

## *Q2 2008 Commentary: Times Are Rough – What’s Next?*

*By Bob Marshalla  
July 11, 2008*

### **Introduction**

Halfway through the second quarter things were looking up. By May 18, the market had gained 8% since the start of the quarter and over 12% since the year’s low point on March 10. We were just a hair away from having recovered all of the losses of the first quarter. But then the market abruptly changed direction and gave back all of its gains. By June 30, the S&P 500 had posted a decline of 12% for the year to date, and 18% since its all time peak on October 9 of last fall.

Why the latest downturn, and what is in store for the future? Clearly the reasons have to do with continued financial sector and housing woes, combined with rising energy and food prices. These factors have combined in an unsavory combination to yield both a stagnant economy and rising inflation at the same time.

But despite the economic slowdown, worldwide commodity sellers have continued to flourish. Does this signal a lasting new secular trend or the onset of the latest bubble? And how, if at all, should we incorporate this into our investment strategies?

I will address these issues herein, starting with my thoughts about the state of the economy. I will then go on to the usual review of market performance by segment and asset class, and follow up with a special section about the commodities situation and another about our investment strategy going forward.

### **Review of the Economy**

In my recent commentaries I have repeatedly discussed two related though distinct risk factors<sup>1</sup> that have been at play in our economy since early to mid 2007:

- The unprecedented turmoil in the credit markets, and
- The more conventional recession or slowdown that is hammering the consumer and the companies in the most vulnerable sectors.

I believe our experience over the past quarter evidences a “good news - bad news” development for these factors. The bad news is that the recession is bad and getting worse by the day. If there is light at the end of the tunnel, it seems to be getting farther away and we cannot even see it yet.

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<sup>1</sup> This year alone, I have discussed these two factors in both my January and April quarterly commentaries and in email notes to clients on March 11 and June 9.

But the good news is that the turmoil in the credit markets seems to be becoming more transparent and less scary. It seems that the Fed's actions may have significantly reduced the risk and fear of a full-scale financial meltdown.

There is still plenty of credit turmoil on the horizon to be sure. Financial companies no doubt have many more large write-offs to come, and these may well spread beyond mortgages to other areas of debt (e.g., credit cards, auto loans, corporate debt)<sup>2</sup>. But that is not the really scary part. The really scary part lies in the trillions of dollars worth of obscure derivatives and "structured" financial products that somehow tie all the big financial institutions to one another – and which nobody fully understands. It means the troubles of one large company like Bear Stearns can potentially spread throughout the whole financial sector, both here and abroad. And even where there are no direct linkages, there is the matter of trust. For the greater financial system to keep working, the various large actors have to continue to have trust – both in each other and in the system in general. If an incident like Bear Stearns causes the trust to turn to fear and distrust, the whole system is in danger of locking up. I have to give the Fed great credit for being creative and aggressive since last August in taking actions to head off such a scenario.

I certainly do not have a sufficient understanding of the impossibly complex shadow banking system that has grown up in world-wide financial markets to give you a cogent analysis of why the worst may be over. But by keeping a close ear to the words and an eye to the actions of the major participants I have gotten a pretty good feeling that things are calming down. People are somewhat less fearful, and more trusting of the Fed to do whatever is necessary to avoid any nightmare scenarios. More concretely, we can observe the changes in credit spreads and the prices of debt securities that are marked to market every day<sup>3</sup>. These are essentially the market prices of trust.

So does this mean the risk of a credit-induced panic has been completely eliminated? Of course not. But I do think the probability of such is much lower now than it was at the times of my last three quarterly commentaries, and that we can now *almost* breathe a sigh of relief about it.

But now back to the recession<sup>4</sup>. Energy and other commodities prices continue to rise. The prices of imported goods in general are increasing due to the declining U.S. dollar. Unemployment, though still not high by historical standards, continues to increase every month. Meanwhile, the housing market is seeing significant price declines, and with new waves of foreclosures hitting the market, there is no immediate end in sight. The losses from bad loans are not only continuing, but continuing to be worse than expected. Even the "lucky" homeowners in no danger of default have found that the home equity ATM they had grown to love so much during the housing boom is now out of service. And with both lower real estate and stock portfolio values, and much less easy credit, consumers are feeling a negative wealth effect. Adding up all these factors, it seems increasingly likely that consumer spending will continue to deteriorate.

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<sup>2</sup> This week fears have come to light about the adequacy of capital for Fannie Mae and Freddie Mac, and their shares (which thankfully none of us own) have plummeted as a result. While not government agencies per se, Fannie and Freddie have always had the implicit backing of the U.S. Treasury. Their failure would be such a disaster that there is no way the government will let that happen. I can't think of anything with closer to a zero probability.

<sup>3</sup> An example that hits close to home is the price of bank loan funds. Their prices had been falling for about eight months starting last summer, not due to actual defaults, but due to a decrease in the trust levels of the market participants. But since about mid February, these prices stabilized and have started heading higher.

<sup>4</sup> I am going to call our economic situation a "recession" from here on. But technically, we may not be in nor ever get into what is officially termed a "recession". For that to happen we need at least two consecutive quarters of negative GDP growth, and so far, we have had none. The first quarter GDP growth rate was a surprising positive 0.8%, although these figures are always subject to revision.

As always, there are some positives as well. Outside the financial sector, corporate balance sheets remain generally healthy and earnings have been decent. There have been some positive effects on consumer spending owing to the checks received from the economic stimulus package, but these effects will be small and transitory. One good source of strength has been exports, which so far have managed to offset much of the impact of the housing decline on GDP. But this could and probably will diminish as our slowing economy “exports” our economic weakness to the rest of the globe, and there are signs that this is happening.

