

## *Q1 2009 Commentary: Glimmers of Light*

*By Bob Marshalla  
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### *Glimmers of Light – But Just Glimmers*

Our deep recession and financial sector mess linger on and will without a doubt stay with us for at least the next several quarters. But they won't last forever. Since the financial crisis went into overdrive last September, it has seemed that the economic news has just kept getting gloomier and gloomier. But within the past several weeks, there have finally been some glimmers of light, although I would not yet call them the "light at the end of the tunnel". These include:

- Housing sales and housing starts showed significant increases in February.
- The inventory of unsold homes nationally continues to decrease and is now actually below its 35 year average. It has fallen by 42% since reaching its peak in July 2006.
- Mortgage rates have fallen to 4.6%, which is lower than they have *ever* been since we began keeping track in the 1970's. Mortgage applications (though mostly for refinances) have surged to levels as high as three years ago. And the mortgage payment on the average new home is lower as a percentage of household income than it has been for over 35 years.
- Some large banks have reported surprisingly good operating results for the year to date. Wells Fargo announced record quarterly profits, and even Citigroup has been turning a profit. A sharply upward sloping yield curve is very good for banking operations, and the Fed is keeping it that way by setting its target Fed funds rate between zero and 0.25%. (Of course future write-offs from bad loans is another story; these are separate from operating earnings.)
- The Treasury finally released the specifics of its plan to deal with toxic assets. No one knows how well the plan will work, and if it does work who from amongst the banks, private investors and taxpayers will benefit most. But the stock market certainly reacted positively, as a nice stock market rally began on the day of the plan's release.

The recent market rally has seen the S&P 500 surge upwards by 27% in just the month since March 9. As of today (April 9), the market is down only 5% for the year to date. While it feels good to see some signs of recovery, I remain dubious that we have fully turned the corner. This is already the third time the market has shot up by over 20% in a short period since last September, and I expect we are in for a continuation of a harrowing roller coaster ride for at least the next several quarters.

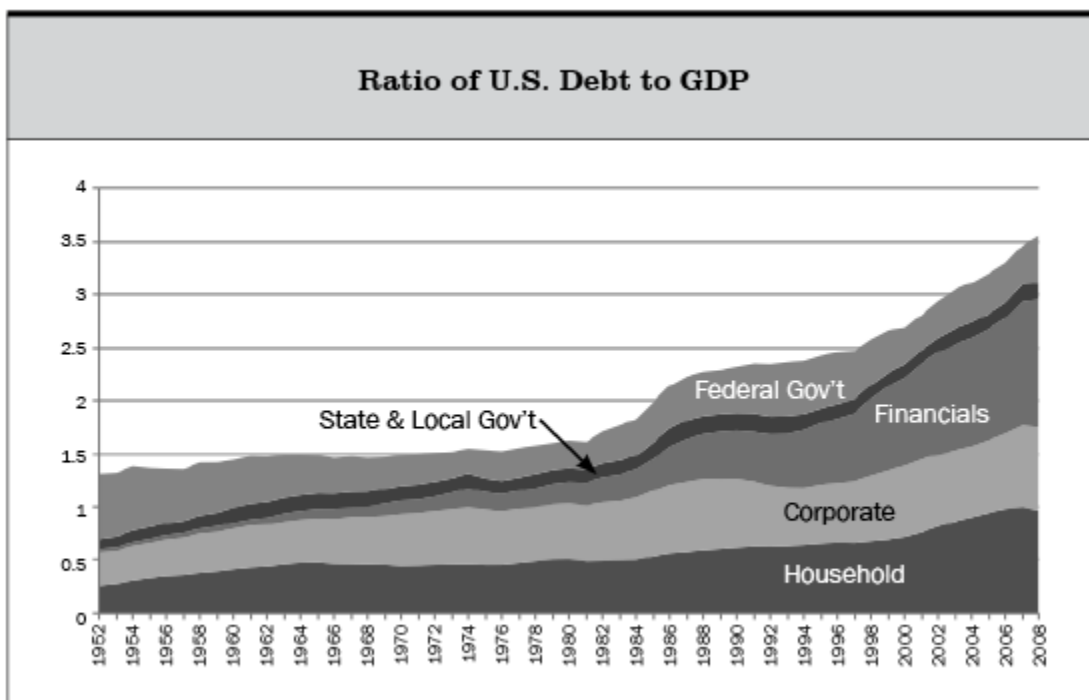
<b>Market Returns - First Quarter 2009</b>			
	<b>Representative Index or Fund (blue font)</b>	<b>First Quarter 2009</b>	<b>Year 2008</b>
<b>U.S. Equities</b>			
Full U.S. Market (98% by MC)	Russell 3000	(10.8)	(37.3)
<b>By Market Cap</b>			
Large Cap	S&P 500 (incl. dividends)	(11.0)	(37.0)
Mid Cap	Russell Mid Cap	(9.0)	(41.5)
Small Cap	Russell 2000	(15.0)	(33.8)
Micro Cap	Russell Microcap	(15.2)	(39.8)
<b>Value &amp; Growth</b>			
Growth Stocks	Russell 3000 Growth	(4.5)	(38.4)
Value Stocks	Russell 3000 Value	(17.0)	(36.3)
<b>Economic Sectors</b>			
Best in 2008	Consumer Staples	(11.3)	(17.7)
Best in Q1 2009	Information Technology	4.0	(43.7)
Worst in 2008 & Q1 2009	Financials	(29.5)	(57.0)
Best for Past 5 & 6 Yrs	Energy	(12.1)	(35.9)
<b>International Equities</b>			
Large Cap	MSCI - EAFE	(13.9)	(43.4)
Small Cap	MSCI - EAFE Small Cap	(9.6)	(47.0)
Emerging Markets	MSCI - Emerging Markets	1.0	(54.5)
<b>Real Estate</b>			
Equity REIT's - Domestic	NAREIT Equity Index	(31.9)	(37.7)
	Morgan Stanley US Real Estate	(29.3)	(38.1)
Equity REIT's - Foreign	EPRA Global ex US Index	(14.8)	(52.0)
	Eur. Investors Int'l Property	(14.2)	(48.5)
<b>Commodities</b>			
Commodity Futures	Dow Jones AIG Com Index	(6.3)	(35.7)
	PIMCO Commodity Real Ret	(0.9)	(43.3)
<b>Fixed Income</b>			
Investment Grade Bonds	Barcap Aggregate Bond Idx	0.1	5.2
Inflation Protected (TIPS)	Barcap US TIPS	5.5	(2.4)
	PIMCO Real Return Fund	6.1	(6.4)
High Yield Bonds	Barcap High Yield Corp Bd Idx	6.0	(26.2)
Floating Rate Bank Loans	Eaton Vance Floating Rate	9.3	(30.3)
Int'l Bonds, Developed Mkts	PIMCO Foreign Bonds	(5.6)	(4.0)
Emerging Mkts Currencies	PIMCO Developing Local Mkts	(3.9)	(14.6)
Short Term Money	3 Month T- Bills	0.1	1.5

