



Investment Commentary
January 2009

Over the last three months, tensions have simmered in the financial markets, while investors come to grips with economic and corporate fundamentals. By the time our last commentary was written, in mid-October, the markets had already inflicted enormous pain, a 20% weekly loss in world stocks having just followed a 9% weekly loss. Since then, we have seen a steady rollout of dire economic reports, and a weakening earnings picture, affirming what the markets had already telegraphed. At the same time, investor focus on Washington has intensified, perhaps seeking reassurance from the change of administrations, and expectations of a strong policy response to the recession as it approaches peak intensity.

The entire fourth quarter drop in the equity markets, here and worldwide – the S&P 500 and MSCI World indices losing 21.5% and 21.6%, respectively – was on the books by the eighth trading day, Friday, October 10th. Both indices were up slightly the rest of the year. Starting with the last two days of September – the 29th was the Monday that a Senate rejection of the original TARP bill triggered a 777 point Dow loss – this two week stay in investment hell turned an almost manageable down 16% year into a down 40% year. The result was the second worst year for stocks on record.

As detailed in these letters, recommended portfolio weightings had become more and more geared to defense heading into 2008, culminating in a large, second reduction in direct equity exposure at the end of 2007, following an initial cut on 3/31/07. We also downplayed credit, including zero weights to high yield bonds and Treasury Inflation Protected Securities (TIPS). This positioning reflected stated concerns about excesses in sub-prime lending and securitization, leverage, and uninformed risk-taking, the unwinding of which would lead to rising volatility, setbacks for lenders as well as consumers, and a shackling of economic and corporate performance. Our 15-20% underweights to traditional stock managers and 5-10% underweights to credit were allocated primarily to private investments, market neutral hedge funds of funds and long-short equity hedge funds of funds, the thinking being that heightened volatility and market dislocation would create opportunities for these types of managers.

The equity underweight certainly proved helpful in 2008. The high yield zero weight helped also, as the Merrill Lynch High Yield index lost 26%. But these advantages were compromised by unprecedented losses at hedge funds, about 20% on average. The forecasted upsurge in volatility and risk awareness arrived on cue, but with an intensity and event shock value (the long list beginning with the fall of Lehman Brothers in mid-September) that was much greater than expected. Operating conditions quickly deteriorated, including an SEC-imposed short sale ban that backfired badly, choking off

price discovery, fueling even greater volatility and tying the hedge fund managers' hands. These managers fell less than their long-only counterparts over the year, but the losses were painful nonetheless, particularly when compared against the flat average hedge fund return during the 22% S&P loss in 2002.

As difficult as 2008 was, client accounts have shown resilience over longer periods. Portfolios generally held their ground against the 20-25% equity market declines that occurred over the most recent three-year stretch, including a 52% peak to trough plunge from October 2007 to October 2008, the worst outside of the 1930s. A combination of tactical positioning and manager selection contributed to wins over static and passive benchmarks. Active management, whether based on fundamental analysis, quantitative modeling or an overlay approach encompassing both, was not relevant in 2008; the market drop was indiscriminate, emotional, and comprehensive. Cheap stocks with intrinsic value just got cheaper along with everything else. But three years provided a number of active managers enough time to convert insight and disciplined investing into meaningful excess returns.

Now, we are concerned with the next three years, and beyond. Investment strategy will need to navigate what will be a continuation of extremely challenging conditions, certainly in the near term. In the upcoming months we are likely to face the worst of a recession that was determined last month to be already a year old by the National Bureau of Economic Research. The downturn thus already is above average in length and only three months from becoming the longest since the 1930s. Through the third quarter of last year, no quarterly drop in this recession has been greater than 1%; this by all accounts will change with a vengeance in the fourth quarter, and, more than likely, first quarter of this year. Output declines on the order of 3-7% are envisioned.

As is well known, we have witnessed unprecedented levels of government intervention and effort in support of economic recovery. Last year, the main focus was on restoring health to the financial system and providing massive monetary support, well into the trillions of dollars, in order to counteract what had become an embargo on lending within banks. Amid much debate about the suitability, clarity and consistency of these measures, there have been some signs of progress as mortgage rates have dropped to below 5.0% and short term credit spreads have begun to narrow, reflecting a warming trend in attitudes toward taking lending and investment risk. But corporations now are retrenching, not borrowing, hiring and building. Readings on unemployment, a lagging indicator in that reports reflect decisions made two or three months ago, have reflected sharply heightened concern about business conditions. Around 2.6 million jobs were lost in 2008, 1.5 million of them in the final three months.