So overall, the macroeconomic picture looks pretty bleak<sup>5</sup>. But the relevant question for this piece is not what the macro-economy will do, but rather how our investments will do. To address this, I will reiterate a factor I cannot mention too often: equity prices are set based on investors’ future expectations, not just on what is happening at the moment. If investors expect a company’s cash flows to be lower in the future than previously expected, be it due to recession or any other reason, then that company’s stock will be worth less to them today than previously. In fact, the price should be pushed down far enough right now so that if these updated expectations turn out to be roughly accurate in the future, then the stock would reward investors with a fair market return from today going forward. Better news in the future is not required to achieve positive stock returns, just a realization of what was expected when the price was re-set.

So regarding stock prices, I see three possibilities for the immediate future. Market participants’ current expectations for future company earnings will turn out to either be:

- About right,
- Too optimistic, or
- Too pessimistic.

It is only in the third case that we should expect stock prices to go down. Current expectations for future macroeconomic and corporate earnings performance are certainly bleak. We *expect* the economy to remain stalled for quite some time, and we *expect* that corporate earnings reports are going to be poor for the next several quarters. But these are the expectations that should already be built into today’s stock prices. If these expectations turn out to be right – no matter how bad that might be – stock prices should not go down. It is only if the economy and corporate earnings perform even worse than current expectations that we should expect further price declines.

This may well happen of course. In fact, I think this outcome is slightly more likely than the other two scenarios, because analysts tend to be too reluctant to change their previous earnings estimates as much as they should<sup>6</sup>. But the key point is that winning with stocks is based on beating a *point spread*, not on absolute performance. We don’t have to actually get out of the recession for stock prices to start going back up. In fact, stock prices have historically been a leading indicator, and have generally moved about six months ahead of the economy<sup>7</sup>, both on the upside and the downside.

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<sup>5</sup> For a little fuller discussion of the current state of the economy, I have attached an excerpt from a commentary by T. Rowe Price at the end of this document.

<sup>6</sup> This is the main reason for the existence of momentum in stock prices. But that is a story for another day.

<sup>7</sup> Please don’t make too much of the six months figure. This is just an average, and it may be six months plus or minus about eight in practice.

## Review of Market Performance

As noted at the outset, the seeming revitalization of equity market performance turned sour about the middle of the second quarter. That observation was based on the performance of large cap domestic stocks (the S&P 500), but as shown in Table 1, year-to-date performance has been lousy across virtually all equity and real estate market segments, not only domestic large caps. The only exceptions are those having to do with oil (see energy stocks) or commodities generally (see commodity futures).

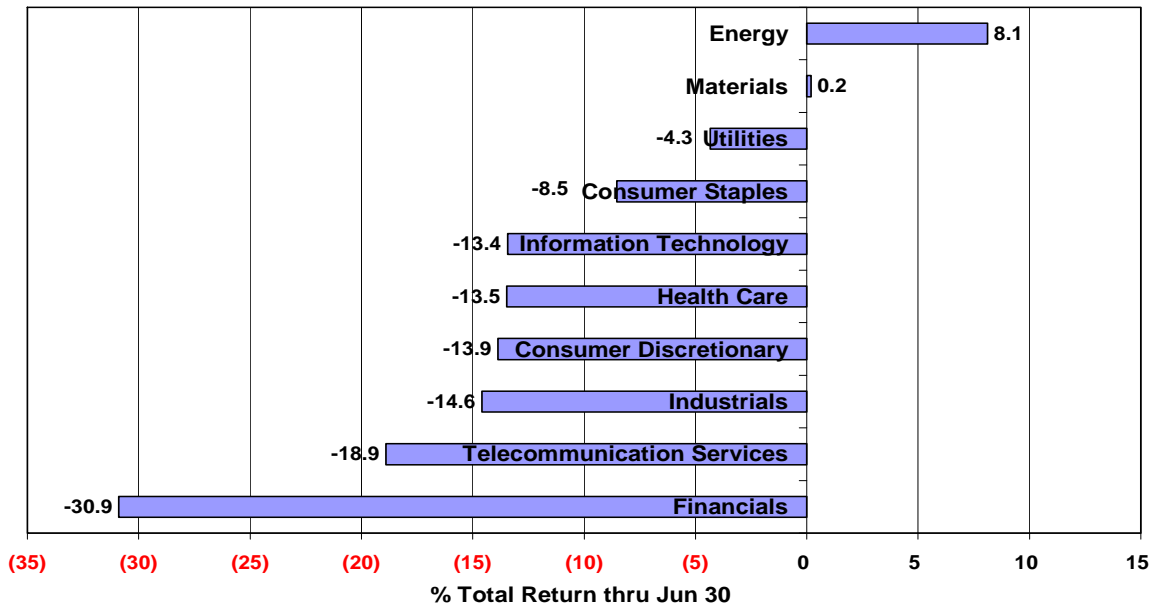
**Table 1 - Quarter 2 and Year-to-Date Returns**