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

Also, a note of caution when viewing your performance reports is that much of the recent market run-up has occurred in the week and half *after* March 31, which is the date that applies to all of the quarter end reports. The S&P 500 was down 11% year to date through March 31, and some other important market benchmarks were down considerably more than that. For example, domestic small cap stocks were down 15%, value stocks lost 17% (largely due to financial stocks), and domestic REIT's lost an incredible 32%. So the good news discussed above is certainly not yet all reflected in your first quarter reports! But as of this writing most of the equity and real estate mutual funds we hold in our portfolios are up by double digits just since quarter end.

### ***Recap of the Current Economic Situation***

The list of issues affecting today's investment landscape is dizzying and at the top is the dismal state of the global economy. The fundamental problem is that over the past several economic cycles U.S. households and the financial sector took on increasing amounts of debt relative to their assets and income in order to fund consumption and investments. This trend was self-reinforcing as purchases with borrowed money drove up asset prices (especially home prices) and profits, which supported even more borrowing. Ultimately the upward spiral was unsustainable, and now forced deleveraging has created a self-reinforcing adverse feedback loop of falling asset prices and lower spending and profits. As the economy deteriorates, contributing factors such as rising unemployment, mortgage defaults, loan write-offs, reduced lending, and overall fear all fuel one another. This "debt-deflation" cycle can be very difficult to break, and is essentially what happened in the U.S. during the 1930s and Japan in the 1990s. Japan has still not fully recovered from it.



Importantly, this is not just a U.S. economic problem, but a severe global economic slowdown—almost certainly the worst since the 1930s. So the United States and other countries cannot count on export-driven growth (i.e., demand from foreigners) to help stimulate their economies.

Indeed, the World Trade Organization recently forecast that global trade (export) volumes would drop by 9% in 2009, “the biggest such contraction since the Second World War.”

In short, we are in the midst of a global economic crisis. In such a situation, most experts agree, the government needs to step in as a consumer and lender of last resort to try to stop the adverse feedback loop, or at least to mitigate the extent of the damage from deleveraging within the private sector. In effect, the public sector (the government) must leverage up and spend in order to try to plug the gap created by the deleveraging in the private sector. The \$800 billion fiscal stimulus package and the monetary and credit policy actions undertaken by the Federal Reserve and the Treasury to support the financial and credit markets are the result so far.

