

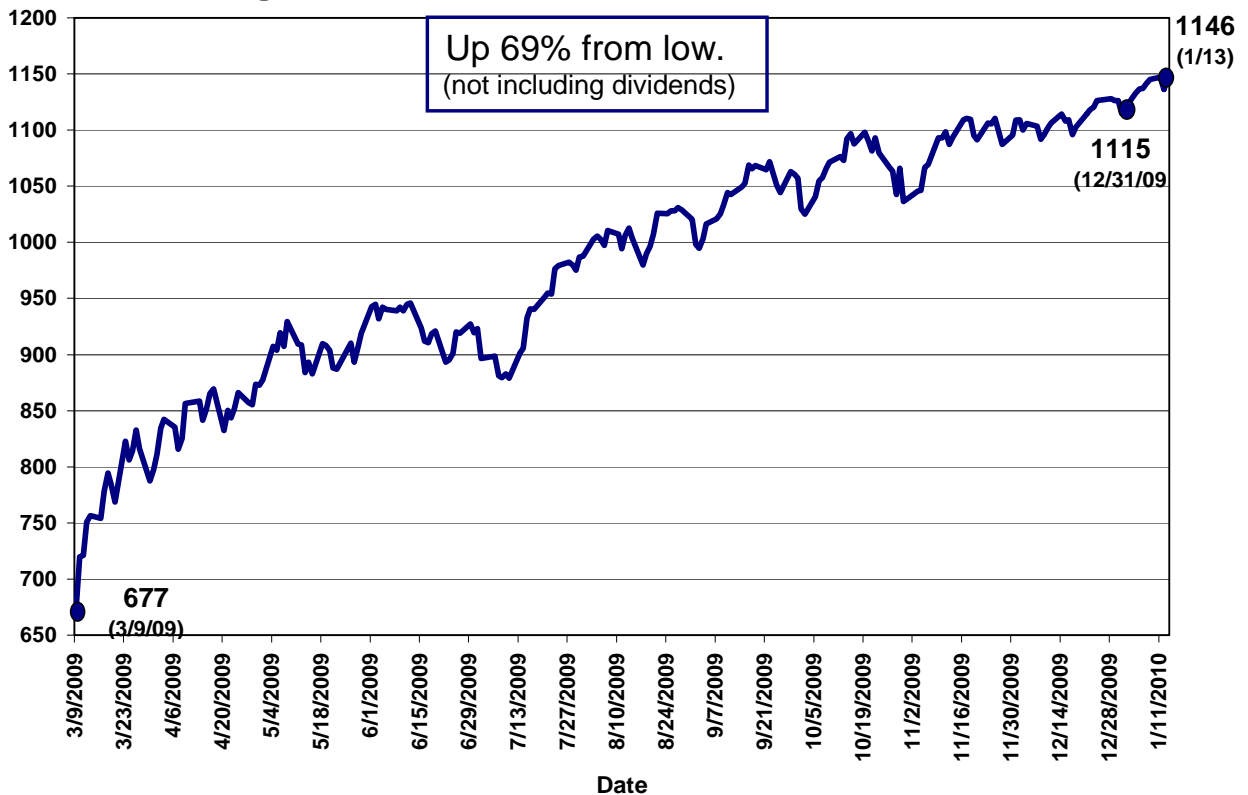
*Year End 2009 Commentary:  
An Excellent Year for Investors,  
but a Cautious Prognosis for the Future*

*By Bob Marshalla  
Jan 14, 2010*

***2009's Equity Market Rally and Future Prospects***

Despite a plodding and fragile economic recovery, equity and most other asset classes, including real estate, commodities and bonds, have continued their robust recovery since they hit bottom last March. The S&P 500 has gained an incredible 69% from March 9 to the date of this writing (January 13)<sup>1</sup>. The figure below illustrates the happy story. Most other equity classes, including smaller stocks, international developed markets and emerging markets have done even better.