|                               | <b>Representative Index<br/>or Fund (blue font)</b> | <b>2nd<br/>Quarter<br/>2008</b> | <b>Yr-to-<br/>Date<br/>2008</b> |
|-------------------------------|---|---------------------------------|---------------------------------|
| <b>U.S. Equities</b>          |   |                                 |                                 |
| Full U.S. Market (98% by MC)  | Russell 3000  | (1.7)                           | (11.0)                          |
| <b>By Market Cap</b>          |   |                                 |                                 |
| Large Cap                     | S&P 500   | (2.7)                           | (11.9)                          |
| Mid Cap                       | Russell Mid Cap                                     | 2.7                             | (7.6)                           |
| Small Cap                     | Russell 2000  | 0.6                             | (9.4)                           |
| Micro Cap                     | Russell Microcap                                    | (3.5)                           | (15.5)                          |
| <b>Value &amp; Growth</b>     |   |                                 |                                 |
| Value Stocks                  | Russell 3000 Value                                  | (5.2)                           | (13.3)                          |
| Growth Stocks                 | Russell 3000 Growth                                 | 1.5                             | (9.0)                           |
| <b>Economic Sectors</b>       |   |                                 |                                 |
| Best                          | Energy  | 16.9                            | 8.1                             |
| Worst                         | Financials  | (19.0)                          | (30.9)                          |
| <b>International Equities</b> |   |                                 |                                 |
| Large Cap                     | MSCI - EAFE   | (2.3)                           | (11.0)                          |
| Small Cap                     | MSCI - EAFE Small Cap                               | (4.5)                           | (10.5)                          |
| Emerging Markets              | MSCI - Emerging Markets                             | (0.9)                           | (11.8)                          |
| <b>Real Estate</b>            |   |                                 |                                 |
| Equity REIT's - Domestic      | NAREIT Equity Index                                 | (4.9)                           | (3.6)                           |
|                               | Morgan Stanley US Real Estate                       | (7.2)                           | (4.2)                           |
| Equity REIT's - Foreign       | EPRA Global ex US Index                             | (11.0)                          | (19.3)                          |
|                               | Eur. Investors Int'l Property                       | (14.3)                          | (20.3)                          |
| <b>Commodities</b>            |   |                                 |                                 |
| Commodity Futures             | Dow Jones AIG Com Index                             | 16.2                            | 27.3                            |
|                               | PIMCO Commodity Real Ret                            | 14.3                            | 30.7                            |
| <b>Fixed Income</b>           |   |                                 |                                 |
| Investment Grade Bonds        | Lehman Aggregate Bond Idx                           | (1.0)                           | 1.1                             |
| Inflation Protected (TIPS)    | PIMCO Real Return Fund                              | (0.8)                           | 4.7                             |
| Int'l Bonds, Developed Mkts   | PIMCO Foreign Bonds                                 | (5.2)                           | 5.0                             |
| Emerging Mkts Currencies      | PIMCO Developing Local Mkts                         | 2.2                             | 5.8                             |
| Floating Rate Bank Loans      | Eaton Vance Floating Rate                           | 5.2                             | (1.3)                           |
| Short Term Money              | 3 Month T- Bills                                    | 0.4                             | 1.0                             |

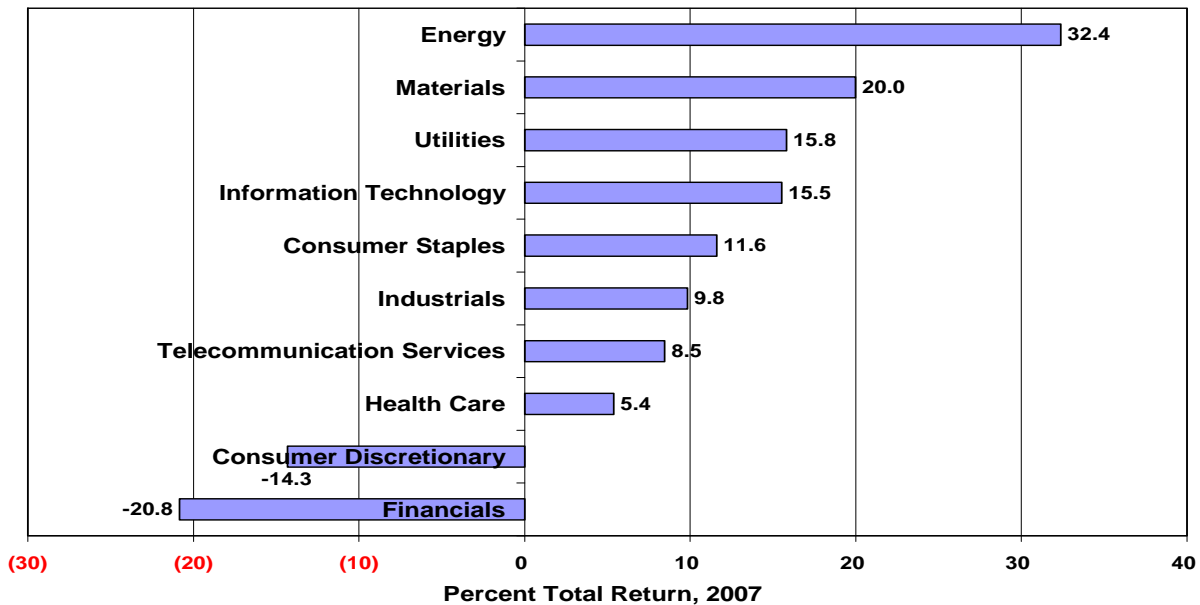
\* Based on mutual fund returns. Others are costless market indices.

**Economic Sectors** – As we saw last year, the most interesting equity performance differentials these days have to do with economic sectors rather than growth and value, large and small cap, or domestic and international market segments. Figure 1A illustrates the dramatic performance differences across sectors for the year to date. The only positive was the energy sector, which has gained a healthy 8%. At the other extreme financial stocks continued to sink at an alarming rate, down another 31% in the past six months. This is the same relative story we observed last year, as we can see in Figure 1B which replays the sector graphs for the full year 2007.

**Figure 1A - Equity Returns by Economic Sector  
YTD at 6/30/08**



**Figure 1B - Equity Returns by Economic Sector - 2007**



Energy and financials have been the big winners and losers, respectively, for the whole past 18 months. The table below summarizes performance for both the first half of this year and all of last year for these two sectors, as well as for the full 18 months. We see that in the past year and a half energy stocks have risen 43% while financials have lost 45%, an amazing performance differential.

