

## Alert: September Financial Market Volatility

The last few weeks have seen unprecedented developments on Wall Street, with the government takeover of mortgage giants Fannie Mae and Freddie Mac, the failure of Lehman Brothers and sale of Merrill Lynch, and now the bailout of the world's largest insurer, AIG. These developments are the latest and most dramatic in a painful process that has been going on for more than a year, and that will take even longer to play out fully. Many of our clients are wondering what this all means and what we are doing with their portfolios.

We have written extensively about the underlying problems stemming from the housing and lending crises in the past, and we aren't going to rehash those here. What we want to communicate is how the unfolding of this financial crisis is impacting our investment strategy.

- First, we continue to believe that over the next five years investors will make money in stocks—probably in the mid to high single digits or slightly better—even if the near-term environment gets a lot uglier.
- However, the problems in the financial system are severe. Very negative scenarios that we previously recognized were possible but unlikely now appear much more possible and to some degree are already happening. The credit markets have remained dysfunctional and this has now worsened, threatening more damage and increasing the chance that the economy will fall into a deep and/or long recession.
- Given the short-term risk, the 5-year returns mentioned above are not particularly compelling, especially in light of the near-term risks. And there are scenarios where returns could only be barely positive, though at present we believe those scenarios are quite low probability.
- The stock market has been consistently behind the curve in discounting the damage to the financial system and in turn to the overall economy. We are concerned that even as equity investors are beginning to grasp the situation, it may take more time before the severity of the financial problems are fully reflected in stock prices, partly because the damage to economic fundamentals is a moving target. However, fear is reaching the point where this could happen quickly—possibly within a matter of days.
- As we continue to assess the situation we decided to reduce the size of our equity exposure by 10 percentage points in our balanced accounts. We often warn against trying to time the stock market in the short term, so we want to make the point that this is not based on our attempting to correctly guess investor reactions to short-term events. Based on our analysis, which includes extensive conversations with investors we respect highly and who have demonstrated a strong depth of understanding of the current financial crisis, we think there is a meaningful possibility that equity prices do not fully discount the economic damage and impact on company earnings that could occur and that further declines could be material. We clearly don't know what will happen but we do think this is a realistic possibility, and that its likelihood has increased in recent days as the problems in the financial sector have worsened. Given that risk, coupled with potential longer-term equity returns that we are not yet enthusiastic about (but that are getting closer), we felt it was prudent to reduce risk in the near term. We have also decided to eliminate

our positions in local-currency emerging-markets bonds in balanced accounts to further reduce short-term portfolio volatility although we continue to believe in the long-term value of these positions (and they have been good performers for us for more than two years).

- We also recognize that selling now creates a potential whipsaw if the market stabilizes and starts to climb higher. Even if we are right and the market continues to trend lower, there is no guarantee that we will have a clear re-entry point that gets us fully back into equities at a lower level than where we are now. So selling now adds risk that in the longer term we will detract from returns by doing so. Therefore we are also focused on identifying clear criteria for when we would get back in. Those criteria will largely be a function of long-term expected returns. It is possible that we may move back into the market quickly.
- Another wrinkle in this highly unusual environment is that the sell-off in the credit markets is creating compelling fixed-income opportunities, some of which match up well against probable longer-term equity returns. Some of the losses in some areas of the fixed income markets are, we strongly believe, largely due to the lack of liquidity (buyers) not the fundamentals of the assets. We believe it is very likely that given time prices will rebound strongly when the markets eventually normalize. We are interested in these fixed-income opportunities because they potentially offer a competitive return opportunity while reducing risk if they are funded from reductions in our equity, rather than core bond, positions.

We want to let you know that while we have made these portfolios moves in light of the developments of the past week, there could still be more changes in the days and weeks ahead. This is a fluid situation that is unprecedented; virtually no one investing in the markets today has experienced a deleveraging environment like this before. History can provide perspective, but a new environment requires willingness to assess it without being tied to precedents that in some cases may be irrelevant. We will continue to focus all of our research efforts on assessing the trade-offs between risk and opportunity amidst this rapidly changing environment, and we will make decisions that we believe will generate the best long-term returns given the levels of risk that our clients can tolerate.

It is very important to keep in mind two things. First, that the worse things get, the more dislocations and asset mis-pricings are likely, and the better the opportunities that ultimately follow. Second, regardless of near-term declines that could happen, under our more negative longer-term scenarios stock returns are still positive, even at stock price levels of a few days ago (higher levels).

We appreciate your continued confidence and will continue to work hard to make the best decisions on your behalf during this challenging environment.