**Figure 1 - S&P 500 From Market Low to Date**

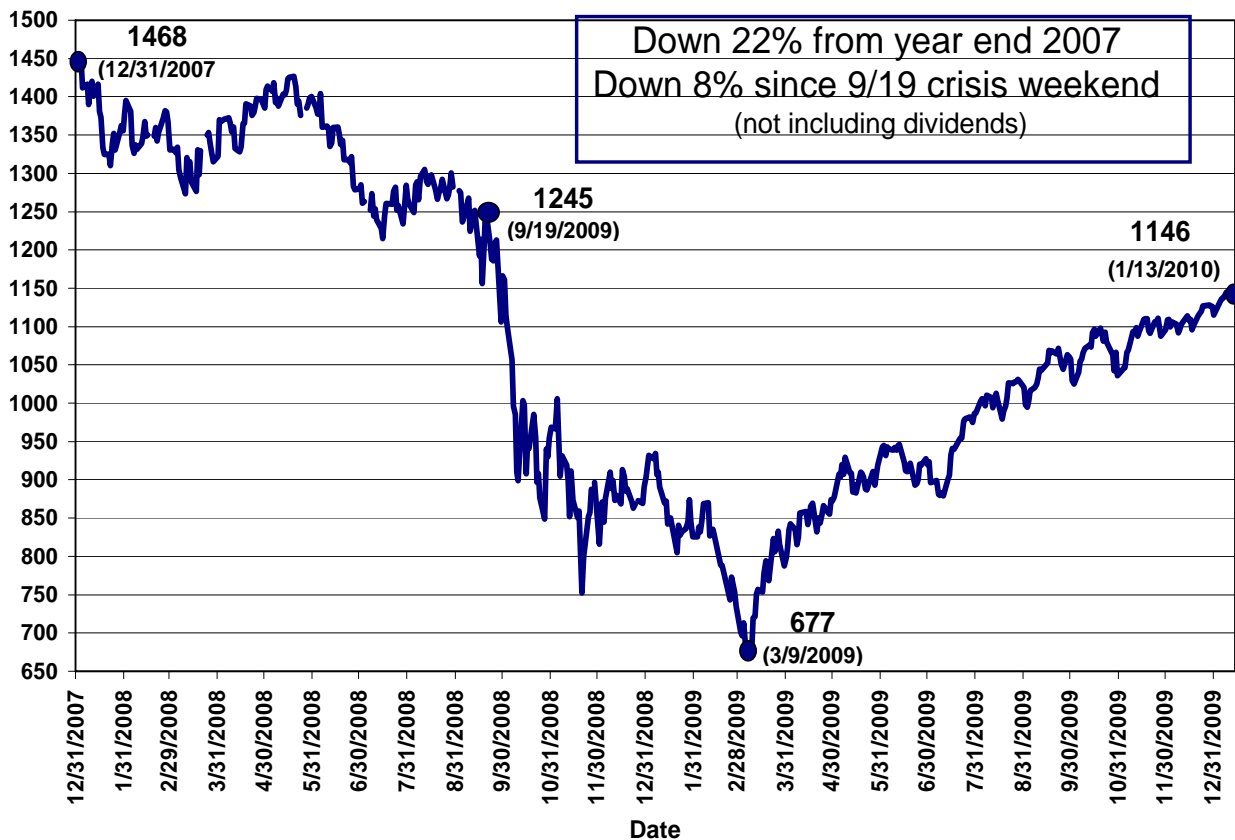


<sup>1</sup> This does not include dividends, which would add about 2% more to the total return.

Of course, investors still have enormous amounts of ground to recover. A nasty recession officially began two years ago in December, 2007, and this was followed by our descent into an acute financial crisis that really took off starting last September. This was easily the most serious financial crisis to ensnare us since the 1930's. Every asset class with any risk whatsoever was hammered as investors became extremely fearful. The S&P 500 lost 57% of its value from its all time high in October, 2007 through last March 9's low. And many other less "blue chip" style asset classes lost considerably more. So while we have enjoyed an incredible recovery in the past 10 months, we still have a long ways to go to get back to previous market highs. (A 57% decline necessitates a 133% gain to get back to even.)

Figure 2 puts the recent market advance in this context, by showing the S&P 500 from the end of 2007 up through today. It shows that the S&P is still down 22% from where it started last year, although it is only 8% lower than at the onset of the infamous weekend of September 19, which I consider the onset of the acute phase of the financial crisis. (It was the weekend that Lehman, AIG and Merrill Lynch all went under at the same time, and when Hank Paulson and Ben Bernanke announced that without immediate government action, the whole financial system might collapse.)