**Table 2 – Best and Worst Economic Sectors for the Past 18 Months**

|                   | <b>Year-to-Date 2008</b> | <b>Year 2007</b> | <b>Past 18 Months<br/>(not annualized)</b> |
|-------------------|--------------------------|------------------|--|
| <b>Energy</b>     | 8.1%                     | 32.4%            | 43.1%                                      |
| <b>Financials</b> | -30.9%                   | -20.8%           | -45.3%                                     |

**Other Market Segments and Asset Classes** - Returning to Table 1, we see that every broad-based equity sector (large to small, growth and value, domestic and international) has lost ground this year, as has commercial real estate (domestic and international). Most bond categories turned in respectable positive returns, but the only other really bright spot – and it shone like the sun – was commodities.

**Commodity Futures** - The Dow Jones AIG Commodities Index was up 16% in the second quarter, giving it a robust 27% return year to date. Notably, this is not only due to oil and natural gas prices, since this index is only one third weighted to energy. The other two thirds represent metals, both precious and industrial, and agricultural products, both crops and livestock. There are 19 commodities in all represented by this index, only 4 of them energy related.

MAM clients are invested in commodity futures via one of both of two investments, an exchange traded note (ETN) from Barclay’s Bank (DJP) that tracks the Dow Jones AIG index directly, and the PIMCO Commodity Real Return (PCRIX) mutual fund, which also attempts to track the index while also seeking to enhance returns via creative investment of the collateral. The ETN’s returns will always equal the index returns, minus its expense ratio<sup>8</sup>. Meanwhile, the PIMCO fund has been doing even better. It was up 14% in the second quarter, which matched its first quarter performance, and has led to an incredible 31% year-to-date gain. Further, this follows up on a 24% gain last year.

## **Commodities: Lasting Secular Trend or the New Bubble?**

Over the past several decades we have been subject to a series of investment “bubbles” in which prices have risen beyond all rational reasons. These include:

- 1980’s – Japanese Stocks
- 1990’s – Technology Stocks
- 2000’s – Residential Housing

Each of these bubbles has been followed by a painful and prolonged day of reckoning. Now it seems the prices of commodities of many types are on fire. Most of our angst and media attention have been on energy commodities – crude oil, gasoline, jet fuel, natural gas. But the

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<sup>8</sup> This ETN is actually a derivative. It is a note from Barclay’s Bank that promises to pay the holders a return exactly equal the Dow Jones AIG index, less its 0.75% per year expense ratio. It does not actually invest directly in any commodities or commodity futures.

prices of many other commodities have also been rising at incredible rates for quite some time. The table below<sup>9</sup> shows the increases in world prices of a number of commodities over a five year period. Some of these, like nickel, copper and zinc, have risen even more than crude oil.

**Table 3 - Worldwide Commodity Price Changes**

|  | <b>2002</b> | <b>2007</b> | <b>% Change</b> | <b>Annualized % Change</b> |
|--|-------------|-------------|-----------------|----------------------------|
| <b>Nickel</b> (\$/lb.)                               | 3.10        | 17.10       | 452%            | 41%                        |
| <b>Copper</b> (\$/lb.)                               | 0.70        | 3.22        | 360%            | 36%                        |
| <b>Zinc</b> (\$/lb.)                                 | 0.35        | 1.45        | 314%            | 33%                        |
| <b>Oil</b> (\$/barrel)                               | 26          | 72          | 177%            | 23%                        |
| <b>Gold</b> (\$/oz.)                                 | 310         | 697         | 125%            | 18%                        |
| <b>Steel</b> (\$/ton)                                | 256         | 555         | 117%            | 17%                        |
| <b>Aluminum</b> (\$/ton)                             | 1,365       | 2,661       | 95%             | 14%                        |
| <b>Corn</b> (\$/ton)                                 | 100         | 170         | 70%             | 11%                        |
|  | <b>2002</b> | <b>2008</b> |                 |                            |
| <b>Oil thru July 2008</b> (\$/bbl)<br>(six year run) | 26          | 144         | 454%            | 33%                        |

Are these price increases indicative of fundamental supply and demand, or the beginnings of another speculative bubble? Increasingly we hear pundits and politicians blaming these price increases on greedy speculators. But there are a couple of holes in that story. For one, some commodities whose prices have skyrocketed, like steel and iron ore, do not even trade on futures markets. Secondly, for most of these commodities (maybe gold excepted), speculators cannot accumulate and hoard inventories of the asset. For example, oil futures contracts turn into oil spot markets on a prescribed day every month, and anyone who was buying the futures contracts on speculation will be sure to have sold them before that date to someone who actually wants the oil. Not too many speculators have oil tanker docks where they can receive the product itself! In the end, physical demand does equal physical supply<sup>10</sup>.

The booms in commodities prices over the past few years have been driven primarily by huge increases in demand, and not from decreasing supply capacities or cartel-inspired cutbacks as was the case in some previous price jumps. And most of this growth in demand has come from emerging markets, which in turn have been dominated by China and India. Still, even though the price growth has come from economic fundamentals so far, this does not provide assurance that prices will not crash in the future. Indeed, commodities present the classic example of boom and bust markets. Required investments in new capacity are large and the lead times long for bringing new supplies online. In the classic boom-bust cycle, increased demand brings high prices initially because supply capacities cannot be increased in the short run. But then people invest in so much in new capacity that eventually the new supplies come to exceed demands, and this eventually causes prices to fall back. This in turn leads to cessation of new capacity investments for a time and thereby initiates the cycle all over again.

<sup>9</sup> This table is courtesy of Newsweek, July 14, 2008, page 18, although I have ordered the rows my own way and added the annualized return column.

