% per year. Ultimately the upward spiral became unsustainable, and the resulting deleveraging has created an adverse feedback loop of falling asset prices with lower consumer spending and corporate profits.

Importantly, this is not just a U.S. economic problem, but a global economic slowdown. It is estimated that there has been roughly \$50 trillion of global wealth destruction over the last 18 months; U.S. households' net worth fell by \$11 trillion, or nearly 18%, in 2008. Both the U.S. depression and Japan's "lost decade" were triggered by deleveraging within their financial systems. Faced with such a situation, governments have needed to step in to mitigate the extent of the damage from deleveraging within the private sector. The monetary and credit policy actions undertaken by the Federal Reserve and the Treasury to support the financial and credit markets, along with the \$800 billion fiscal stimulus package in 2009, have been implemented in an effort to prevent deflation from taking hold. Recently, economic "green shoots" have begun to poke their heads out of the economic muck. The most important of those are positive earnings surprises, especially for financial companies such as Wells Fargo and Goldman Sachs which had previously been expected to suffer severe losses in the first quarter. A steep yield curve is great for bankers because they pay little to depositors and lend out at higher rates. Short-term rates have never been lower, so banks are seeing good profit opportunities, and with "mark to market" rules relaxing, troubled loans on their balance sheets don't have to be valued as if they will be sold in the midst of this bear market. Housing news also recently surprised, as builders' confidence surged to the highest reading in six months and new home sales showed an increase. Housing inventory has leveled off and begun to drop in many parts of the country, though still high by historic standards, all driven by lower median home prices and low mortgage rates. Those rates have also created mortgage refinancing opportunities for millions of homeowners,

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providing additional cash flow for spending or saving. Even manufacturing activity is appearing to stabilize in 5 of the 12 Fed measurement areas.

It is impossible to know when and to what extent the current crop of extraordinary economic policies will be successful in stopping the current deep economic recession. And as uncomfortable as it is to say it, no one really knows. We do know that the current administration and Federal Reserve are very aware of the severity of the economic challenges we are facing. For example, Federal Reserve chairman Ben Bernanke and President Obama's Chief Economic Advisor (not sure if these should be caps or not – seems like it) Christina Romer have previously written papers on the causes of and lessons from the Great Depression. Treasury Secretary Timothy Geithner spent a number of years with the International Monetary Fund (IMF) in Japan while that country was in the midst of its lost decade. All of their expertise is working to do everything they can to turn back the threat of deflation.

### **First Quarter Portfolio Performance**

With the poor equity markets, your portfolio suffered additional losses in the first quarter. Our results exceeded their Blended Benchmark, which contain an allocation to commodity and real estate indexes in a percentage applicable to your portfolio type. This Benchmark can also change over many years to remain in alignment with your portfolio as we add additional asset classes or strategically alter the target percentage of an asset class. Over medium term periods, this Benchmark provides a better assessment of our relevant performance.

Our Blended Index is a simple and stable mix of the U.S. stock market (S&P 500 index), the international stock market (MSCI Europe, Australia, & Far East index, or EAFE) and the fixed income market (Barclays Capital Aggregate Bond index). This Blended Index is a relevant assessment of our long term performance. During a period when commodities and commercial real estate perform so poorly, as they have over the past six months, your portfolio will generally trail this index. While we have justifiable concerns about the existing and forthcoming difficulties in these asset classes, much of the damage has already been done. Oil has dropped from \$147 to \$47 per barrel while REIT prices have declined over 75% in the last two years. While we have been underweighted in these asset classes, still owning small amounts has hurt performance. We are currently maintaining our underweight; we are comfortable with the positions we have and anticipate we will see a boost in returns in the future from them.

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## 2009 Outlook

With the advent of Spring and a rising stock market, we would like to think the difficult markets we've been facing are behind us like a cold, hard winter. Unfortunately, predicting the end of a bear market is not as clear as predicting when a river flood stage will hit a Midwest town, even if a late snowfall augments the challenges. The recent positive signs in the economy have led a number of analysts that are generally optimistic to announce, with near certainty, the start of a new bull market. On the other hand, the pessimistic strategists like Nouriel Roubini believe the market will retest the lows. While the recent spate of good news is promising, we expect there will be more volatility and difficult transitions to still be handled. We continue to be slightly over weighted to Fixed Income and Cash until we are more convinced that a base for recovery is in place. Though the market is in the midst of a 20%+ rally from its March 9 low of 676 on the S&P, we know that rallies of 20% or more within longer-term bear markets are the historical norm, and do not guarantee continued advances.

We think it is very prudent to be cautious and we are applying our analytical and research capabilities toward identifying opportunities to act with discipline and conviction when the risk/reward tradeoff is compelling. Taking advantage of those opportunities also requires patience since getting the timing of tactical moves exactly right is almost impossible. As is always possible, the market could move against us for some period of time after we make a shift. Such occurrences are always trying as it feels terrible to buy more of an asset class that has been performing poorly. Yet buying low and selling high remains a fundamental way to both rebalance and make money over time.

Longer term, we remain positive about the potential for growth of our economy and our markets. We will be contacting you prior to your anniversary date with us to schedule our annual planning review. If you feel you need to come in sooner, please let us know and we'll make that happen. Clients that have recently met with us to update their plan tell us that it has helped them to stay centered in an uncertain time and to identify actions that will help better position them for the future. We look forward to more of these meetings and conversations.

For those clients who have been asked by friends or family for financial advice, we thank you for your recent referrals. We look forward to being of help in the years to come. Although the past six months have been difficult, we are fortunate to be able to work with and be of help to you.