**Figure 2 - S&P 500 from 2008 to Date**



This year's market action is a glass half full half empty tale. We have recovered a bit over half of the market's losses since its all time high, and we have done so in record time. But we still have a long way to go, and progress from this time forward is likely to be much slower and fitful (i.e., with downs as well as ups). We still would need an increase of 37% in the S&P 500 to get back to its all time high.

I believe the market's rally was legitimate, despite the context of occurring within a still stalled economy. Investors had sold stocks so indiscriminately that by late last winter, they were selling at

astonishingly low valuation metrics. Of course, had the most feared outcomes of the financial crisis not been averted, and had we not managed to stop and begin to reverse the freefall of the economy, then even those valuation metrics would not have saved us. But we did do those things, and investors began to come back into the water. And it took a rally this furious just to get valuation metrics more or less back to normal.

As of today, the forward looking PE for the S&P 500 is 15.2<sup>2</sup>, which is right about equal to its long term average<sup>3</sup>. So stocks today look to be about fairly valued, neither way over-priced, nor great bargains. What this means is that from here on we should expect returns from stocks to equal the growth rate of corporate earnings plus dividends. And in turn the aggregate growth of corporate earnings and dividends both should depend directly on how fast our economy and those of our trading partners, are able to grow. If I am correct that current valuation multiples are about right, then from here on, equity investors' returns should be strongly linked to macroeconomic growth.

As regular readers know, I am at best lukewarm about future macroeconomic growth. The economy is headed in the right direction. GDP is growing again. Unemployment is still increasing but at sharply reduced rates. Lending is still very tight, but is becoming more available. And perhaps most importantly, housing prices have stopped declining<sup>4</sup>. On the other hand, the rate of growth will be severely hampered by the deleveraging process – consumers and financial institutions paying down debt, and thereby keeping spending lower than income. Also, some of the recent bump in economic growth has come from businesses replenishing depleted inventories and from government stimulus programs, neither of which are likely to last much longer than the middle of the year. A little further down the road (2011 at the earliest) taxes are likely to go up, and this will create one more headwind to growth.

All in all, a likely scenario is that economic growth will continue but at a grudging pace. Given our starting point this should allow U.S. and other developed markets' equity prices to keep rising, but at unexciting rates. The largest alternative to equities is fixed income, but fixed income rates are very low today. And after a year or two, interest rates are likely to begin increasing<sup>5</sup>, which would put a further crimp on fixed income investors. So I still believe equity returns over the next 3 or 4 years, while unlikely to be greater than mid to upper single digits, will on average still be greater than fixed income returns.

### ***Asset Class Returns by Calendar Year***

Table 1 shows the market returns for all of the asset classes we regularly monitor over calendar year periods. The first column shows the returns for the full year 2009. Even given the declines in the first two months of the year, these returns look wonderful for everything monitored. To be fair and balanced, I have added the second column to remind us of the 2008 results, which were of course as bad as any year's outcomes we can remember. For a longer term perspective, the third column shows the annualized returns for the previous five years before 2008, i.e., for 2003 thru 2007. Returns for

---

<sup>2</sup> As reported by the Zacks Research Wizard, using the Zacks database. The forward PE is today's S&P 500 level, 1247, divided by the consensus of analysts' projections of the next 12 month's earnings of the companies in the index, namely \$74.60.

<sup>3</sup> Actually a PE of 15.2 is better than it sounds because interest rates are so low. The fair level of PE depends critically on the discount rate one uses to add up expected future earnings. The lower the discount rate the higher the fair value PE. One's discount rate need not be directly determined by prevailing interest rates, but they are the most important factor influencing it.

<sup>4</sup> More than one quarter of all mortgages in the U.S. are still underwater. Rising house prices is the only thing that can fix that problem without either the homeowners or lenders suffering substantial losses.

<sup>5</sup> Interest rates can increase even if inflation does not pick up. An interest rate has two components: the real rate plus the inflation rate. Real rates continue to be very low. As of December 31, the real rate for 10 year TIPS is 1.48% and for 10 year Treasuries, 2.14%. (Source: JP Morgan Asset Management, Guide to the Markets, p. 31)

those five years were uniformly positive. This means that in the past seven years we have had six positive years and one negative year, but the one negative year was truly terrible. To pull this all together, the last column of the table shows the annualized returns for the full seven year period, 2003 thru 2009. The returns in column 4 are positive, which goes to show that as bad as 2008 was, it was not enough to destroy the positive returns of the longer seven year period.

