

## Monthly Investment Commentary

Stocks regained momentum in July after pausing in June, with large-cap U.S. stocks (as measured by Vanguard 500 Index Fund) gaining a robust 7.6%. Smaller-cap stocks did even better, with the small-cap iShares Russell 2000 ETF climbing 9.6%. The small-cap advantage was driven by the 11.5% gain from small-cap value stocks (based on the iShares Russell 2000 Value ETF) while small-cap growth performed roughly in line with the broader equity market. For the year to date, Vanguard 500 Index Fund is now up 11%, and growth has a sharp advantage in return over value across the spectrum of company size. Looking overseas, foreign stocks did even better, with Vanguard Total International Stock Index tacking on 10% for the month to bring its year-to-date gain to almost 22%, while Vanguard Emerging Market Stock Index gained 11.6% in July and is up a whopping 50% so far in 2009. High-yield bonds saw gains a percent or two below those of U.S. large caps in July, but the 36.7% year-to-date return for the Merrill Lynch U.S. High Yield index is more than triple the return of U.S. stocks. Vanguard Total Bond Market Index Fund was up 1.4%, and it's worth noting that active bond managers continued to handily beat that index in July.

July Benchmark Returns (Preliminary)		
Large-Cap Benchmarks	July	YTD
Vanguard 500 Index	7.6%	11.0%
Russell 1000 (iShares)	7.6%	12.3%
Russell 1000 Growth (iShares)	7.1%	19.3%
Russell 1000 Value (iShares)	8.2%	5.1%
Mid-Cap Benchmarks		
Russell Midcap (iShares)	8.8%	19.6%
Russell Midcap Growth (iShares)	7.9%	25.7%
Russell Midcap Value (iShares)	9.8%	13.3%
Small-Cap Benchmarks		
Russell 2000 (iShares)	9.6%	12.6%
Russell 2000 Growth (iShares)	7.7%	20.0%
Russell 2000 Value (iShares)	11.5%	5.8%
Other Benchmarks		
Vanguard Total Int'l Stock Index	10.0%	21.8%
Vanguard Emerging Mkt Stock Index	11.6%	49.7%
Vanguard REIT Index	10.6%	-2.3%
Vanguard Total Bond Mkt Index	1.4%	3.6%
Merrill U.S. High Yield Cash Pay	6.0%	36.7%
Barclays 7 Yr Muni Bond Index	2.2%	5.3%
Citigroup World Govt. Bonds Index	1.8%	0.3%
JPMorgan ELMI +	2.3%	8.3%
DJ-UBSCI (Commodity Futures)	3.2%	8.0%

### Q&A with Dan Fuss, Manager of Loomis Sayles Bond Fund

Dan Fuss manages several mutual funds, including Loomis Sayles Bond Fund, as well as institutional separate accounts. He has been in the investment industry for nearly 50 years. In addition to his portfolio management responsibilities, he serves as chairman of the Loomis Sayles' Global Investment and Bond Policy committees. He has been with the firm since 1976. We have always had a high level of respect for his knowledge and candor, and believe that his insights deserve to be considered by readers. This interview was conducted on July 13.

**A year like 2008 was probably one you never imagined would happen to the fund—it was down 22%. Can you talk about what you think were the biggest analytical and portfolio management mistakes that you and your team made last year?**

Not having good foresight. I did not see the [Bond fund] withdrawals coming, or their magnitude.

**The withdrawals happened because of fear stemming from the extreme dislocations in the credit market—the credit crisis. So saying that you didn't see the withdrawals ... wasn't it really the fundamentals?**

Right. The one sort of caused the other—there's the chicken and the egg.

Around Boston, the first Monday in October, when the asset allocation memos went out from Fidelity and State Street, the bond manager response was at first to laugh at them—and then to realize that people were going to act on that. But the bond managers couldn't implement their

own [firms'] asset allocation advice. That created quite a headache. The bond managers literally couldn't sell at the prices that were being assumed to purchase the stocks. Unless it was high quality, like Treasuries or agencies.

So that fed on itself through the fall. I've told the story of AstraZeneca that had brought their long bond in the fall of '07 at approximately par. You couldn't get a bid at 74 [last October]. That's a double-A [rated credit]. That was in our secondary reserve [i.e., the bond fund considered the security as part of their liquid reserve to meet redemptions if necessary].