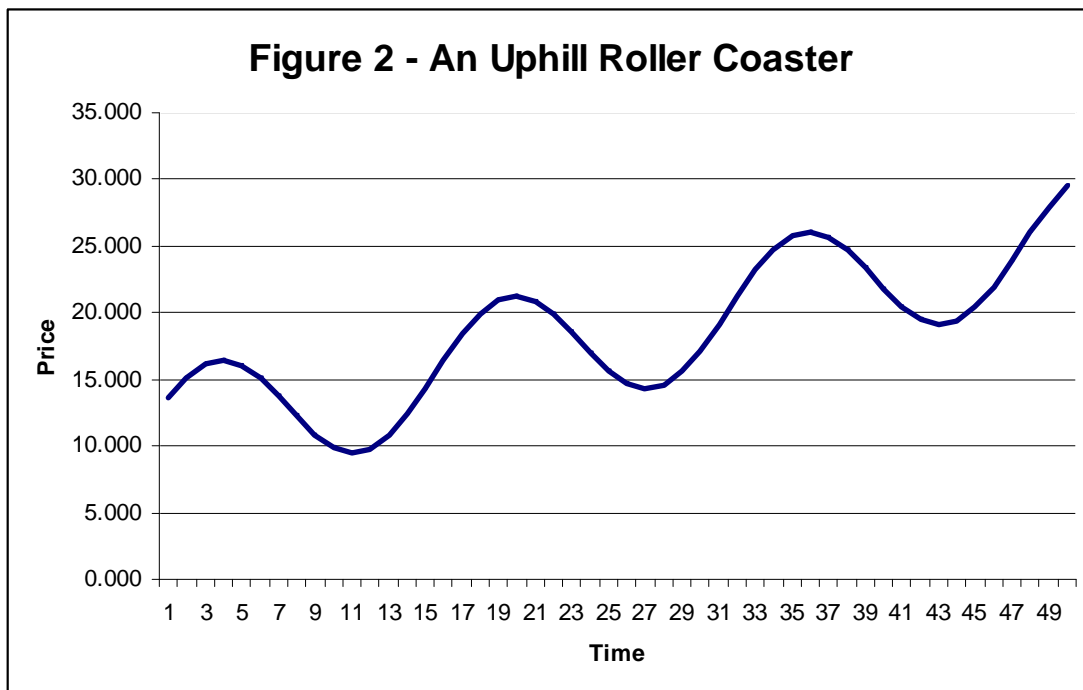
<sup>10</sup> Of course there are limited storage facilities for oil and other commodities, but no one believes these have been ballooning in size as speculators hoard the valuable commodities.

So are we simply in the boom part of a classic boom-and-bust cycle, or is something different this time? The commodity bulls would point to a couple of factors that make this time different:

1. The explosion of demand due to the industrialization of the 2.4 billion China-India complex, plus numerous other emerging markets, is absolutely unprecedented in scale and expected duration. The explosive increases in commodity prices have yet to put a dent in the growth of these economies, and we are still only in the very early stages of their rise.
2. For some commodities, most notably crude oil, the ability to expand supply is less than in the past, due to the facts that the cheapest and most abundant resources have already been tapped, and because environmental and political considerations are seriously constraining our abilities to maintain, let alone increase supply capacities.

The slowdown in the U.S. and (soon I expect) other developed economies will surely decrease the demands for oil and other commodities. But the linkage of the rest of the world to the U.S. economy is weaker than in the past. And the internal demands of the emerging economies are becoming ever more important. So whether the U.S. economic slowdown will be enough to stop the rise of commodity prices – or even if it does, whether it stops it for long – are very much open questions.

I admit I have long been somewhat of a skeptic when it came to projecting commodity price booms into the future. But there is surely something to the argument that the last few years are more than just the latest cycle in a typical boom and bust pattern. If I had to choose, I think the most likely pattern for oil and other commodity prices over the next decade or two will be a continuation of ups and downs, but with those ups and downs cycling around rising trend line, kind of like a roller coaster built up a hillside. A stylistic version of this idea is shown in Figure 2.



## Investment Strategy

A worldwide economic slowdown means we may be due for a correction in commodity prices soon. Indeed, as I write this, oil prices have fallen 6% in the past two days. But for the past couple of years, the only kinds of investments that have made much money have been those in assets somehow related to them. And even if prices fall over the next few months, the longer term trend is likely upwards.

From an investment strategy perspective, the objective is not to make the best forecast possible and invest to support it, but to prepare for a range of possible futures. In other words, the only prudent strategy is to spread our bets – to neither avoid nor go whole hog into commodities related investments. The meaningful questions for us are *how much* of our portfolios we should tie to these markets, and via *what kinds* of investments?

The kinds of investments I like best are those that are influenced by commodity prices, but not entirely dependent on them. There are commodities related investments that can make money even if commodity prices do not keep going up. In fact, all of the four kinds of investments I will discuss below fall into this category.

I will next describe (1) what I have been doing about this over the past year or so, (2) where we stand today, and (3) what I plan to do in our investment portfolios in the future.

### What I Have Been Doing

Energy Stocks - As I have discussed on numerous occasions, most of our portfolios have been underweighted in energy stocks as a consequence of the kinds of equity fund managers we have been utilizing. Since last September I have been gradually increasing our energy stock weightings during portfolio reviews by buying energy stock ETF's or an energy sector fund, and in some cases individual energy stocks. These increments have been modest however, typically amounting to an extra 2% to 3% of equities. The effect has been to move our portfolios closer to the market weight of energy stocks, but still leaving them a fair amount below it. For MAM as a whole the combination of adding new energy stocks plus the growth in value of the existing stocks has brought energy stocks up to a market cap weighting of 10.6% of all equities. By Morningstar's metrics, energy stocks comprise about 16% of the market cap of the whole U.S. market<sup>11</sup>.

The energy sector has numerous segments, both vis-à-vis fuel type (oil, natural gas, coal, renewables), and supply chain segment (exploration and production, refining, transportation, distribution, energy services, plus integrated companies like Exxon Mobil that do it all). In adding energy stocks, my emphasis has been on the upstream exploration and production segment of the oil and natural gas industry. My concern has been that we are too underweighted in energy, and it is my belief that we get the most leverage with respect to oil and natural gas prices by investing in this upstream segment of the industry.