Keep in mind that the returns for the multi-year periods are annualized, not cumulative. For example, the 2003 – 2009 return for the Russell 3000 is shown to have been 6.2% per year. This translates to a cumulative seven year return of 52.5%.

<b>Table 1 - Market Returns Thru Year 2009</b>					
	<b>Representative Index or Fund (blue font)</b>	<b>Year 2009</b>	<b>Year 2008</b>	<b>Previous 5 Yrs 2003-07</b>	<b>Last 7 Yrs 2003-09</b>
<b>Equities</b>					
U.S. Market (98% of MC)	Russell 3000	28.3	(37.3)	13.6	6.2
<b>U.S. Equities by Mkt Cap</b>					
Large Cap	S&P 500 (incl. dividends)	26.5	(37.0)	12.8	5.5
Mid Cap	Russell Mid Cap	40.5	(41.5)	18.2	9.6
Small Cap	Russell 2000	27.2	(33.8)	16.2	8.6
Micro Cap	Russell Micro Cap	27.5	(39.8)	15.9	7.0
<b>Value &amp; Growth</b>					
Growth Stocks	Russell 3000 Growth	37.0	(38.4)	12.4	6.1
Value Stocks	Russell 3000 Value	19.8	(36.3)	14.7	6.1
<b>Economic Sectors</b>					
Best in 2009	Information Technology	59.9			
Worst in 2009, Best in 2008	Consumer Staples	11.2	(17.7)		
Worst in 2008	Financials		(57.0)		
<b>International Equities</b>					
Large Cap	MSCI - EAFE	31.8	(43.4)	21.6	10.3
Small Cap	MSCI - EAFE Small Cap	46.8	(47.0)	26.4	14.0
Emerging Markets	MSCI - Emerging Markets	78.5	(54.5)	37.0	21.6
<b>Real Estate</b>					
Equity REIT's - Domestic	NAREIT Equity Index	28.0	(37.7)	18.2	9.1
	Morg Stan US Real Estate*	29.7	(38.1)	n/a	n/a
Equity REIT's - Foreign	EPRA Global ex US Index	44.6	(52.0)	n/a	n/a
	Eur. Investors Int'l Property*	51.4	(48.5)	n/a	n/a
<b>Commodities</b>					
Commodity Futures	Dow Jones UBS Commodity	18.9	(35.7)	14.3	5.9
	PIMCO Commodity Real Ret*	39.9	(43.3)	10.3	(1.3)
<b>Fixed Income</b>					
Investment Grade Bonds	Barcap Aggregate Bond	4.9	5.2	4.4	4.6
	PIMCO Total Return Fund*	13.8	4.8	5.3	6.4
Inflation Protected (TIPS)	Barcap US TIPS	11.4	(2.4)	6.3	5.7
	PIMCO Real Return Fund*	17.5	(6.4)	6.4	5.9
High Yield Bonds	Barcap High Yield Corp Bond	58.9	(26.2)	10.9	10.2
Floating Rate Bank Loans	Eaton Vance Floating Rate*	46.5	(30.3)	4.6	3.6
Int'l Bonds, Developed Mkts	PIMCO Foreign Bonds*	21.3	(4.0)	7.5	7.6
Emerging Mkts Currencies	PIMCO Develop Local Mkts*	21.6	(14.6)	n/a	n/a
Short Term Money	3 Month T- Bills	0.2	1.5	3.1	2.5

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

Some comments about the returns table, focused mostly on 2009 outcomes, are the following:

