



First Quarter Investment Commentary April 2009

“When the facts change, I change my mind. What do you do, sir?”

- John Maynard Keynes, economist

The Quarter in Review

The first week or so of 2009 showed some promise, but it was not long before both the Dow Jones Industrial Average (DJIA) and the S&P 500 went down to multi-year lows in early March before enjoying a nice rally towards the end of the quarter. The rally continued right up until the point that the Obama administration ousted the CEO of General Motors and threatened bankruptcy for both General Motors and Chrysler. While we are in favor of this decision, we would have liked to see it made before billions in aid were handed out to the two companies.

Treasury Secretary, Tim Geithner, unveiled his new plan to help the banking system. The plan calls for the federal government to work with private investors to try to restart the market for the troubled mortgage loans and securities, which in turn officials hope improves the financial condition of banks that have already received billions in capital injections from the government. The federal government will pair as much as \$100 billion with private capital to generate \$500 billion in purchasing power to buy the assets, and Mr. Geithner said the plan could reach \$1 trillion in size over time. Opinions over this plan have varied widely, as you might assume.

The Current Environment

The following portion of this commentary will get a little technical in places, but we want clients to have some insight into our in-office discussions, meetings and research.

The current economic environment continues to be one of the most challenging in a generation. We remain committed to making solid investment decisions using a rational approach in which careful analysis and thorough research—not emotion—underlie decisions. Key tenets of our philosophy include:

- **We will continue to have reasonable exposure to equities.** Though getting out of equities can feel like taking control of your financial situation, it is a short-term strategy that will likely have long-term negative results. Many of the lessons learned and reinforced over decades of investing have not applied in this market. One example is the idea that a 20% decline in stocks creates a good opportunity to buy. This past September that wasn't true, because the market was very late to fully discount the level of economic damage brought on by the credit crisis and the unwinding of a global debt bubble.

Our investment approach is based on long-term return expectations. This is a bit of an oversimplification, but the core analysis behind our return expectations is based on what

we think corporate earnings could be in the years ahead, and the price (P/E) at which stocks might sell at the end of our forecast period. We look at a range of broader economic scenarios, which are currently skewed toward negative outcomes—including a very negative scenario in which corporate earnings fall by levels on a par with what was experienced in the depression of the 1930s, and where at the end of the period stocks are selling at a multiple that is historically lower than at past similar points in the earnings cycle. Even in our most negative scenario, returns from equities are decent from current levels—at least in the mid single digits (this reflects downward revisions in our earnings assumptions of a few months ago and a lower assumed P/E). They would be better than that in a still-bad, but less-severe economic environment.

So while we are confident that from current levels stocks offer good longer-term return potential, we don't know what might happen in the shorter term. Stocks could drop further, or they could rebound sharply. If we try to predict this and invest accordingly, we have to consider the consequences of being wrong. If we go to cash, the market could rebound sharply before we can get back in. It is possible we could see more rallies of 20% or higher before concrete signs of sustained economic improvement appear. This is because the market is forward looking and nearly always reaches a bottom well before the economy troughs. If that happens, we could see a material portion of the good multi-year return potential that we believe exists realized in a short time. At that point we'd need to decide whether the market's turn is going to be sustained, and get back in, or continue to wait and risk losing further upside. If we did get back in, we could be whipsawed if the upswing proved to be temporary, as commonly happens during volatile markets.

On the other hand, if we remain invested, our analysis gives us confidence we will earn a good return over our five-year investment time horizon, independent of what the short term brings. We also know that we will continue to see tactical opportunities amidst the near-term weakness, and that our active managers will do their best to add value by buying stocks that have been oversold due to fear rather than fundamentals. Longer time horizons have the highest value when short-term fear is greatest, because that is when the greatest opportunities are created, but those are also the times when a long time horizon is the most difficult to sustain.

- **We are gathering as much data and information as possible to make reasoned decisions in the midst of a rapidly changing and uncertain environment.** Our ongoing research is based on a wide variety of sources, including analyzing in-house and third-party data, and reading a wide variety of opinions and analysis from independent experts. Obtaining this information and augmenting our own work helps us stay grounded and make decisions with confidence amidst this highly challenging and uncertain environment. We have been successful over many years with our tactical asset class allocations, but the potential impact of the macro environment on asset classes is far more important now than it ever had been prior to last fall. As a result, we have dug deeper in our asset class work and calibrated return expectations under varying scenarios across asset classes. Our work in this area allows us to make longer-term allocations decisions with higher confidence.
- **We continue to carefully research the managers in whose funds we invest.** We have also gone back and revisited our work on every active manager we own to assess

the degree to which their economic assumptions match ours. We aren't second-guessing at a stock-picking level, but we want to be sure our managers are appropriately factoring in the impact of a very negative environment. The same evaluation is being made of any exchange-traded funds (ETFs) we are using.

