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## LETTER FROM THE PORTFOLIO MANAGERS

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### ***Through A Mood Darkly: 2009 Market Outlook***



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While most professional investors realize that forecasting an unknowable future is mostly folly, at this time of year, the media is full of investment predictions for the New Year because everybody wants them. We are happily providing our predictions, not just because we want to satisfy the desire for them, but because the exercise of reading, thinking and writing about our outlook for the future can actually be extremely useful.

In making predictions we must think about possibilities: not only why a particular market may go up, but also why it may go down. We must think not only of possible scenarios, but also what risks there may be to those scenarios. Especially provocative predictions may seem to border on silliness, but they too can serve a useful function in stretching our thinking and forcing us to consider even seemingly unlikely scenarios. As we were all reminded this past year, anything can indeed happen.

We also benefit from the outlooks of portfolio managers with whom we are invested or considering for investment. Examining their outlook can provide valuable insight about how they think about, and potentially construct portfolios. The accuracy of their forecast isn't the object of the exercise; it is attaining a better understanding of their investment philosophy and process.

Even though, with varying degrees of conviction, we have our own market views and forecasts, we believe in the wisdom contained in this famous quote from Oliver Wendell Holmes: "Prophecy as much as you like, but always hedge." In other words, while we may tilt our portfolios towards those market segments that we believe offer the best combination of reward and risk, "hedging" those opinions by building balanced, diversified portfolios remains the prudent way to invest.

All that said, it's time for our own outlook. Our somewhat different approach, however, is to identify a few market opinions that might qualify as "surprises" to the current year-end market consensus. We are not trying to be radical in predicting a long shot event. Instead, we are trying to identify those situations where most participants appear to be leaning one way, and go against the grain. In our experience, when most investors are leaning one way, the market has a tendency to go in the opposite direction.

Before we introduce our list for 2009, let's quickly take a look back at our 2008 list.

### **Review of our Potential Surprises for 2008**

#### **The Economy and Corporate Earnings Will Do Worse Than Many Expect**

At the end of 2007, the consensus expectation for 2008 year-over-year operating earnings growth was +15%. We thought those estimates were too high. As we mentioned last year:

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“Principally, we still don’t see any signs that the residential real estate market is stabilizing ... match that with rising unemployment, deteriorating consumer confidence, high energy costs, a credit crunch, and record consumer debt levels, and it is difficult to imagine that consumers will be able to sustain spending at the same levels they have in recent years.”

Needless to say that was on target as earnings growth in 2008 is now expected to *decline* by approximately 25% (based on actual data through September and estimated fourth quarter earnings).

### **The Dollar Will Get Stronger**

We expected that the U.S. dollar would be stronger against a broad basket of currencies in 2008 primarily due to negative sentiment and attractive valuations. The positive trend in the current account balance also pointed to a stronger dollar.

Helped by those factors as well as the “flight to quality” trade from global investors, the U.S. Dollar Index was up roughly 6% in 2008. This gain came despite dollar weakness at the end of the year (the dollar had been up over 11%), and the dollar’s worst year against the Japanese yen in two decades.

### **U.S. Stocks Will Outperform International Stocks**

Again, due to valuation and sentiment factors, along with our expectation that the U.S. dollar could be stronger in 2008, another potential “surprise” we saw was that U.S. stocks would do better than international stocks.

This was another hit as the S&P finished 2008 down 37%, while the Morgan Stanley All-Country World Index (ACWI), minus the U.S., lost 45% and the Morgan Stanley Emerging Market Index was lower by 53%.

### **The Stock Market Will Perform Better Than People Expect**

Our fourth prediction, however, was a significantly different story. The year started poorly and most months during 2008 prices went backwards, not forwards. The year ended up ranking among the worst in U.S. market history.

