

# Q2 2008 Quarterly Investment Commentary



*Authored by Mark Duvall, Chief Investment Officer, CFA® and David Firth, Director of Client Services, CFP®*

With summer upon us, we hope you are enjoying your favorite warm weather activities. Of course, in California we've seen lots of forest fires already this year. Unfortunately, the heat in our forests is not managing to warm up the investment markets, which have been struggling through one of their most difficult times in some years.

## Q2 Market Performance

The second quarter of 2008 was a challenging time for the Equity Markets and the American Economy. Following the solid months of April and May, June was a very difficult month, reminding us of the unpredictable nature of our complex global economy and markets. The S&P 500 lost nearly 8.4% and the Dow Jones Industrial Average lost 9.4%, making June one of the worst months since October 1987 and turning a good quarter into a poor one. April and May's positive returns partially offset the poor June, with the benchmark S&P 500 finishing the quarter down -1.9%. Financial shares were the chief culprit, as continued liquidity and earnings concerns dominated the headlines both in June and into July. U.S. equity asset class returns were mixed in Q2, with Large U.S. Value at -5.3% significantly trailing Large U.S. Growth at 1.3%. U.S. Small Cap companies returned +0.6% while U.S. Mid Cap US managed decent returns of +2.7%. Developed and Emerging International stocks were off moderately at -2.8% and -0.8% respectively. On the back of rising oil prices, Commodities again provided diversification with positive returns of +16.1%. Commercial Real Estate was caught up in concerns of a weakening economy, returning -5.4%, while Fixed Income was hurt by inflationary concerns, dropping -1.9%.

## Q2 Portfolio Performance

Diversification proved to be a benefit in Q2 as the wide range of asset class and manager returns reduced volatility and the overall degree of negative returns. Nearly all of our portfolios beat their respective blended indexes in Q2, and for 2008 to date, and are significantly ahead of the S&P 500. Most of our managers beat their benchmarks in Q2; we continue to monitor all of our managers, particularly those trailing the index.

## The Economy

While the investment markets have struggled, the U.S. economy has not formally entered a recession.

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Though unemployment has risen, GDP estimates for Q2 have remained positive after a final +1% growth in Q1. As we begin the third quarter, however, two chief concerns are weighing on the markets and people's minds: the continued weakness of our housing market hurting our financial system and the high price of oil.

With housing prices still dropping nationally, investors don't know how to value the loans that financial institutions hold on their books. As a result, stock prices have dropped considerably and asset write-downs have continued. Loans of all types are more difficult to obtain and in markets such as mortgage financing, the process of securitization has all but ended. Freddie Mac and Fannie Mae, Government-Sponsored Entities that have guaranteed an estimated \$5 trillion of mortgages, have lost over 80% of their stock value in 2008. This significant drop caused the market to fear some sort of collapse. The short term pain has been significant but the actions by the Federal Reserve and SEC in mid-July are decisively backing these entities and providing long term support, with potential additional action by Congress set to help support the housing market itself.

Adding to the cost of living and doing business, the price of oil had risen over 40% in 2008 at its peak of almost \$147 per barrel. The drain on consumer pocketbooks is dropping consumer spending and lowering U.S. standards of living. The longer term "silver lining" is that already we have seen the U.S. driving fewer miles than in any year since 2006, while energy alternatives are becoming more economically attractive. Foreign countries are lowering or eliminating subsidies on gasoline which should help moderate the global oil demand.

U.S. exports and agriculture are two bright spots in the economy and are helping to keep the unemployment rate from falling significantly. Longer term, we think the U.S. economy will adjust to accommodate lower consumer spending and will invest into new ways of generating energy, and many fundamentals for the World economy should be very positive. Shorter term, we would not be surprised to see GDP fall into recessionary territory as we continue in 2008, and to stay there for a few quarters. The challenges our economy faces are significant, just as it has faced and overcome serious problems before.

### **Why Stay Invested?**

Living through a tough economic period is difficult, and seeing portfolio values fall is never easy. In such circumstances, clients frequently ask us: why choose the sometimes volatile equity markets to invest savings, and why is staying invested so important? In answering, we find that most of us need asset growth to reach our retirement and financial goals. To merely stay ahead of inflation our re-

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turns must exceed 3% per year, and to reach retirement goals most of us need in excess of 6-7% annually. To achieve such asset growth, few options exist: invest in the equity markets or invest time in “active” arenas such as rental real estate or running a business. Most people do not have the skills, interest or time to take on such active projects, leaving the equity and bond markets as the preferred way to build wealth. Historically, this solution has successfully generated asset value growth while saving time and resources to enjoy family and live a good life. Since 1928, equity markets (as represented by the S&P 500) have returned close to 11.7% annualized, while today’s rates for 10 year U.S. Treasury bonds means they will provide 4.1% pre-tax. There are few for whom bond returns are sufficient to reach their goals; for most of our clients, a diversified portfolio professionally managed is the best choice for long term wealth appreciation. As for staying invested, this week’s volatility in the financial sector provides good grounding for that. Slightly lower oil prices, an SEC rule slowing short-selling and an earnings release from Wells Fargo led to the market deciding, over two days, that some of the largest U.S. banks were actually worth 30% more than it thought earlier in the week. With that kind of potential rise occurring that fast, leaving the market to wait for better days is not a winning strategy.

We have often written about the advantages of diversification utilizing different asset classes. There are periods of time when even this diversification cannot create positive returns. Asset allocation in such market environments can moderate the negative results of a poor market while remaining positioned for the growth cycle that will inevitably follow. While we believe the economy and markets will continue to be volatile in the near-term and possibly into 2009, we also know this will change. Just as cooler temperatures will eventually bring an end to the California fire season, cooler heads and a stabilized housing market will bring an end to our difficult smoky bear markets.