J&J [Johnson & Johnson] was the same way. It used to be that we questioned whether that should be in the [fund's] secondary reserve or the primary reserve. Well, as it turned out, you couldn't get a bid. You could get bids on Treasuries and agencies—although you didn't really want to sell them. You could get a bid on nearly all the foreign governments—Australia, Mexico, Brazil, etc. And then as you could, we would work the corporates.

**So one element was just not estimating or seeing the potential for outflows and illiquidity. What are others? You owned some positions that probably permanently lost capital. Were there analytical or risk-management mistakes? Have you made any changes to your process as a result of the experience of last year?**

Oh, yes. I think the economics unfolded along with the markets. The inability of a number of issuers to "roll over" their financing, as they lost access to the commercial paper market—that was the biggie. That affected all sorts of people.

We certainly did not anticipate the depth of the economic decline. As a matter of fact, our chief economist and I were arguing because he didn't think it would qualify as a recession. I thought it would just barely qualify. I thought it would be inventory only, with a little slowdown in capital spending.

Well, it turned out to be a humongous inventory correction. It's like the whole world became the semiconductor industry. It just hit all the industries. It caught the currencies. To the degree there were carry trades out there—which was still large, although they'd been coming down—they all got upset. And then with a lag, the capital spending decline, which is still with us.

**We talked to you in mid-September, a few days after Lehman went under. You expressed some significant concerns about what was going on in the market and the economy. At that point, even if you had wanted to unwind some of your corporate positions, was it too late?**

The liquidity was lousy. But had I known what the end of October was going to look like I would've taken the mid-September prices. But I didn't know that. I didn't know how tough it was going to get.

**In terms of not foreseeing the severity of what became a global crisis, do you fault yourself or your team at all for not spending enough time really assessing what was going on in housing? How the trigger was there—the leverage—and how the tentacles of that were just extending everywhere?**

Well, I wish I had thought of that outcome. But again, the extent of it, I think, was very surprising to a lot of people, including me. Then how it rippled through the markets. What was already a thinning of what I call the "middle" of the market—the dealer function, the bids, and the offers—was getting thinner. We were certainly aware of that. Then it just went away. The demarcation really [began with] the Fannie/Freddie weekend. Then one weekend later you had Lehman fall. That was the point.

I don't know what else to add beyond that, but that made a difference in the economy and therefore the earnings. It certainly made a humongous difference in the markets.

Part of the market distortion—the valuation—where there wasn't economic damage to the

issuer has been correcting, really, since last December. But the economic damage done, and what I call the general financial system damage done—that's going to take a long time.

**Are there any enduring lessons from what happened to the bond fund last year? Any impact on your research or risk-management process as a result?**

With regard to the open-end funds, it's pretty clear that what qualifies as secondary reserve is a much lower number. A lot of things—triple-A [and] double-A corporates—we figured certainly qualified as secondary reserve and wondered if they should be primary reserve.

Well, experience tells us they're not secondary reserve in extreme settings. Most of the time they are. On the Friday afternoon before Freddie and Fannie, you could've sold many of those items—certainly \$5 [million] or \$10 million—easily at a fair bid.

Another thing happened in there, as you're probably aware: dealers lost confidence in the credit default swap market as a means to hedge. They didn't lose confidence in them as a way to make money, if they could be doing the writing—but as a way to hedge. Therefore, they were going to hold even less in the way of inventory.

I worked very, very hard ... on the distribution side [for the mutual funds]. Any time I give a speech or interview, I try to emphasize that the mutual funds can bounce around. That's the politest way to put it. That can be driven by cash flows alone. I mean the investment-grade fund has swung wildly. It's like you were on the top of the mast of an old sailing ship during a storm: you went back and forth on valuation.

They're not a good thing to [invest in] if you want to have principle stability. If what you want to have is income stability over time—with hopefully maybe some increase in income, and hopefully maybe an increase in asset value over time—then this is a good approach.

**So those are both fund cash-flow-related lessons.**

Now analytically—and this applies not just to the open-end funds, but across the board—you do have to keep in mind that there are circumstances—we just went through them—where you're comfortably outside of any definition of "normal" or "extended normal" insofar as the capital markets and the economy go. In other words, you're outside not only of two standard deviations, but you're outside of five or six or seven.

There've been a lot of books written on this. A few before and a lot since, saying these things do happen. What will happen to your issuer—whether that issuer would be a corporation, or a municipal government, or for that matter, a country—if this happens?