But there is significant doubt and disagreement as to whether and to what extent the current crop of economic policies and programs will be successful in stopping the economic slide. And as uncomfortable as it is to say it: *no one really knows*. Economics is an inexact science, to put it mildly. There are too many variables that interact in dynamic and unpredictable ways. Moreover, as globalization has led the world’s economies to become even more interconnected this complexity has only increased.

### ***Public Policy***

While I freely admit to being uncertain about a lot of things in this environment, I am confident that the current administration and the Federal Reserve are very aware of the severity of the economic challenges we are facing. For example, Larry Summers, the head of the White House’s National Economic Council, has talked of the need to “contain what is a very damaging and potentially deflationary spiral.” And Federal Reserve chairman, Ben Bernanke, and President Obama’s chief economic advisor, Christina Romer, had previously written papers on the causes of and lessons from the Great Depression. We are also confident that they will *try* to do everything they can to break the downward momentum. Last December, for example, the Federal Reserve cut the Fed Funds interest rate to zero for the first time ever. It subsequently took additional unprecedented steps to inject more liquidity into the economy and loosen up the sclerotic credit markets, by announcing that it would buy up to \$300 billion of longer-term Treasury bonds and \$1.25 trillion of agency mortgage-backed securities. Most recently, the Treasury announced the details of its plan for a public-private fund to purchase up to \$1 trillion of “toxic mortgage assets” from bank balance sheets with the goal of getting the lending markets to start functioning normally again.

The policies and programs recently announced are likely to help move the economy towards recovery. But what we have now is not enough to fully solve the serious problems we are facing and additional government actions are likely in the months ahead. Still, no matter what policies are introduced the impact of consumer and financial system deleveraging will almost certainly be a significant drag on economic growth over the next several years, as saving and paying down debt replaces borrowing and spending.

Furthermore there will likely be longer term consequences in the form of a weaker dollar, higher inflation, higher interest rates and tax rates and, consequently, subpar economic growth and corporate profit. So while preventing a debt-deflationary spiral from taking hold right now absolutely must be “job one” of the government, the longer term side effects of the cure may include lower growth and/or higher inflation down the road. But if there is no cure now, the longer term future would undoubtedly be even worse, as the current recession and financial paralysis could linger on for years more instead of just a few quarters.

There is a huge amount of uncertainty as to how this all plays out. But it is important to remember that while uncertainty is uncomfortable, it is always an aspect of investing and it is

what creates great long-term opportunities. (If there was perfect certainty about the future, one would never be able to buy an undervalued asset.) So how do we make investment decisions in this environment? We use the same framework that we have always used: assessing the potential risks and longer-term return opportunities in various scenarios across a variety of asset classes.

### ***Our Less Risky “Middle Course”***

I am in the process of completing the investment strategy changes I explained to you about three weeks ago. These changes include a second phase of decreasing our asset allocation targets for risky assets (stocks, commodities and real estate), as well as shifting some assets within the equity category into what I am calling “adventurous” bond funds. To review, the combined effects of these changes plus those made last fall, are to:

- (1) allocate 10% to 15% less of portfolio assets to the risky asset classes,
- (2) shift about 8% of equities to somewhat safer adventurous bond funds, and
- (3) hold the next nine months worth of anticipated cash withdrawals in safe money market funds, accounted for outside of allocated assets.

This is the “middle course” I discussed in last quarter’s commentary. It is a course that is still based on long term optimism about our economy’s ability to function, even if not quite as robustly or safely as we once thought. In other words, we are continuing to stay invested in things that have the potential to generate good after-tax, after-inflation returns. But we are doing so with a little bigger allocation to the safer assets that will moderate the roller coaster ride that the higher potential return assets travel.

(Not quite everyone at MAM has decided to pursue this middle course. In several writings, I have suggested the possibilities of taking either a more conservative or a more aggressive path, and a handful of you have chosen each of those alternatives. Given the wide variation in personal circumstances and heightened uncertainty we all face, I have tried to be open to differing perceptions and amenable to developing differing individual strategies.)

We have retrenched a bit, but our basic long term investment strategy remains the same. As I have said many times, it is a strategy that requires faith and patience, and our faith and patience are being tested now like never before (unless you were alive in the 1930’s). But if you believe as I do that the economy *will* recover -- as it has over the past two centuries from every war, depression, financial panic, terrorist attack and more -- then keeping with our strategy of staying invested in diversified asset classes for the long term makes as much sense as ever.

***Best Regards,***

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