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An E*TRADE Wealth Management Company

Letter From The Portfolio Managers

December 2008

Turn, Turn, Turn

Eric M. Kobren

Rusty Vanneman

You are not alone.

There is an old Wall Street saying that warns not to confuse brains with a bull market. The opposite also holds true — don't confuse a bear market with stupidity. Bear markets make fools of everyone: This bear market is no exception.

Sure, there will be stories about investors who called the bear market right and somehow made money in this extraordinary environment, much like investors who had life-changing and spectacular returns in bull markets. These success stories, however, are not as common as you might think.

The reality is that this bear market has thrashed nearly every asset class, investment strategy and professional money manager. Asset classes that typically provide cover in down markets have not. Disciplined investment strategies, even those some may consider conservative, have lost ground. The list of proven, experienced investment managers with deep losses (often far exceeding the overall market) is long. As of November 20th, all of the nearly 12,000 equity funds monitored by Morningstar had lost money for the year. "Smart" money has lost. "Big" money has lost. "Fast" money has lost.

While weak and still deteriorating worldwide economic conditions are obviously a leading reason the global stock markets are down so much this year, the brutal magnitude of the losses and the extreme volatility have been greatly amplified due to non-economic factors such as emotional and forced selling. Motivated by sharp losses and extreme volatility, individual investors have been crying "Just get me out of the market," regardless of fundamental factors such as valuations. They have now dropped their equity allocations to their lowest levels in decades. Institutional investors meanwhile, such as mutual funds and hedge funds, are being forced to sell securities to raise enough cash to meet shareholder redemptions — regardless of what the portfolio managers may think of the investment merits of the individual securities.

The silver lining to such emotional selling is that it thankfully tends to be temporary. The markets will eventually revert back to tracking fundamental factors at some point. When they do, given the degree of market dysfunction and dislocation in recent months, there should be plenty of opportunity.

Nonetheless, while bear markets are normal, and just a part of the market cycles, this current bear market has been particularly brutal. It has shaken basic confidence in the markets to the point that investors are starting to wonder why they should even invest.

Can You Be An Investor?

Many years ago, I worked with an investment professional who consistently stressed that the most important question for an investor to ask is not "Which way do I think the market is going?" but simply, "Can I be an

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investor?" In short, long-term investment success wasn't about calling the market, but more about being aware of one's personal financial and emotional capability to invest in a volatile stock market.

From a financial capability standpoint, in order to be a long-term investor one needs to be able to stay the course during challenging markets and ride out temporary losses. Important factors here include a sufficient income and net worth. The level of debt, if any is held, should be manageable. A safety net, such as insurance and a reasonable amount of cash on hand (at least enough to cover six months of living expenses), should be established to handle emergencies. By definition, a longer time horizon is required. If the money in question was needed for a specific purpose within the next few years, the capital should not be exposed to the stock market.

As for an investor's psychological or emotional capability to take on risk, everybody's emotional reaction to market volatility is different. It is not uncommon to see people who take significant risks in their professional or personal lives have conservative investment temperaments – or vice versa.

Sometimes, it may take years to adequately sort out one's emotional risk tolerance. Whether an investor does it on their own, or through dialogue in a relationship with an experienced investment professional, an investor often has to live through the ups and downs of the markets to begin to fully appreciate and understand how much risk and market volatility they are willing to tolerate. Determining one's risk tolerance is not easy, but awareness of how it may be evolving is critical to formulating an investment strategy that will serve an investor well over time.

The Best Time to Invest

The stock market is not a zero-sum game. Historically, it has provided a positive long-term total return. Moving forward, it is expected to provide a positive long-term total return. Given this positive expectation, long-term investors should take note of some advice from late, great money manager Sir John Templeton, who once quipped — the best time to invest in the stock market is whenever you have the money.

A common statement of many investors of late is that the losses over the last year are so steep that it will take many years ("if ever" for the truly gloomy) before they will recover what they have lost. Thus, they are exiting the markets; to this investor, we would like to make a few remarks.

While the losses on stocks are indeed severe, a decision to invest in the stock market today should be based on expectations of total returns **going forward**, rather than on what they have been in the past. Then those return expectations need to be compared with those of alternative investments including cash (money markets).

On that score, we have commented recently on how the expected return on stocks looks better now than it has in decades. In addition, the return expectations on stocks versus Treasury bonds or cash are the most attractive in decades, as well.

To look at one example of why we find stocks very attractive moving forward, the chart below shows