You can't really make credit selections on the basis of "well, everything has to withstand the 1,000-year event." But I think one conclusion I've drawn is that you have a more precarious situation now, analytically speaking. The world has changed. It's been gradually changing for a long time. If you examine the supply chain for any final product, you will find stuff coming from all over the place geographically.

That introduces a different element of risk or uncertainty, and for that matter, of potential. I think what happened last fall and what is happening right now in the economy [has] brought that point forward in living color. It's one thing where you're a process industry or a final fabrication that goes through extraction perhaps overseas. But any sort of fabrication, putting parts together and so forth, comes within the domestic area. You'd put it together and sell it domestically. That's one sort of thing—and that, I think the analysts are quite used to.

But when steps are taking place, for example something where the raw materials start in a place like Australia, and they move through China and Singapore ... but they're finally sold in Chicago or Berlin or Amsterdam or London, that's a very different setting.

An inventory correction really becomes a bell-ringer when you go through that many geographic locations, as well as levels of fabrication. So it makes it look that much more like textiles looked like 40 or 50 years ago—where you have all the different layers.

As you go through each layer, the amplitude of the swing in production increases. I think that caught a lot of companies off guard, with their just-in-the-nick-of-time inventories. They had assumed that inventories through the whole system were bare bones and they weren't. [And that was true for] some of the major industrial companies.

There's one other thing in here: The rating agencies have changed their approach, for now [in terms of whether] they rate through the cycle or not with a cyclical credit. They're saying, "No." But you have to understand, this is one bear of a cycle. So therefore, maybe they can't [avoid] it this time.

When you're looking at a credit that's large but doesn't have the ability to be dominant, say International Paper, Alcoa, Weyerhaeuser ... chemical companies, anything along that line, they wind up on "watch-negative." It's a reasonable assumption that a number of them will, in fact, go below investment-grade. Then they'll hopefully, with a lag, return to investment grade as the economy recovers.

That provided some decent opportunities this year. Particularly as you got into February, March, and even April to buy some really, really cheap bonds as long as you'd be willing to live through the next three to four years. At which point, they'd return to investment grade. Many examples actually now will be, we think, solid single-A credits, where they started this as mid-triple-B. Because they've learned from this, too, that you can't always go to market and raise money—even though you're a large important company that's not overly leveraged you can still lose access to the market. So they want to have a stronger credit rating.

**You've always been willing to hold something that may be volatile over the shorter term. In terms of how you put together the portfolio, has the balance between potential shorter-term volatility and longer-term potential returns changed? Again, last year was obviously such an extreme year. Has it led you to change your own risk-return balance and the way you view the bond fund, specifically?**

I'm into the next phase of thinking about the markets and the economy and what that's causing me to do is start to just very gently bring in the average maturity of the portfolio. The reason for that has nothing at all to do with building liquidity, although building liquidity is obviously a side effect of that.

Looking forward, I think the odds are increasing [that] we'll have higher interest rates for a long time to come, on a secular basis, but with a number of cycles superimposed on that. For a comparative, I would use the period of the '60s and most of the '70s.

With that happening, you say, "Whoa, I don't like the sound of that. That doesn't sound very good for bonds or for stocks either for that matter." It sounds like the rate of discount on future cash flows is going to go up. I agree with that. That's what's going to happen.

I think more near-at-hand ... and I'm not 100% confident ... this is not going to get away from us because the inflation pressures that come from such a large budget deficit that has to be financed (and will eventually have to be financed entirely domestically)—the inflation pressures that come from that aren't going to be overwhelming because we're just not using the capacity right now. We certainly do have enough plants and enough apartment buildings and enough office buildings and what have you.

**And people.**

And people. Good point. Although people are part of the problem. It's old people that are the problem. I mean I'm the problem because you guys are out there supporting me.

**Well, you're still working, Dan.**

Yes. That's true. You're still cash-flow-positive from me. But when the day comes that I don't,

then I'm going to become a big liability for you. Particularly on the medical side. I do plan to live another 30 years, and then probably vanish in a hurry. So it won't be bad. Don't worry about it. I'll try not to burden you.

**Has your view on how the secular or cyclical interest rate cycles play out changed significantly over the past six months, given what's happened to the economy? A very popular statement out there is that we're moving to a "new normal."**

In general, I agree with that.

**Where do you disagree?**

I basically expect the economy to be fully recovered [back to its previous high] four years from the past peak—which I call the middle of November 2007. I think we get back to that level—gross, not per capita, but gross—in the U.S. somewhere around November 15, 2011, at about 10:15 eastern time, in the morning.