- **We are continuing to make decisions based on assessing risk and reward over our longer-term investment time horizon.** It is never easy to make decisions when uncertainty is high. But the uncertainty mainly revolves around what markets might do in the shorter term, and that is something we know we can't predict accurately. There is longer-term economic uncertainty, but we can still assess potential returns after taking into account a very poor scenario that encompasses even the most negative end of those assumptions. By doing this we can make decisions with confidence if we believe we'll earn at least acceptable longer-term returns under even very pessimistic scenarios.
- **We are taking nothing for granted.** We have sought out the most negative views we can find with respect to our overall assumptions and in the scenarios and valuation work at the asset class level. We remain willing to take risk, but the opportunities being created allow us to be selective. We want to identify only those opportunities that have a very high likelihood of rewarding us over our investment horizon.
- **We are considering every possibility in order to make informed decisions.** Intellectual honesty requires a willingness to consider new ideas and new ways of thinking, and to recognize that much of investing will always involve uncertainty. While we can't know for sure what will happen and how far the economy might deteriorate (it is this uncertainty that is grinding away at stock prices), we can assess the return environment by making assumptions so pessimistic that it is unlikely they could be exceeded. This gives us a greater margin for error on the downside and allows us to have more confidence in the low end of our return forecasts. We will continue to challenge every assumption and remain open to new information should it deserve to influence our analysis.

Looking Ahead

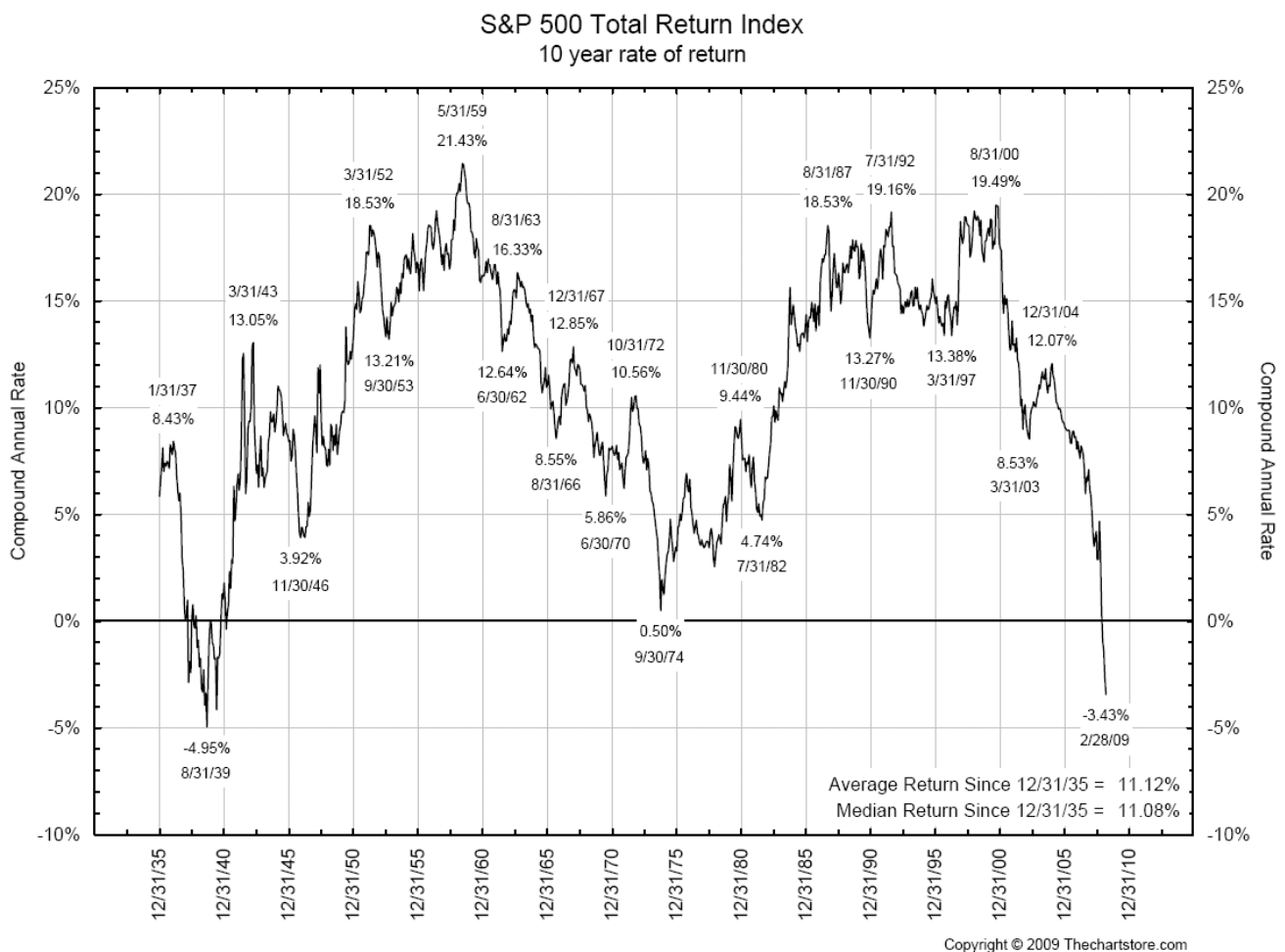
"Obama & Co. are making so many grievous mistakes in so short a period that it is simply wonderful. Wonderful, because the mistakes are so egregious that they are increasingly likely to be reversed. And that is very good news for a market that was priced to the end of the world as we know it." – Scott Grannis, economist