Commodity Futures – I have been allowing commodity futures to assume a larger allocation in our portfolios, albeit in a passive manner simply by not rebalancing all the way, or at all, back to our original commodity futures targets. Since commodity futures prices have been rising so fast, both absolutely and relative to everything else, they have been growing as a percentage of our portfolios' total assets. Client portfolio targets had generally been set at only 4% to 5% of

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<sup>11</sup> Morningstar's metric for the energy stock weighting in the S&P 500 is 16.3%. For the Russell 3000 index it is a bit lower, at 15.5%. The Russell 3000 is a very broad based index of all domestic stocks, large and small, weighted by market cap. It is interesting to see how the energy sector fraction of the market has grown as energy prices soar. Three years ago energy comprised only 8% of the S&P 500 market cap.

portfolio assets as late as last November, but by the end of this June, the actual weight of commodity futures across all assets under management at MAM had grown to 7.4%. Individual portfolio weights currently range between 4% and 13% of assets, although most portfolios are pretty close to the 7.4% average.

Commodity futures prices are surely correlated to commodity spot prices, but as you may recall from my earlier paper<sup>12</sup>, it is not essential that commodity prices increase in order to earn positive returns on commodities futures. This is one of the nice features about accessing commodities markets via the investments we use. We can afford them a permanent place in our portfolios, rather than being dependent on guessing when commodity spot prices may be trending upwards or downwards.

Emerging Markets Stocks – Emerging markets stocks are not a pure play on commodities, of course, although they are certainly related given that the major exporters of most of the hot commodities are amongst the emerging markets countries. The MSCI Emerging Markets index averaged an amazing 37% per year total return for the five years ended 2007. This year, however, the index has fallen like everything else, and shows a 12% year-to-date loss (as of June 30), a fact which clearly highlights its lack of perfect correlation to commodity prices.

I have not in the last few years had a dedicated allocation to emerging markets stocks funds in our portfolios, but I have selected international fund managers who have the prerogative and actual track record of selecting emerging market stocks when they so choose. The biggest holdings of international stock funds we own, two funds from Oakmark and one from Thornburg, have taken opposite views on the matter over the past couple years. The Oakmark funds have almost no emerging markets stocks (only about 2% in OAKIX and 4% in OAKEX), while the Thornburg International Value (TGVIX) fund currently has 16% of its assets so invested (and had over 20% there at its peak). The result of this is that for MAM as a whole, we have just under 9% of international equities and just under 2% of all equities invested in emerging market stocks,.

Emerging Markets Currencies and Fixed Income – For the same reason that I mentioned emerging markets stocks, the currencies and locally denominated fixed income instruments of these countries also represent a play on the commodities boom. The U.S. dollar weakness is very much dependent on our continuing (though decreasing) current account deficit, which is itself highly exacerbated by our imports of oil and other commodities. The fact that worldwide trade in crude oil and other major commodities is priced in U.S. dollars has contributed to U.S. dollar weakness as well.

I have been keeping between 25% and 30% of both our portfolios' equities and fixed income both invested in securities denominated in foreign currencies for the past several years. Last week I made a significant change in the composition of our foreign fixed income holdings. Heretofore, I had been splitting the approximate 30% of fixed income dedicated to foreign currency securities about evenly between two mutual funds, one of which invests in bonds of developed markets (the PIMCO Foreign Bond Fund, (PFUIX)), and the other of which is dedicated only to short term securities in emerging market countries (the PIMCO Local Developing Markets Fund, (PLMIX)). The former fund's securities are almost entirely denominated in euros, British pounds and Japanese yen. But these economies are on the same side of the commodities boom as is the U.S.; i.e., they are net importers of oil and other

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<sup>12</sup> See "The Case for Diversifying with Commodity Futures", September 30, 2005, posted on the MAM website, [www.marshalla.com](http://www.marshalla.com).

commodities. Even Britain with its North Sea assets has now become a net importer of oil, and Euroland has recently joined the countries with net current account (i.e., trade) deficits.

Last week I made the move to sell out all of our holdings in the developed markets fund (PFUIX) and re-invest them all in the emerging markets fund (PLMIX). So now the typical MAM portfolio has about 30% of its fixed income assets in this fund.

I still believe the U.S. dollar is likely to remain weak, but much more so against emerging markets currencies outside of Europe and Japan. In fact, by now the euro seems to be fairly- to over-valued relative to the U.S. dollar<sup>13</sup>. It has appreciated 19% versus the dollar over the past year and half. During the same period, the British pound has about held about steady. The Japanese yen had been rising versus the dollar about as much as the euro for most of the 18 month period, but it changed course abruptly three months ago, during which time it depreciated by 6.5%. Its net change in the 18 months was a rise of 11% versus the U.S. dollar.

### **Where We Are Now**

I thought it would be interesting to see what fractions of total assets under management (AUM) at MAM are currently accounted for by the four investment categories discussed above. After completing the foreign fixed income transactions described above (July 2), the approximate percentages are the following:

- **Commodity Futures** – 7.4% of AUM
- **Energy Stocks** – 10.6% of equities, or about 7.5% of AUM
- **Emerging Markets Stocks** – 2.7% of equities, or about 1.9% of AUM
- **Emerging Markets Local Currencies** – 4.2% of AUM

Adding these up, we conclude that about **21%** of assets under management are accounted for by investments that are tied to commodities and emerging market economies. Actually many of the large multinational companies that we and our mutual funds hold obtain a substantial portion of their revenues from emerging market economies, so the total participation is actually even higher.

The focus of this discussion has been on the worldwide commodities boom. I've noted that none of the four investment categories discussed here are actually direct plays in commodities. Even so, these have been the four best performing investment categories in which we are participating. So if we changed the focus of the discussion to "winning investment categories", these would still be the ones to discuss.