But my guess is that this cycle is ... a sharp, deep, prolonged cycle with a blip up in the middle—which we're in the middle of, right now, by the way. You could call it a "W," if you want. But we're back to that [prior peak GDP] level in four years because the [consumer] demand offshore and Asia—and [to a lesser extent] in Latin America—is much stronger than it's been in earlier cycles. It's not only up in terms of gross levels, it's up in terms of per-capita demand.

Consumer income —per-capita income—has hit the level of where people can buy many more things than they used to. That still wouldn't make for a grand lifestyle for people in this country, but to be able to get toothbrushes, toothpaste, etc.—that's something quite new for China.

**So U.S. companies that are selling to those emerging markets should do okay? But domestically-focused U.S. companies are in for a rough time since the U.S. consumer is not going anywhere?**

Yes. But again, this cycle is short. Now all of a sudden, I'm going to sound absolutely ebullient. Put yourself in the position of software for machine tools, or some sort of equipment manufacturer. As you go forward, P&G [Proctor and Gamble] gets over there. They need whatever equipment they need to make toothpaste. They're going to have to get it somewhere. It just so happens that's made here and in Germany.

And P&G tend to favor companies centered around Cincinnati because that's who they play golf with. They get orders. When they get orders, they start to recall [hire] people. When the people are recalled, they get paid. The people who make the equipment to make the liners for diapers actually have a fairly decent business going.

**Why don't we segue from diapers to inflation or deflation.**

I think deflation is pretty much gone from North America. Not that you won't have lower prices for a while on things. But I think the underlying pressure is inflation.

We're very different than Japan in the '90s or this past half decade. Our population is still growing. Theirs is shrinking. That makes a humongous difference. The attitudes and habits of the people are different. But basically, it's a monetary argument. It says, "Well, we've had this enormous expansion of bank reserves." Poor Milton Friedman is spinning more rapidly in his grave right now.

**In a Bloomberg article a month or so ago, you were saying you thought in 10 years, CPI could be 6% or higher. In the meantime, you are also saying your wild guess for the peak in the 10-year Treasury yield is 6.25% four to five years from now, which**

**suggests that you don't think inflation is probably going to be more than 3% to 4% or so in that time frame.**

There's no magic here. But I certainly would use a number more like 4%. [Here] is a point where very reasonable people disagree. I think inflation expectations over the short term are just a residual calculation from other numbers. They're not very meaningful. Over a longer term, they can be meaningful. Or if you start to get a rapid increase in the price of consumer goods ... then I think the expectations in effect force the outcome—with the outcome being very high inflation.

Let me get really specific, but point out that it's all guesswork. We have the situation right now [where] the federal deficit has gone bananas. There will be further upward pressure on the federal deficit from the state deficits. The state deficits are partially driven by the county deficits—which are partially driven by the city deficits. In other words, the public sector as a whole is suffering from reduced revenues and higher expenses. So they have to borrow more money if they can.

Now the federal government can, as long as they're willing to, borrow it locally. Foreigners may not choose to continue to lend. In an environment like this, that probably means higher rates. But not right away. This part gets tricky, but think of the various programs that go to stimulate the economy and save the banks, etc. They wash out in a few years. They start to get their money back. The Treasury and the Fed get a higher return—at least right now—than their cost of money. If they decide to fund this with two-year Treasuries, they've got a very positive spread.

So as you look forward at the Treasury borrowing requirement, it just really escalates right now. Then it actually noses over and comes back down—starting in less than a year. But it doesn't come back down all the way, even though, by this point, the economy is on the upswing. [The deficit] doesn't get back down to, say, 2% or 3% of GDP. It gets stuck around 4%. Then it's rising again.

There are two factors in there. The dominant factor—by far—is the age distribution of the population. You're supporting more old people—particularly for medical. A secondary factor is the short-term and intermediate-term rates, and to a lesser degree, long rates go up on Treasury debt. But the cost of carrying the debt starts to rise at an escalating rate. That's forcing that deficit up.

The inflation rate won't get caught up in that right away. We do have enough capacity to make toothpaste in this country, and what have you. It's only when you start to run at fairly full capacity [that] prices start to move up. That's in this cycle. This is what I would consider a very long cycle. This recovery isn't aided until near the end by capital spending. The last part of that rise is what gets you to 6.25% [on the 10-year Treasury]. Maybe a year before that, you were at 5%—or 4.75%—or even 4.5%.