In 2009, the federal monetary push will be joined by fiscal initiatives, also of a scale that would have been hard to fathom just a year ago. Barack Obama and his economic team will immediately be charged with crafting, selling to Congress and quickly implementing a stimulus program, totaling \$825 billion as this is written. The package will be aimed at near term economic pain relief along with more long term-oriented upgrades of our national chassis, including our energy grid, transportation arteries, and electronic network

of health care records. The plan also may include tax cuts for businesses as well as individuals. To say the least, this will be a complicated piece of legislation, as it will draw in a wide range of constituencies, but there is apparent wide support for this type of action, and Obama will arrive at peak influence, as is typical of incoming presidents.

Assuming a significant amount of this money is spent in fiscal 2009 (ending 9/30/09), we are looking at federal deficits in the neighborhood of \$1.3 trillion. This would represent 9% of our total economy, easily eclipsing the 1983 post World War II high of 6%. Compared to the size of our government and federal budget, the relationship is even scarier; a \$1.3 trillion deficit would mean we spent something around \$3.7 trillion while bringing in revenue of \$2.4 trillion. In 2000, by comparison, we spent \$1.8 trillion against revenue of \$2.0 trillion. The good recent news is that the government has been able to refinance its debt at lower rates, thanks to the enormous popularity of Treasuries during the market crisis; rates on ten-year paper were driven down from 3.8% to just over 2% over the last three months of the year. However, all the new issuance of bonds will need to attract continuing buyer interest, or rates will have to rise. China, for one, a close second to Japan as an owner of \$504 billion of Treasuries (as of 6/30/08), is expected to switch from paper investments to domestic stimulus programs of its own this year.

The investor flight to the safety of Treasuries, and intense disfavor for other types of bonds, have created a variety of opportunities within fixed income, and this is reflected in our tactical weight changes as this year begins. Investment grade corporate bonds saw their yield spreads over Treasuries literally move off the charts late in 2008, to roughly 350 basis points (3.5%), compared to a previous 15 year high of 170 basis points and an average spread of 120 basis points. High yield bonds moved to spreads of around 1350 basis points versus a previous 15 year high of 700 basis points and 475 basis point norm. As expressed in our July letter, we are concerned about default rates moving higher; the current 3-5% range is well under the 10% level we saw during the last two recessions, and may be understated because of the absence of default-triggering covenants placed into 2006 and 2007 credits. However, current spreads appear to compensate for this concern.

Also, in a year in which Treasuries gained 13.7%, their inflation-linked counterparts (TIPS) actually lost 2.4% of their value, and the yields on the two types of bond converged to a point at year-end where virtually no expected inflation over the next ten years was priced in. To be sure, inflation is not a big concern at the moment, but all the monetary ease provided by the largest of the world's central banks over the last several months is certain to have an effect down the road. Newly issued TIPS also offer an "asymmetric" return profile: if inflation rises, corresponding extra percentage returns accrue to the TIPS investor; if instead we get rampant deflation, par value is maintained.

Stocks, after losing about 40% of their value in 2008, appear to reflect underlying risk far more acutely than we felt was the case a year ago. Using actual trailing twelve month earnings, U.S. stocks have reached their lowest valuations in 17 years, and non-U.S. markets are trading at single-digit multiples of trailing earnings, close to all-time lows in some cases. However, a sustained upward move appears held in check until there is

greater clarity about the extent of the earnings slide, now at six quarters and counting. Financials have experienced sharply weaker earnings already, and the pain is shifting now to retailers, basic materials producers, and auto manufacturers, among several other sectors. Overall, we favor an exposure to traditional stocks that is closer to but still under the neutral weight. Coupled with an above-neutral allocation to long/short equity funds, the overall equity allocation thus moves back up to neutral.

Finally, hedge funds – those that survive the current shake-out – should be able to find their footing in a more normal market environment, even if it's a persistently bearish one for a time. Talent in securities analysis, a non-factor in 2008, eventually gives rise to excess returns, and there is definite talent at hedge funds. Moreover, these funds may offer an extra layer of appeal over the next year or two. Losses on the order of 20-25% last year, combined with fee structures dependent on the reattainment of “high water marks” (against which previous fees already have been taken), create potential performance fee holidays on the next 30% or so of gains. In this type of environment, a 20% gross return might net out to something closer to 19% instead of 16%, which is a significant, if temporary, advantage.

Going forward, we feel it will be critical to revisit and reaffirm investment policy and mission statements with clients. To the extent the trauma of 2008 has altered views on risk tolerance, new allocation targets geared to lower volatility and implied risk may, or may not, be appropriate. This perhaps becomes even more topical as we now are recommending new commitments to traditional stocks and bonds. Our investment strategy at the firm level, and in the models that serve as a guideline for actual portfolios, needs to draw a distinction between risk *tolerance* and risk *assessment*, as only the latter has a bearing on expected returns and portfolio behavior over time.

As never before, we appreciate the trust and faith you have placed in us. Always, please feel free to contact me or any other member of the investment team for any reason.

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