### **Investment Strategy Going Forward**

Is 21% the right amount to be allocated to these "hot" investment categories? This may not seem like a high percentage to some, and in fact, most of our portfolios are still underweighted in energy stocks relative to the market. But, I estimate that a year ago this percentage was closer to only 12% or 13% of AUM. Given that my style is to make modest and deliberate changes in our asset allocations, this looks like quite a significant increase to me.

It is a dangerous practice for investors to chase last year's winners, unless there are good *fundamental*, valuation-based reasons to believe they will continue to be good investments in the

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<sup>13</sup> An important factor keeping the euro strong for now is relative interest rates. The ECB has yet to follow the U.S. in decreasing European interest rates; in fact, they *increased* the reference rate in Europe last week to 4.25%, a seven year high. This compares to 2.00% for the equivalent U.S. rate. This differential may keep the euro strong for now, but I don't expect the differential to remain this wide for long.

future. In early 2000, the PE ratio for Cisco Systems was over 90, and even though Cisco was, and is an excellent company, it was horribly poor investment to make at that time and price<sup>14</sup>. On the other hand, I believe the fundamentals for some of the highlighted investment categories still look pretty good even now after their big price run-ups. Just as one small example, the forward PE ratio for Exxon Mobil currently stands at 9.4, an awfully far cry from the near or over triple digit PE's that the big tech stocks had eight years ago<sup>15</sup>. In fact, energy stocks in general continue to have fairly low PE multiples, which signals that investors have *not* valued them based on the idea that energy prices will continue to rise as they have recently. And the emerging market currencies surely seem to remain undervalued. On the other hand, valuations are a little worrisome for emerging markets stocks and commodity futures, although they have not reached clearly over-valued status.

All things considered, my plan is to continue on a path similar to that of the past year or so, which is to say to deliberately and modestly continue adding to our portfolios' participation in the commodities and emerging markets stories. I don't favor jumping in with both feet. But a well diversified portfolio should not be markedly under-weighted in these segments either. Here are some specifics:

- **Commodity Futures** – Since I first introduced commodities futures as an asset class for our portfolios three years ago, I have always thought they could eventually be a larger part of our portfolios, perhaps as much as 10% or a bit higher. But I took a conservative route of starting with a much smaller allocation and planned to build it up if things worked out. As I go through our next round of portfolio reviews over the second half of the year, I expect I will be comfortable with targets between 6.5% and 9.0% or so, depending on the portfolio's aggressiveness. So you may end the year with a bit more commodity futures than you have now, but not much. If allocations grow beyond these new targets, I will resume rebalancing them back to their targets.
- **Energy Stocks** – I am still not a full fledged bull on energy stocks, but even with the additions I have been making to our portfolios, our energy stock weights are only about two thirds of the weights for the US market. So I think it makes sense to add another shot of energy stocks to our portfolio during the next round of reviews. I would envision another 1.5% to 3% of equities being added, but this will depend on the valuations of energy stocks at the time.

This may not be a bad time to add more energy stocks, given that energy stocks on average have fallen about 8% in the past two weeks, while the upstream oil and gas segment has dropped 11%<sup>16</sup>. The price-to-prospective earnings ratios of these two segments stand at only 11.3 and 14.0, respectively, both of which are lower than the overall stock market average.

- **Emerging Markets Local Currencies** – As mentioned above, just last week we executed across-the-board trade orders that approximately doubled our holdings in the PIMCO Local Developing Markets fund. It now commands about 30% of our fixed income holdings and 4.2% of overall AUM. This was a very bold move for me, given my

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<sup>14</sup> Cisco stock came to exceed \$80 per share in March of 2000. Despite huge growth in revenues and earnings since then, it closed at \$22.88 today, and currently sports a PE ratio of about 16.

<sup>15</sup> In the 8 plus years since March 2000, the Exxon Mobil stock price has increased by 123%, while its dividend has nearly doubled. Over the same period, Cisco stock has fallen by 71%.

<sup>16</sup> The price changes cited are those of the Vanguard Energy ETF (VDE) and the SPDR S&P Oil and Gas E&P ETF (XOP) between June 23 and July 8, as reported by the MSN MoneyCentral Investor website. Their current PE ratios are taken from Moringstar.com.

usual more deliberate style. I don't expect to move any farther in this direction during the upcoming round of reviews. Just for perspective, I first began buying this fund for client portfolios in March 2006, with initial targets set at around 12% of fixed income.

- **Emerging Markets Stocks** – I have agonized over emerging markets stocks for just about the whole time I have been in this business. In principle, I like the idea of selecting international fund managers with the prerogative to buy stocks in whichever countries they like, be they emerging markets or developed countries, and that is what I have been doing for most of the time since the start of MAM. However, in practice we do not usually get very much emerging markets exposure this way. As I mentioned, the Thornburg International Value Fund<sup>17</sup> does have a significant (16%) weighting to emerging markets stocks now, but the others do not. As a result, emerging markets represent only 2.7% of all equities at MAM, and just under 9% of international equities.

An alternative for increasing our exposure to emerging markets stocks would be to add a dedicated emerging markets equity fund to our portfolio. One negative argument against this is that emerging markets stocks have been far more volatile than stocks from more developed regions. There are a number of reasons. One, some of these countries live and die with commodities cycles. Two, the local monetary, economic and political systems of these countries have historically been far from stable. And three, investor sentiment seems to have at times swung these investments all over the map for reasons that are more emotional than rational. But the basic issues of monetary, economic and political stability have now receded in significance to a significant degree. Some of these emerging market countries – like Brazil, China and India– have come a long way on all of these fronts in the past five years or so, and might now be considered closer to “emerged” economies. The monetary systems have stabilized and future economic growth rates will almost certainly be much higher in these countries than here or in Western Europe and Japan.