Our expectation that stocks might do better was built on a few factors. Heading into 2008, sentiment, for instance, was quite negative. While we thought the economy would be softer than people expected, and that credit conditions would remain difficult, we simply did not think losses would cut as deeply and as painfully as they did. We were wrong. We also expected that while the economy would remain weak, the market would begin to recover well before the economy. While that is still our expectation, it simply did not happen in 2008.

## Potential Surprises for 2009

### 1. Earnings Growth Will Be Better Than Expected

In the closing weeks of 2008, analysts continued to slash their estimates for 2009 corporate earnings. As of this writing, consensus reported earnings expectations for the S&P 500 in 2009 are around \$42, while operating earnings (defined as reported earnings minus “extraordinary” one-time items) are expected to be approximately \$82. These numbers are 20%- 30% lower than the respective consensus of \$59 and \$104 just a few months ago.

We think that these forecasts, especially for reported earnings, are probably too low. We believe that low interest rates along with aggressive and massive stimulus from the government are going to make a difference. A variety of government programs, including the TARP (Troubled Assets Relief Program) and the upcoming American Recovery and Reinvestment Plan proposal from President-elect Obama, could help the housing market and the over-all economy stabilize much sooner than most expect. In that case, corporate profits could easily beat the downtrodden consensus forecasts over the course of the year.

There is something else to keep in mind regarding earning expectations. Wall Street analysts (who form the consensus expectations) have the same tendencies as most economists and investors; they typically expect the foreseeable future to be like the recent past. But markets tend to exhibit strong cyclical tendencies over time. In other words, the consensus usually misses the inflection points in the economy and markets.

Lastly, the current recession is already a year old (and for corporate earnings the recession is even more mature having started in the third quarter of 2007). Since the Depression, recessions have averaged a bit under one year in length and the two longest (1973-75 and 1981-2) were each 16 months. So it is likely that this recession is closer to its end than its beginning. In fact, depending on how one looks at the earnings data, we may have seen the worst of the earnings recession in the third quarter of 2008.

### 2. The Global Stock Markets Will Have Above-Average Returns

Would this really be a “surprise” given that many prominent voices already seem to be calling for a significant rebound? That’s a fair question, but the reality is that the sentiment and actual asset allocations of both individual and institutional investors suggest that most remain hunkered down, still quite concerned about the market’s prospects.

The potential reasons for a good year in 2009 are many. The prevailing negative sentiment just alluded to is one reason and the aforementioned possibility that earnings growth could be much better than expected next year is another. Valuations, which are powerful drivers of longer-term returns (though admittedly not necessarily great short-term market indicators) are at their most attractive levels in decades (depending on which valuation metrics one looks at). The Federal Reserve has stated it will keep interest rates low for quite a while which is a positive backdrop for

stocks and there is a lot of cash (pent-up demand) on the sidelines.

Technically, the market is very “oversold.” The term oversold refers to a market that has come under extreme selling pressure, pushing prices down more steeply and more quickly than warranted by the underlying fundamental conditions. What it may also mean is that the selling pressure has been exhausted.

The market just finished one of its worst years of performance in the last 100. It should be noted that, as shown in the table below, in the prior ten worst years of performance for the Dow Jones Industrials, the Dow rose the following year 8 out of 10 times, with an average gain of 25%.

**The Worst 10 Years in Dow History**

Year	Percentage Change	Percentage Change Following Year
1931	-53%	-23%
1907	-38%	47%
1930	-34%	-53%
1920	-33%	13%
1937	-33%	28%
1914	-31%	82%
1974	-28%	38%
1903	-24%	42%
1932	-23%	67%
1917	-22%	11%
<b>Average</b>		<b>25%</b>
<b>2008</b>	<b>-32%</b>	<b>?</b>

Source: The Bespoke Investment Group

If one takes out the Great Depression years of 1930, 31, 33 and 37 (we think the only real parallel between the current environment and the 1930s is the level of market volatility; in economic terms the current environment doesn’t even come close), then all six of the remaining years on the ten-worst list reported gains in the following year with an average return of 38%.