"The misguided policy of defending bondholders against losses with public funds has increased uncertainty, crowded out private investment, harmed consumer confidence, and prompted defensive saving against possible adversity." – John Hussman, Hussman funds

Nassim Taleb, former options trader and author of *The Black Swan*, which we have discussed in previous commentaries, is angry about the financial establishment's role in bringing about the credit crash. He calls for a new capitalism, which he calls Capitalism 2.0, in which complex derivatives are outlawed and leverage (excess debt) is eliminated. Taleb feels that the Treasury's plan is unfair to taxpayers and rewards the failure of banks that didn't understand the risks they took when using debt to boost returns in the mortgage market.

As is indicated above, the wild card in the investment landscape over the last several months has been government intervention. This will continue to be a factor in the months to come. While this does not mean that capitalism is dead, it is clear that the situation has changed due to government involvement and that we are not in an environment like 1983 through 1999, when a rising tide lifted all boats, and like driving across the plains of Kansas, you could just set your portfolio to cruise control and enjoy the ride. Portfolio management will need to be a little more active, with more adjustments than we have made historically, with the understanding that nobody can predict the market.

The chart below indicates how bad things have been over the past decade for stocks, and the velocity and ferociousness of the decline last fall. What it also shows is that, historically, such poor returns have been followed by much better returns.



Our thanks to The Chart Store for this information.

We do not believe that capitalism is dead, or that our economy is headed towards another Great Depression. Even Professor Nouriel Roubini, known as "[Dr. Doom](#)," the most famous of the handful of economists who actually predicted the current debacle (since 2004) was recently quoted as saying he might see some "light at the end of the tunnel." Roubini is not predicting an imminent recovery. He thinks that most economists are still way too bullish, that the stock market will retest its lows, and that unemployment will eventually rise over 10%. He

just thinks that the quarter that just ended will be the worst rate of decline in the economy and that things will gradually stop deteriorating and then get better from here. An economy growing without the benefit of excessive debt in the system will grow at a slower pace than one built on debt, but it will also be more stable. This is ultimately what we are looking for in the future.

Closing Comments

What does this mean for our clients? It means more use of non-traditional assets, including hedging against higher interest rates, inflation and market volatility, while making greater use of active managers who have the flexibility to take advantage of this volatility to make money. In summary, it means doing some things that are out of the mainstream and may be unfamiliar and even a little uncomfortable at times.

It also means that every one of us needs to re-assess our risk tolerance. We need to ask ourselves if it is more important to keep pace with the stock market than it is to protect principal. This is a discussion we intend to have with clients during this quarter.

We have always invested alongside our clients, so we certainly understand the disappointment and anxiety over the loss of wealth during the last year. We appreciate your confidence and patience through these difficult times, and we look forward to continue to work with you in better times ahead. We also look forward to speaking with all of you and meeting with as many of you as possible over the next few months.



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