

February 2009

## Monthly Investment Commentary

In an unwelcome but fitting encore to the worst calendar year since 1931, stocks posted their worst January ever. The large-cap S&P 500 (as represented by Vanguard 500 Index Fund) was down 8.4%. Smaller caps did even worse, with the iShares Russell 2000 ETF falling 11.1%. On the growth-value spectrum, value trailed growth by a wide margin across all market caps. Developed market foreign equities (Vanguard Total International) were down 12% in January, more than their U.S. counterparts, while emerging market equities (Vanguard Emerging Market) were down 8.2%, about the same as U.S. stocks. REITs had the worst month of any of the asset classes we track, with a 17.4% plunge, more than offsetting their 17.4% gain in December. High-yield bonds were the best-performing asset class, with a 5.3% gain.

The domestic investment-grade Vanguard Total Bond Market Index Fund was down 0.7% in January as Treasuries retreated.

<b>January Benchmark Returns (Preliminary)</b>		
<b>Large-Cap Benchmarks</b>	<b>Jan</b>	<b>YTD</b>
Vanguard 500 Index	-8.4%	-8.4%
Russell 1000 (iShares)	-8.2%	-8.2%
Russell 1000 Growth (iShares)	-4.8%	-4.8%
Russell 1000 Value (iShares)	-11.5%	-11.5%
<b>Mid-Cap Benchmarks</b>		
Russell Midcap (iShares)	-7.4%	-7.4%
Russell Midcap Growth (iShares)	-4.5%	-4.5%
Russell Midcap Value (iShares)	-10.3%	-10.3%
<b>Small-Cap Benchmarks</b>		
Russell 2000 (iShares)	-11.1%	-11.1%
Russell 2000 Growth (iShares)	-7.6%	-7.6%
Russell 2000 Value (iShares)	-14.3%	-14.3%
<b>Other Benchmarks</b>		
Vanguard Total Int'l Stock Index	-12.0%	-12.0%
Vanguard Emerging Mkt Stock Index	-8.2%	-8.2%
Vanguard REIT Index	-17.4%	-17.4%
Vanguard Total Bond Mkt Index	-0.7%	-0.7%
Merrill Lynch High-Yield Bonds	5.3%	5.3%
Citigroup World Govt. Bonds Index	-4.3%	-4.3%
JPMorgan ELMI +	-5.7%	-5.7%
DJ-AIGCI (Commodity Futures)	-5.4%	-5.4%

### Research Team Q&A

We regularly use a Q&A format to address questions from readers about our investment views and current strategy. The Q&A format allows us to address questions individually without worrying about being limited by a particular theme or subject, and also allows readers to focus on areas that are of concern or interest to them. This question-and-answer piece addresses questions we received during the past several months.

### **In recent months the portfolio changes you have made seem inconsistent with your long-term focus. What's wrong with sticking to longer-term allocations if you know you can't predict the short-term anyway?**

We understand this perception since we made more tactical asset allocation changes in the last few months of 2008 than we usually make in a few years. And we have also been more particular about the valuation levels at which we are making these changes, as we seek to make sure that very big and rapid swings in prices

don't work against us. In the current environment of extreme market volatility this often requires executing the trade quickly.

But our process has not changed. We continue to make investment decisions, including tactical over- or underweightings, based on return expectations over a longer-term (typically five-year) time horizon. We have always said we want to buy an asset class tactically when it is undervalued and then sell it when it is fairly valued, and that we typically expect this to unfold over a period of years as fundamentals and prices ultimately converge. We don't know precisely how long it will take to happen, and it could happen quickly. If it does, we might own an asset class tactically for a relatively short period of time, which benefits us by letting us realize the return more quickly. This is the reason we use index vehicles instead of active managers for tactical positions: we don't want to risk being right on the asset class but having a manager who (even though they may have superior performance over the long haul) happens to be out of synch (on the downside) with the index during the period in which we own them.

What is unusual in this environment is the speed at which relative valuation levels are changing therefore creating and taking away opportunities. REITs provide an example of this—there were a few occasions in November and December when they spiked or plunged 20% in just one or two days. A 10% move up reduces our five-year annual return expectation by about 200 basis points a year—that's enough to change a tactical decision, especially if one asset class is rapidly becoming more attractive while another is rapidly becoming less attractive.