We’re not necessarily calling for a 25% gain in 2009 (though we recognize the possibility). The point, however, is that deeply oversold markets do tend to produce sharp rallies in the following years.

**3. Larger Companies Will Do Better Than Smaller Companies**

Another potential surprise for 2009 is that larger companies will do better than smaller companies. This would qualify as a surprise because in the early stages of an economic recovery and stock market rebound, smaller companies typically outperform larger companies. The idea is that smaller companies’ performance tends to be more cyclical and thus driven by the economic cycle. Larger companies meanwhile, given their more diversified products and services, tend to exhibit smoother earnings streams. Companies with less earnings volatility tend to be considered “higher quality.”

However, it isn’t a given that large companies must lag in market rallies and lead during slumps. Last year was a good example of that as large caps did not display consistent leadership despite significant economic and market weakness. Returns for small- and large-cap stocks were fairly similar across both growth and value.

The key reason large caps may do better than small caps is their relative valuations. Historically, small companies tend to trade at a slight discount (lower P/Es) to the valuations on larger companies, but are now priced at large premiums. Based off work from Leuthold Weeden Institutional Research, using five year normalized earnings, small caps were recently selling at 22% above their

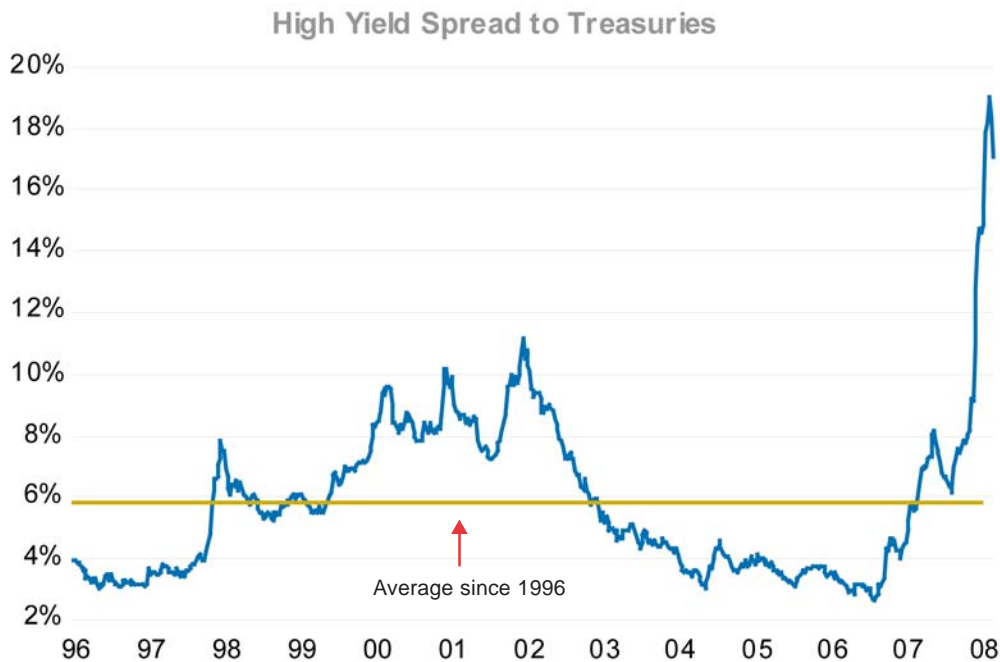
normal relationship to large caps. This is particularly unusual because when the market is recovering off recession or bear market lows, small caps are typically at their *most attractive* valuations.

While admittedly this relative over-valuation of small caps has persisted for the last few years, (and actually improved a bit last year), small caps are still at some of their most unattractive valuations relative to larger companies since the early 1980s.

#### 4. Lower Quality Bonds Will Outperform Higher Quality Bonds

Typically, when higher quality stocks are outperforming lower quality stocks, then higher quality bonds (like Treasury bonds) are generally outperforming lower quality bonds (such as high-yield corporate bonds). This year, however, could be the exception to that rule. Again, it boils down to valuations. While the stock market may have priced in a healthy recession, it could be said that the credit or fixed-income markets have priced in a depression.