- The S&P 500 ended up with a net gain of 26.5% for the year, which was stitched together out of a 25% fall from January 1 to March 9, then a 67% return from then until the end of the year.
- Mid cap stocks in the U.S. returned 40%, which was significantly better than both large caps (27%) and small caps (also 27%). It was a “Goldilocks” market for stocks, with mid caps too small to have engaged in highly leveraged financial ventures, but large enough to have escaped the severity of the credit crunch that especially afflicted smaller businesses.
- Growth beat value by a whopping margin of 37% to 20%. This was enough to bring growth and value into a virtual tie for the full seven year period covered in Table 1. Although not shown in the table, it is quite interesting that fundamental indexing beat traditional market cap indexing by a substantial margin in 2009, 42% to 28%<sup>6</sup>. This is very unusual because fundamental indexing is generally a value tilted method and would be expected to underperform the cap weighted indexes when growth is outperforming value.
- The best performing S&P economic sector for the year was information technology at 60%. The worst was the relatively staid consumer staples sector at 11%, although, as the table shows, it also had the smallest losses of any sector during 2008.
- MSCI EAFE, the index of developed markets in Europe and the Pacific region, gained 32%, which outperformed the S&P 500 by 5 percentage points. But all of this outperformance and more was due to currency movements. In local currencies EAFE gained only 25%. So the declining U.S. dollar *benefitted* those of us invested in EAFE countries by 7 percentage points last year. EAFE has outperformed the S&P in 7 of the last 8 years, with 2008 being a notable exception (when investors poured *into* the U.S. dollar and caused a big rise the dollar exchange rate).
- Emerging markets equities were the star performer of all asset classes last year, with their MSCI Emerging Markets index up an amazing 79%. True, emerging markets fell more than developed market stocks did in 2008, but the net returns of the two years combined still favors emerging markets. And over the full seven year period reported in the table the emerging markets return of nearly 22% per year doubles the rate for EAFE and almost quadruples the rate for our S&P 500.

Oftentimes when a stock or index has risen precipitously its valuations get pushed up beyond the levels at which we should be interested in investing. But I do not believe this to be the case for emerging markets. I explain my reasoning and my decision to increase our investment in this area in an enclosed companion paper.

- Domestic REIT's had a good year, similar to equities in general, though they fell more than stocks in general thru early March and regained more afterwards. As readers will recall I exited domestic REITs in our portfolios in September because I believe commercial real estate still has significant problems ahead of it. Nevertheless, some well financed and well run REIT's may actually be able to exploit this situation, so I am not fully committed to staying out of this sector for long if I can find a way to distinguish the most capable REIT's from the rest of the sector.
- International real estate had a fantastic year, with the EPRA index up 45% and out mutual fund up 51%. Although some international markets face problems similar to those in the U.S.,

---

<sup>6</sup> Source: Morningstar Principia, Dec. 31, 2009 edition. Returns noted are for actual investment funds, SFLNX for fundamental indexing, and IWB, an ETF that seeks to track the cap weighted Russell 1000.

it is not the case everywhere; in particular not in some Pacific Rim countries. The manager of the fund in which we invest has the discretion to go anywhere looking for healthy markets and companies, and I believe he is an exceptional real estate investment manager. I did not sell out of our international real estate investments last fall, only the domestic fund.

- Commodity futures was the only non-fixed income asset class to trail the S&P 500 last year, with the Dow Jones UBS Commodities index returning only 19%. Nonetheless, the PIMCO fund in which we are invested had an outstanding year, with a 40% return. (Much of the difference has to do with how PIMCO invests the roughly 95% collateral that is posted by commodity futures buyers.)

It is hard to generalize about commodities in 2009 because the individual components of the index were all over the map. On the plus side, industrial metals as a group rose 80% and precious metals 29%. Agricultural products were on both sides of the fence, with live hogs doing the worst at minus 23% and sugar the best at plus 86%. Energy components were also mixed, with unleaded gasoline gaining the most at 74% and natural gas the least, with a 52% decline. I would not want to have to forecast the future of any of the 19 components of the Dow Jones index!