It's only when the central bank gently leans against the markets, when inflation hits the front page of the newspapers, that you start to get action [much higher rates]. But it's my guess that the central bank will not lean all that hard.

This isn't true just in the U.S. This is true elsewhere. They're not going to lean so hard as to really drive the economy down. Just slow it down. Lessen the demand. Then, when a little bit more stress shows, they'll relax and you'll be into the next [cycle].

**With our limited remaining time let's discuss the bond fund's positioning.**

We haven't made major changes. We are gradually bringing in the average maturity. I prefer to use "average maturity" because duration goes with the level of interest rates. How long will that go on? With fits and starts, unless we change our view of the world—that's probably going to be the case for the next four or five years. Then we may let it lengthen a bit, and then it will probably shorten some more.

## **Because you see this long-term secular rise in rates?**

Correct. Now, individual markets can really get oversold from time to time, for lack of bid, which really drops prices on you and gives you attractive valuation. We can respond to that. Or if we see something that we really, really like that might be a bit on the longer side, but is very cheap, we'll go buy that.

Recall that as interest rates rise on a cyclical basis—and particularly with the secular string of these things, your yield spreads actually narrow. Treasury is your incremental borrower. They borrow most of the money.

And gradually, the corporate section shrinks and shrinks in the intermediate and long area. So we watch for those things. You do your best to minimize market risk by using specific risk. Or I should say specific uncertainties. That's what we'll probably be doing for the next 20 years.

## **What about on the currency?**

From a longer-term viewpoint, I anticipate the stronger currencies being where the growth is. That's essentially in Southeast Asia. Assuming political stability, you could also say a couple of parts of Latin America. It's very hard to see a positive outlook relative to the dollar for either the euro or the yen. That's an inflammatory statement. So don't put that in headlines, please.

**It seems like that's somewhat the consensus. People say the dollar stinks, but where are you going to go? Europe's even in worse shape, and Japan is completely headed toward disaster with their demographics, etc.**

Yes. It's the demographics in both Europe and Japan. Japan will probably handle it easier than Europe. Europe has a demographic thing that's a nightmare because you have large groups of people moving into other areas, where they're not always well received. In Japan, that's very controlled.

**Back to the emerging-markets currencies, where you're roughly 4% or so in both Latin America and Asia currencies. Why not have a larger position?**

Southeast Asia is very circumstantial. You just watch for your opportunities. Latin America at this point in time is really just Brazil and Mexico. Very different types of risk [but] there is risk. [Our allocation to] Australia and New Zealand actually could be up another 1% or maybe more depending on what happens in the next few months. [By prospectus] we get capped out on everything outside of the U.S. and Canada at 20%.

Canada is at roughly half of its maximum [weighting]. The yields are no longer really attractive relative to the U.S. There will be corporate financing up there now. This fall it will start. We'll probably be doing some Canadian dollar corporate financing, if it comes to pass. That relates to the oil sands and the infrastructure necessary to support that. So I would hope at that time to be doing something. As long as our economy is still going slow, I think that I'm not going to worry about being too light with Canada.

**Looking at your triple-B exposure, it sounds like it's still kind of a sweet spot?**

That's where you'll have some good moneymakers. The typical credit in this category would be an International Paper type situation. Not dominant, but large, important, [and] number one in market share in a number of the submarkets in the paper area. They're buying in their own debt. So it's starting to look like maybe it's a mistake to anticipate them going below [investment grade]. That makes me feel good because you've got an up bond in a down market.

That's where the bargains were. They're not as much of a bargain right now. Other people are starting to recognize this.

**In terms of a reasonable return expectation for the bond fund ... the yield-to-maturity is 8.7%.**

Yes. Knock 1% off that and that'll give you a workable number if the world doesn't change.

**What's your assessment of the risk-return for bonds versus stocks, broadly speaking?**

I actually prefer corporate bonds to stocks. I'd prefer stocks to Treasury bonds. I think that sort of sets the parameters, right there.

**Thanks Dan, we've run over on our time. We spent a lot more time than we usually do on big-picture.**

That's all right. Now that the market has come back into some reasonable shape, I actually do think we're much better off focusing on the bigger picture. I think the big picture is going to dominate for a long time. My plan is to use specific risk to deal partially with market risk. But you don't have enough specific risk in bonds to offset what I think is coming from market [risk]. So we'll have to deal with market risk as well.

Everything will certainly fall into the category of not necessarily "famous last words," but words that weren't right on target.

**"Subject to change."**

Right.

*—Stapp Financial Planning, PLLC*