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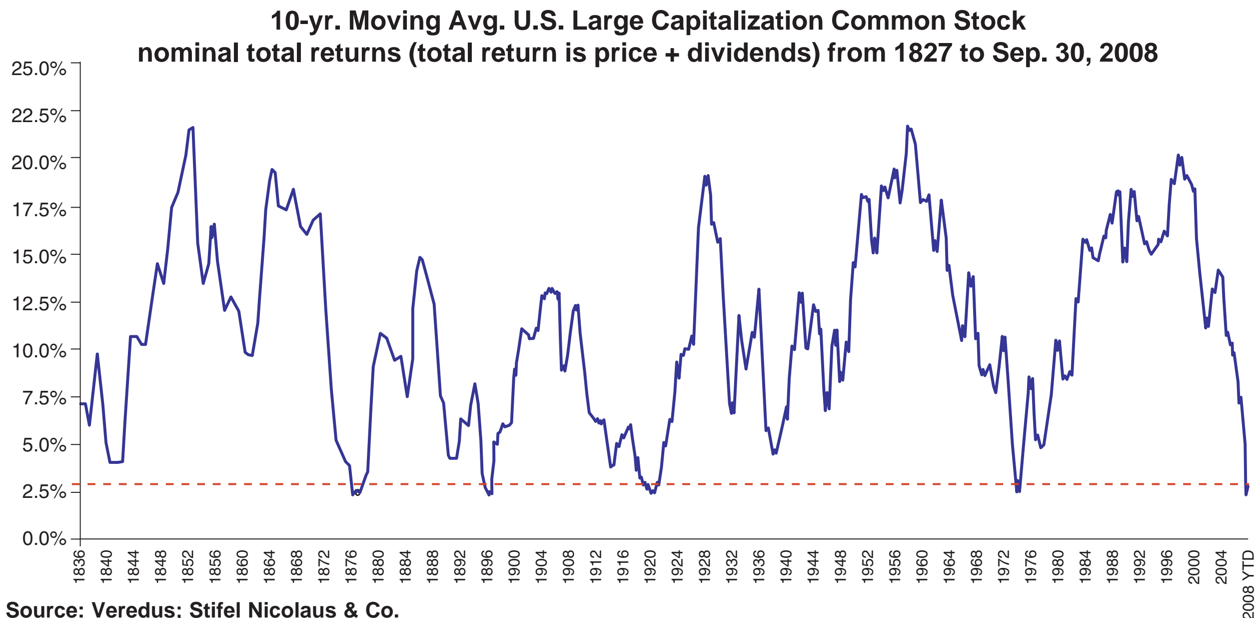
the rolling 10-year annualized return on our favorite sector of the U.S. equity market – large cap stocks. As you can see, the most recent 10-year annualized returns on large cap stocks through Sep 30th were very weak at around 2% (through Nov 30th they were roughly flat). Large caps have touched these levels 4 previous times since 1827 and each time the fortunes of large cap stocks were to turn quite strongly for the better. Like the economy, the market tends to move in cycles.

Historic Opportunity For Large Cap Stocks



Source: Veredus; Stifel Nicolaus & Co.

Overcoming Emotions

Many investors these days do in fact "intellectually" accept the notion that the stock market is reasonably priced, if not cheap, and may present its best buying opportunity in many years. Despite that view, however, many are not "emotionally" able to commit new funds — even to simply rebalance their portfolios back to desired long-term targets.

Say for example you were at your long-term target allocation at the beginning of this year with a mix of 50% stocks and 50% bonds. Using the returns of the S&P 500 index for stocks and the Lehman Aggregate Bond index for bonds, you would now have 38% in stocks and 62% in bonds. So just to return your portfolio to its long-term target would suggest shifting roughly 20% of your bonds back into stocks.

Yet because investing has a strong emotional component and volatility has been so destabilizing, it is very hard to do. One potential way around the emotional nature of this issue is to try moving towards your goal in steps.

Take an investor who is currently all in cash, but recognizes that a more reasonable long-term allocation to the stock market given their personal situation is more like 60%. They could move 20% of their

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cash into stocks now, another 20% in three months, and the final 20% in another three months time. Compared to an “all or nothing” decision, moving toward your desired allocation in a somewhat systematic and non-emotional way, is both easier to start and easier to stay with. If the market continues down during that first month, only 20% of your money was affected, and the next 20% will be buying at cheaper prices. If the market rises, at least you enjoyed those gains on 20% of your money.

One More Thing – Withdrawal Rates

Ultimately, investors cannot control the markets. Investors do have some control, however, over key elements in a successful investment program, including how much they can invest, how a portfolio is invested, and how money is withdrawn from an investment portfolio.

On this last point regarding portfolio withdrawal rates, it is important to maintain the discipline to keep withdrawal rates at reasonable levels, particularly during bear markets. This may mean that lowering the absolute amount of dollars withdrawn may be required. Standard rules of thumb for annual withdrawal rates are typically 3% to 5% of the over-all portfolio value. Some institutions, such as foundations and endowments, may establish spending policies that look at withdrawing a set percentage of a multi-year (such as over 3 years) portfolio value average instead of a single period value. Either way, adjusting withdrawal rates based off over-all portfolio values is prudent and perhaps even necessary for some investors given the current market conditions.

A Time to Plant

We believe that most investors are better served by not being radical in their investment approach. Instead, for most investors the best investment plan is to build an appropriate allocation based on their unique time horizon and risk tolerance. Moderate adjustments may be made around the neutral allocations based on relative valuations. Re-balancing, more than ever after strong market moves, is also a good investment practice.

In the end, investing is humbling. This is the case in all market environments, but especially so when the stock market is down. Nonetheless, it is important to remember that a new bull market will likely follow the current bear market — just like it always has. There is simply a time and place for each. Like there is a time to harvest, there is also a time to plant. With the stock market at its best valuations in at least a generation, this appears to be an excellent time to plant.

Sincerely,

Eric M. Kobren
President
Portfolio Manager

Rusty Vanneman, CFA
Director of Research
Co-Portfolio Manager

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