- The financial crisis upended fixed income markets even more so than equities in relative historical terms. Investors worldwide fled to the safety of U.S. Treasury issues and out of everything else, which caused us to see the widest credit spreads in history for all kinds of bonds and other debt<sup>7</sup>. High yield spreads reached nearly 20% in December, which was nearly double their previous record high over the past twenty years. Even AAA corporate bond spreads reached all time highs, and high quality corporate bond yields climbed to over 8%. As investor confidence began to come back, these spreads began falling, and most are now all the way back to normal levels. At year end, the high yield spread stood at only 7.9%. AAA spreads meanwhile fell from over 5% down to 0.8%, which is almost exactly equal to its ten year average. Falling spreads mean big capital gains for bond holders, so as a consequence, investors who bought bonds when the spreads were so high enjoyed tremendous returns in 2009.
- The high yield bond index quoted in the table returned 59% last year, while the JP Morgan High Yield bond fund, which is the largest such holding by MAM clients achieved a 49% net return<sup>8</sup>. In a similar vein, our bank loan fund returned 47%. Bank loans are short term loans by banks to companies that generally do not have the most solid balance sheets. Although they had historically been a stable, low yielding investment class, much like short term bonds, this crisis turned them into something that can best be described as “high yield light”.
- As readers may recall, I invested a significant amount of MAM assets in high yield bond funds last winter and spring, and clients already held varying amounts of a bank loan fund well before the financial crisis developed. These have been extremely profitable investments in 2009, but I believe the big profits have already been made. I don’t consider it dangerous to continue holding these investments, but now that credit spreads have returned to normal, I will likely begin selling out or at least lightening up on our commitments to these types of investments during our next review cycle.

---

<sup>7</sup> A “credit spread” for a class of bonds is the difference between their current yield and a similar duration Treasury’s yield. The spread is the commonly used metric of the amount of credit risk that investors perceive to be inherent in a given class of bonds.

<sup>8</sup> The high yield bond funds in which I have invested our clients’ assets have notably higher average credit ratings than does the Barcap and other high yield bond indexes. So the expected result is that our funds will gain somewhat less than the indexes when spreads are falling, but will lose less when they widen as well.

- The table tracks two kind of foreign fixed income, traditional intermediate term bonds from the developed countries, and very short term credit instruments issued in emerging market currencies. These fixed income classes have relatively little credit risk but are fully exposed to currency variations. For U.S. investors like us, such fixed income provides a U.S. dollar hedge. The U.S. dollar was strong in 2008 and weak in 2009, and as expected these fixed income categories performed in just the opposite ways for U.S. investors: weak in 2008 and strong in 2009. Each of these foreign bond had total returns over 20% last year after losing money the year before. (Most MAM clients have substantial holdings of the short term emerging markets class of fixed income, but we do not currently hold any dedicated developed market foreign bond funds.)
- TIPS (inflation protected bonds) also enjoyed double digit returns last year, with the index up 11.4%. Our fund (also shown in the table) outperformed the index last year by 6 percentage points, after underperforming it the year before by 4 points.
- Finally, even conventional investment grade bonds performed well last year. As mentioned, credit spreads had ballooned for all kinds of bonds that were not Treasuries, so as they fell back to normal, even conservative high quality bond investors profited. The Barcap Aggregate Bond index gained only 5%, but that is because a large part of the index is composed of U.S. Treasury securities (about 37%) which did not benefit from the spread compressions.
- Our favorite investment grade bond fund, PIMCO Total Return, returned a hefty 13% after fees last year. Only a small part of the outperformance was attributable to having a lesser fraction in Treasury issues. The fund has limits on how far it may venture from the Barcap index, and it does have 32% of assets in Treasuries, only 5% less than is in the index. Given that PIMCO Total Return is the largest bond fund available to individual investors, and that by prospectus it is not allowed to venture too far from the Barcap Aggregate index, I find it phenomenal that it has been able to so consistently outperform its index, and by so much. Last year it beat its index by almost 9 percentage points. It has only failed to outperform the index in two of the past ten years, and in each of those years, it only unperformed by amounts approximating its fees.

### ***Summary and Wrap-Up***

This year end commentary on the markets and economy has been shorter than usual because I have also distributed a companion piece about emerging market equity investments. I believe that emerging markets may be our best alternative for avoiding the slow growth most economists expect to see in the U.S. and other developed countries over the next few years. But rapid economic growth is by no means enough to guarantee that investors will enjoy high returns. In any investment, the current valuations at one's entry point must be reasonable, and the economic and political environments in which the companies will be operating must be reasonably stable and hospitable. In my companion paper I discuss why I think these things are so in the set of countries now comprising the "emerging markets" moniker, and why as a result I plan to increase our allocation to equities in these markets.

As always, please be sure to call me or Amy if you have any questions, or if you would like to get together to review your own portfolio and/or update your financial plan.

***Sincerely,***

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