**☑ In the Barron's cover story on January 5 they gave a compelling argument that Treasuries are extremely overvalued. Would you consider taking a short position against Treasuries as a tactical play?**

Long-term Treasury yields have risen significantly since the beginning of the year, with the 30-year bond ending January at 3.6% compared to 2.7% at year end. But we agree that Treasuries on a longer-term basis still look unattractive given their low current yields—unless the economy is headed for a sustained period of deflation, which is a scenario we would not rule out. In that scenario, long-term Treasury yields could decline significantly even from current, very low levels. Look what has happened in Japan during the past decade.

There are short Treasury ETFs that are leveraged 2x to the inverse daily performance of Treasuries. We haven't looked closely at them, but would not use them due to their leverage and the negative compounding effects over longer-term holding periods. Another option would be to take a short position in a long-term Treasury ETF. That would be a lower-risk approach than a 2x inverse fund. This is not something we have analyzed in depth, but quick math shows that if long-term Treasury yields rose back to their levels of mid-year 2008, the return from shorting would be around 15%. Of course, if rates drop back to where they started the year, you would have a double-digit loss on the short. Because of this risk, if we were to

short Treasuries in a balanced account we would likely reduce our equity exposure by a similar amount in order not to increase the portfolio's overall "deflation risk" exposure: an environment in which Treasury yields are falling sharply again is not likely to be good for equities.

Instead of shorting Treasuries we prefer to focus on the areas within fixed income that look to be offering very attractive returns (both in absolute and risk-adjusted terms), and to get our exposure through flexible actively managed funds. Our investments in PIMCO Total Return and Loomis Sayles Bond funds have very little or no exposure to Treasuries right now, as those managers also believe Treasuries are unattractive. We also recently added a position in the PIMCO Unconstrained fund, and that fund does have the flexibility to short Treasuries.

**Does modern portfolio theory still work in today's world? Should we build portfolios using asset classes with supposedly lower correlations to reduce risk or just invest client assets in asset classes that offer the most relative value at any given point in time?**

Building strategic portfolios with multiple asset classes that are not perfectly correlated in most environments is a sensible approach that should generate satisfactory risk-adjusted returns over the long term with less volatility relative to an approach that concentrates in only one or a few asset classes. But we also believe that a fundamental- and valuation-driven tactical allocation discipline can add additional value over a static multi-asset portfolio. For us, it comes down to considering what scenarios we might see in the years ahead, and how various combinations of asset classes might perform in those environments.

While diversification across various risk assets—such as equities, real estate, and commodities—did little to mitigate downside losses in 2008, we don't think it makes sense to give up on diversification based on one-year returns in an exceptionally unusual environment, though this has become a popular theme among the financial media. Meanwhile, diversification across equities and high-quality fixed income worked very well last year, e.g., the Barclays 7-10 Year Treasury iShares ETF was up 18%. It is not that surprising that in an extreme environment we experienced (and are still experiencing), where fears of a major global economic recession, that global equity markets would be highly correlated, and that REITs and commodity futures would also perform poorly, and that Treasuries, which have been historically viewed as a safe haven, would perform very well.

Looking ahead, though, one could imagine an environment where fear of inflation took hold. In that environment, one wouldn't be surprised to see commodity futures perform very strongly while Treasuries and stocks both performed poorly. So you wouldn't necessarily get much diversification benefit from stocks and bonds. But it's possible that the stocks of some natural-resource rich countries would perform strongly, providing some diversification benefit. And the same might be true for real estate, depending on the underlying supply/demand fundamentals. So it is

important not to simply rely on historical long-term average correlations when considering different scenarios.

Our experience in 2008 reinforced some important lessons that we have always believed. One is that there is a risk to relying too heavily on historical asset class correlations, modern portfolio theory, or complex mathematical models that say the chance of such and such event happening is one in a million (based on normally distributed outcomes of course). Another is that there are “fat tails” to asset class returns—that extreme outcomes happen more frequently than a normal distribution would predict. And in extreme environments, “correlations go to 1,” i.e., the average historical relationships do not hold. That’s why our approach to strategic portfolio construction has always had a strong common-sense and forward-looking overlay, on top of the historical quantitative analysis that we do.

In addition to that strategic approach, we also believe valuation and fundamentals matter, and that you can tilt the odds in your favor by identifying and tactically overweighting asset classes that are undervalued and by underweighting overvalued asset classes. This is based on our belief that within our five-year analysis horizon, fundamentals and prices will converge. Over those time horizons, valuation-driven tactical shifts can both increase returns and lower risk. We believe this is currently the case with our tactical high-yield position in lieu of equities.

