

# Q3 2008 Quarterly Investment Commentary



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Autumn is normally a beautiful time of year with changing colors and that brisk feel in the air. Given all the uncertainty in the markets and unsettling news, it's quite possible you've barely even noticed the changing seasons. We hope you are able to take a few minutes to observe, breathe, and enjoy the change in the outdoors. Perhaps some momentary reflection will offset the recent economic din.

## Q3 Market Performance

The third quarter of 2008 and on into October has been a very difficult period for global economies and markets as the credit crisis and economic troubles dominate the news and U.S. elections. With all the negative occurrences in September, when the month finally came to a close, REITs and Money Market accounts were the only positive asset classes, as REITs returned 4.8% and Cash 0.4%. Bonds outside of Treasury securities suffered unusually sizable declines—corporate and municipal bonds were particularly poor performers. Other asset classes were broadly negative: large U.S. value stocks returned -6.1% while the S&P 500 fell -8.4%. Asset classes that have provided diversified positive returns in the past cost portfolios. The Russell 1000 Growth index returned -12.3%, Russell Mid Cap index returned -12.9%, the developed international stock index lost -20.5%, emerging market stocks dropped -26.8% and commodities fell by -28.5%.

## The Economy

What happened the week of September 15 was unprecedented. While the government takeover of Fannie Mae and Freddie Mac the prior week was stunning, the failure of Lehman Brothers and near-collapse of AIG triggered major panic. In order to avoid Lehman's fate, Merrill Lynch suddenly chose to sell itself to Bank of America at a price that was unthinkable a year ago. A major money market fund that was too heavily invested in Lehman's bonds "broke the buck" (the price went below \$1), starting a run on non-government money market funds. The following weekend found the last two major U.S. investment banks (Goldman Sachs and Morgan Stanley) converting themselves into commercial banks. By the time the FDIC seized Washington Mutual, the nation's largest bank failure ever (immediately sold to JPMorgan), we were almost desensitized to these incredible events raining down on the economy. So many well known financial institutions falling is the result of a toxic brew of: 1) hundreds of billions of dollars of bad loans, primarily in the real estate sector; 2) the high leverage of some financial institutions; and 3) the highly complex securities derived from, or backing, real

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estate loans that intertwine many players in the financial system. With declining stock markets and frozen debt markets, policy makers expanded their response. Initially, the Treasury Secretary's three page rescue proposal was defeated by the House, triggering wild market swings, only to be resurrected in three days by the Senate and approved with changes by the House. Hedge funds and other large leveraged investors have been forced to sell stocks due to margin calls and the need for additional liquidity.

We believe decisive and coordinated action by our Fed and other central banks around the world have brought the global financial system back from the edge of disaster and with it prevented a major global economic depression. Many governments are buying into their banks through preferred stock, along with ensuring higher levels of deposits, guaranteeing repayment of short-term corporate lending, providing huge amounts of funds to borrow and lowering interest rates by 0.5%. As a result, we currently have a measure of stability, credit is beginning to ease (short-term interest rates are declining) and as these intended results cycle into the economy, the seeds of a recovery will slowly begin to sprout. We expect markets to continue to be volatile as the evidence of a recessionary economy is trumpeted by the press. While it will take time for these measures to fully work, it is important to remember that we have been through other crises in the past. They have all been extremely difficult to live through, yet eventually markets and the economy recover. Warren Buffett said much the same thing in his October 17 editorial in the New York Times. At Opes Advisors, we draw inspiration by looking to the past to see that the fundamental principles of capitalism have prevailed through the darkest of times, and they will again. Like the seasons, this too will pass; unlike the seasons, no one knows exactly how long before it does.

## **Q4 Outlook and Staying Invested**

The decades-long expansion of debt relative to the size of the economy has ended and can be expected to reverse to at least some degree. This suggests that consumer spending growth and ultimately economic growth will be slower than we have experienced over the last 10 years, though partially offset by continued growth in emerging economies and growing U.S. sales to those countries. Expectations for stock returns are moderate in a range of 5% - 9% with 6% - 7% long-run returns most likely. We are encouraged by our belief, supported by the rallies of history, that good opportunities will be presented to us in the months and years ahead and this can allow us to generate solid returns in our clients' portfolios.

As we have faced this difficult and volatile market environment, our investment approach remains unchanged. Because we know markets cannot be timed, asset allocation and diversification are the

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way to generate long-term returns. The turmoil in the markets over the past year and particularly over this past six weeks into October has been painful. This period has been truly rough on everyone.

Many of our client conversations over the last month have been about time horizon or risk tolerance. Those of you who don't need significant capital for many years, whether because you are already financially secure or because your age and future income potential provide opportunity, can be confident that your portfolio will grow over a long time horizon, benefitting from the good periods to come regardless of the short-term volatility. For some with shorter-term needs that are creating a situation where downside risk is no longer tolerable, we recommend a meeting to assess a change in strategy to moderate market risk.

This year's summer end coincided with extremely high market volatility. Though not as systematic as the seasons, the subsequent policy actions are combining with some silver linings (low inflation) to shift the tenor of this crisis. While the onset of summer found us worried about stagflation, our current recession has removed inflation as a near-term concern, leading to lower interest rates. Soon, lower energy prices will have a direct impact on consumer checkbooks. This reduction in energy costs will represent nearly \$200 billion of savings that consumers can then invest or spend in other ways.

We appreciate the trust you place with us.