I think that long term, emerging markets stocks should have a significant place in a diversified portfolio, and probably a good amount larger than the 2.7% of equities we have now. What I would like to do is to add an emerging markets equity fund to our target allocations, while continuing to let our other diversified international managers have the prerogative to buy where they choose. This would put a floor on our emerging markets exposure equal to the target for the new emerging markets fund, while allowing our discretionary managers to flex that percentage up or down based on their own judgments. I am thinking that an allocation of something like 4% to 8% of equities for a dedicated emerging markets fund would be reasonable. Based on today's numbers for our other funds, this would give us a total stake in this market segment of roughly 8% to 11% of equities.

The dilemma is finding an entry point. Although emerging market stocks have cooled off this year, they were so hot for the five previous years that I am concerned that we would be buying at too high valuations. So I am not yet making the move to add an emerging markets fund to our portfolios, but I am keeping a careful eye on the market and waiting for an entry point. Consequently, it should not come as a surprise if you see an emerging markets fund added in your next portfolio review or two.

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<sup>17</sup> This was the best performing fund held at MAM last year, with a 28.2% total return.

## **In Summary**

It has been a lousy year for investors so far; there is no way to sugar coat it. Energy stocks and commodity futures have been the only bright spots. But market fluctuations are nothing new. Large cap domestic stocks have declined an average of almost one out of every three years since the 1920's, and in 15% of all rolling three year periods. On the other hand, there has *never* been a fifteen year period in which stocks have lost money, and over five year periods they have lost money in real (inflation-adjusted) terms less often than have supposedly safe bonds.

Our macro economy continues to be very weak, and there are no signs yet of recovery. The busting of the housing boom, exacerbated by absurd mortgage lending practices, and combined with the surge in oil prices, has dealt severe shocks to the system that cannot be quickly shrugged off. It looks like we are going to be in a recession for at least a few more quarters. But on the plus side, the scariest aspects of the credit crisis have diminished. And for investors, the good news is that we are unlikely to have to wait for the economy to actually revive before look-ahead investors start to push the prices of at least some market segments upwards.

Commodity prices have been going up for more than five years, and some have increased even more than oil. Commodities are notoriously subject to boom and bust cycles, and I believe that up and down cycles in prices will continue to occur. But the unprecedented scale of industrialization and growth going on in huge countries like China, India and Brazil are likely to cause the up-and-down path of commodity prices to be appended to a secularly rising trend line. We still must be very careful in attempting to invest in this story, since we are probably closer to a local cycle top than bottom. But the growth of emerging economies and the effects, not only on commodity prices, but on investments of virtually all types, cannot be ignored.

Our investments that are the most closely tied to the commodities boom and to the growth of emerging markets include the following:

- Commodity futures – via the mutual fund PCRIX and the exchange traded note DJP
- Energy stocks – through energy ETF's (IEO, VDE and others), directly held energy stocks, and diversified equity funds
- Emerging markets currencies – via the PIMCO Local Developing Markets (PLMIX) fund
- Emerging markets stocks – presently through stocks selected by our diversified international equity fund managers (especially TGVIX), and likely someday through dedicated emerging market stock funds as well.

I have been gradually adding to our participation in these areas over the past year, and presently about 21% of our assets are so inclined. I will most likely continue to modestly add to these areas over the rest of this year. But as always, I may refine or modify this strategy if prices or other economic conditions so warrant. (Given the current political climate I hope this won't cause me to be called a "flip-flopper"!)

In closing I remind you as always to keep the faith and maintain the kind of patience that is essential for the success of any investor in volatile but potentially rewarding asset classes.

***Best Regards,***

***Bob Marshalla***  
***Your Financial Advisor***

*An excerpt from:*

## **“Why Are Stocks Sinking Again?”**

*In Market Insights, by T. Rowe Price, June 2008*

Why the latest downturn? The crux of the problem is that the U.S. economy is experiencing slow growth while inflation is rising—perhaps the worst of all worlds. The Federal Reserve reduced the fed funds target rate from 5.25% in September 2007 to 2.00% in April 2008 to help the economy get through the credit crunch that started last summer. However, inflation is on the rise, and raising interest rates to combat it could hurt the still-fragile economy.

Here are some of the particular concerns weighing on investor sentiment:

**Continued financial sector woes.** Some investors had been hoping that the worst of the subprime mortgage market implosion—which started over a year ago—had passed and that the fundamentals for financials would start to improve. But many banks, brokerages, and insurance companies have continued to warn about mortgage-related losses, weak earnings, dividend cuts, or the need to raise additional capital to replenish their balance sheets. With the sector representing nearly 16% of the S&P 500 at the end of May, weakness in the sector is dragging down the rest of the broad market.

**Housing market weakness.** The residential real estate market remains weak, with foreclosures and mortgage delinquencies increasing, and very few signs of broad stabilization in housing sales or prices. Falling home prices may make homeowners feel as if their net worth is declining, even if they have no intention of selling. What is certain is that falling prices mean homeowners have less equity to tap via home equity loans or lines of credit. Some even owe more on their mortgage than their house is worth.

**Rising food and fuel costs.** Eating is necessary for survival, and most people depend on their cars for daily transportation. Consequently, higher food and energy prices reduce the amount of money available for discretionary purchases and contribute to slower economic activity.

**Inflation.** The U.S. imports many products, and as the U.S. dollar weakens versus other currencies, import prices rise. Also, businesses whose earnings are being eroded by higher costs are increasingly seeking to raise prices of their goods and services. As other businesses do the same, inflation takes root in the economy, and money loses its purchasing power. In addition, rising prices may also discourage or delay some economic activity. For example, some consumers may decide to save their money or wait for their next raise before making a big purchase.