A way to examine valuations for the credit market is to simply look at yield spreads. In the chart below, we compare the spread in yields between high-yield bonds and U.S. Treasuries of similar maturity.



Source: Kobren Insight Management

As one can clearly see on the chart, high-yield bonds now enjoy a whopping 17% yield advantage over Treasuries (already coming down from nearly 20% a month ago) compared to an average of just under 6% since 1996. Such a huge spread provides a considerable margin of safety, and likely will provide a very attractive rate of return for high-yield even if defaults rise significantly (which they likely will) over the next year or so.

High-yield bonds are not the only attractive area in the fixed-income markets. In fact, there is historic cheapness in many areas, as the dysfunction and disarray in 2008 washed out many segments. Many active managers are talking about how the buying conditions for a variety of fixed income asset classes and sectors are the best that they have been in many, many years, if not generations.

## 5. Inflation May Reappear

One reason why many fixed income segments look so appealing, however, is that they are simply being compared to Treasury bonds. Due to a combination of reasons including flight to quality, liquidity preferences, and diminished concerns of inflation, yields on Treasuries have been pushed down to their lowest levels in decades. These low yield levels are not likely to persist, however. One reason is simply because liquidity preferences tend to be shorter-term considerations, but just as important, we think the markets are currently underrating the prospects for inflation moving forward.

There are a couple of ways to look at how the market is assessing the future prospects of inflation. One is to look at the over-all level of interest rates for Treasury bonds. The current yield for a 10-year Treasury is just over 2%. That's really a remarkable level. The long-term rate of inflation has been about 3% a year. If that history is any indication of what inflation may be like moving forward, that means investors would be accepting a negative real (after inflation) return of -1%. Obviously investor inflation expectations must be lower than the historical average, if not close to zero.

Another way to look at inflation expectations is something called the "break-even inflation rate." This is calculated by comparing the yields on nominal (regular) Treasury bonds to yields on inflation-linked Treasury bond (called TIPS, which is short for Treasury Inflation Protected Securities) of similar maturities. Currently, the break-even rate is under 0.25% for 10-year maturities. This basically means that the expectation for inflation over the next 10 years is only 0.25%! If an investor who must invest in Treasury bonds has the option to choose between nominal and inflation-linked Treasuries, actual inflation only has to be over 0.25%/year for TIPS to be a better investment.

Given the expected economic contraction and retrenchment of the U.S. consumer, then why would we expect inflation to be higher than these expectations? In short, it's due to the same reason we think the markets could do better in the short-term – massive liquidity coming into the marketplace from government programs and actions.

In so many words, the Fed essentially reduced the short-term interest rate under its control to zero and pledged to print an unlimited amount of dollars, with the intention of stabilizing the economy in the short term, while risking higher inflation in the longer term. We are not debating the need for the stimulus, and in the short run, it won't likely be inflationary as it is simply hoping to help arrest the decline in consumer spending. But a potentially much larger inflationary problem looms when the consumer does stabilize and the economy starts to get some traction. Will the Fed be quick enough to remove the stimulus, or will there be too much wood on the fire for too long, so to speak?

### The Right Principles

Though many believe the most important element to successful investing is having the most prescient outlook, that is not necessarily the case. As Benjamin Graham, investing legend and author of the seminal text “The Intelligent Investor” said in an interview back in 1976: “I think we can do it [investing] successfully with a few techniques and simple principles. The main point is to have the right general principles and the character to stick to them.”

The key element to remember about forecasts, ours included, is that they are obviously far from infallible. While some may appear to have called the recent market correctly, they surely have had their misses in the past and they will have them in the future as well. We’d like to believe, however, that we do have the right general principles. In our view, the disciplined practice of diversifying your money across asset classes remains the best recipe for long-term investment success.

Wishing you a happy and more prosperous New Year.

Sincerely,



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