**The respected BCA Research suggests that, “A likely scenario is that the market will churn for an extended period as occasional decent rallies will not be sustained.” Will your models become even more tactical and will you use inverse funds through ups and downs?**

We would not be surprised to see the type of market environment that BCA describes because we don’t think fundamentals are going to begin a sharp and sustained improvement any time soon due to the long-term effects from the bursting debt bubble and resulting deleveraging. We have already seen a couple rallies of around 20% followed by sizeable declines in the past couple of months. As we have already discussed, to the extent volatility remains very high and asset classes move from undervalued to overvalued more rapidly than they used to, we are likely to make more frequent tactical moves in our models.

We would consider using inverse funds, but we definitely will not use leveraged inverse funds, since they do not do a good job of tracking the index over longer time periods. The leveraged funds are constructed to track daily index moves, but if they are held over longer time periods—i.e., longer than one day—the compounding effect can give unexpected and very unpleasant results. For example, the UltraShort Real Estate ProShares ETF, which is designed to produce twice the inverse of the daily performance of the Dow Jones Real Estate (REIT) Index, lost 50% last year while the REIT index lost 40%.

Rather than using inverse funds it is more likely that we would simply reduce our exposure to asset classes that we view as expensive and/or risky and add to investments in the relatively attractive asset classes. But if we considered an asset class to be egregiously overvalued, we wouldn't rule out taking a more aggressive bet against it through an inverse vehicle.

### **What is your view on gold?**

At this time we don't have a high-conviction view on gold, and historically it has not been an asset that we seriously considered for our client portfolios. However, given the current environment (i.e., the huge expansion in our budget deficit and aggressive stimulative monetary policy), we are doing research on gold as a possible hedge or insurance against the risk of a sharply declining U.S. dollar, reignited inflation, or even a sustained deflationary/depression-type of scenario. An investment in a broad-based commodity index—such as the Dow Jones-AIG index—may provide similar inflation insurance as gold and would clearly be a more diversified bet. But we are going to look more closely at gold's performance historically and in various economic environments to see if there is a strong argument for adding a small position as insurance given the current environment and risks that we see. This reflects our being open to new possibilities and not anchoring to previously held views. We aren't saying we are going to invest in gold; but we are going to analyze it and give it careful consideration.

You've written about improvements to your asset-class analysis and decision making as a result of the market upheaval that began last September. Specifically, what changes have you made?

As we've discussed, our investment approach has not changed. But both the extreme volatility of the markets as well as the realization that we were likely facing an economic and investment environment unlike any we had experienced in our investing lifetimes led us to improve our analytical and decision-making framework. Here are some of the key points.

- The extreme volatility we've been experiencing requires that we be quicker to adjust to relative and absolute valuation shifts among and across asset classes. In previous years, it usually made little difference to long-term returns whether a tactical buy/sell decision was made today, tomorrow, or a week from now because valuation relationships rarely changed significantly over such short periods of time.
- We are now updating our valuation models and expected return ranges on a daily basis, and sometimes intra-day, so that we can be prepared to act quickly if necessary.
- We have also started using index ETFs (and limit orders), if needed, to capture an intra-day price without the risk that a sharp upswing prior to the

- close reduces our return potential. We now communicate these changes to subscribers via email rather than at month-end as we had done previously.
- We have enhanced our asset class models and improved our valuation framework by digging more deeply into the historical data and analyzing the set of relevant variables (such as earnings growth, dividend yields, multiples, default rates, and recovery rates) in more depth. We also have expanded the number of valuation methods and models that we look at.
  - We've expanded the range of macro scenarios that we consider possible or plausible, not limiting ourselves to just the post-WWII period.
  - We've worked harder to calibrate our scenario assumptions across asset classes, so that when we are comparing expected return ranges, we are confident that we are making apples-to-apples comparisons.

☒ The many improvements we've made over the past several months are necessitated by the environment we're in, and this is not to say we are done. We continue to make refinements and improvements to our models, to look for more and better data as inputs to our analysis, and to continually challenge ourselves and our assumptions so that we are doing the best job possible in objectively weighing the potential risks and returns. Andy Grove's saying, "Only the paranoid survive" is appropriate for a period this difficult, and we aren't willing to leave any argument unchallenged or any view unconsidered. We are pushing ourselves harder than we ever have to make sure our analysis is rigorous, thorough, open-minded, and intellectually honest.

—*Stapp Financial Planning, PLLC*