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## Letter From The Portfolio Managers

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March 2007

### ***The Return of Volatility?***



Eric M. Kobren

Are the markets back to normal?

On the second to the last day of February, the US stock market lost over 3%. Most markets lost 3-4% that day, with international emerging market equity markets losing around 8%. It was a tough day.



Rusty Vanneman

It wasn't totally unexpected though, as eventually the market needed to take a breather. As we have mentioned in past comments, the stock market has put on an incredible performance of steady upward price movement since the summer of 2006 without a retracement, even a small one. In fact, the recent rally in the S&P 500 ranked among the four longest since 1928 that didn't have a single 2% correction. Cutting the data another way and using data on the Dow Jones Industrials, we are currently in the second longest rally without a 10% correction going back over 100 years. To re-state, a big loss in the markets last Tuesday wasn't the exceptional event; the long rally without any correction was.

Another way to demonstrate that the market has been unusually placid is to compare its recent volatility to more "typical" levels. Over the past year (2006), for example, the volatility in the daily returns of the S&P 500 was 45% less than the over-all volatility in that index from 1998 to today. Virtually all asset classes and economic sectors have had drops in volatility (with the exception of energy, Japanese, and emerging market stocks) since then. It would not be unexpected to see volatility start to move back towards typical levels over the course of 2007.

### **How Does the Market Typically React to Large One-Day Declines?**

As many of you know, we update our "Five-Factor Equity Model" early each month on <http://www.kobreninsightmanagement.com/>. Reviewing the five factors, our outlook remains mostly the same from the prior month: We remain market agnostics, but err on the side of caution. While additional declines may be in the tea leaves, we are currently standing pat. This may have been the beginning of a long overdue correction, but not necessarily the start of a protracted bear market.

Speaking of tea leaves, and analyzing something which is admittedly not part of our five factors, how about if we simply analyze last Tuesday's price action and what it might mean for the market moving forward? Can that tell us anything? As with a lot of market data, it all depends on how you look at it.

### **On One Hand**

On one hand, given the sharp declines from last Tuesday, one could argue looking at recent data that we could see some above-average returns for the stock market over the next year. Kobren Insight Management Research Analyst Ben King collected data on each of the days over the last 20 years that the S&P

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lost 3% or more (34 days) and analyzed what returns looked like over the next 12 months. The average return over the next 12 months was approximately 15% while the median return was almost 20%! The market was positive nearly 4 out of each 5 times over the next 12 months after a 3% daily loss. So, it's all good, right?

### On The Other Hand

On the other hand, however, what makes this time different is that the market was simply way overdue for a market correction. Using data (going back over 100 years) from Morgan Stanley and Ned Davis Research, we looked at the subsequent declines following the 19 longest rallies without a 10% decline in the Dow Jones. The average correction was -16% (median was -13%) with an average duration of 111 calendar days (the median duration was 81 calendar days). In other words, it is highly unlikely that last Tuesday was the extent of the losses.

These two conflicting views of what the decline on Tuesday meant, gets back to the essence of what we do: build diversified portfolios. Nobody knows for certain what will happen in the future. The data can be cut to support nearly every market view. Historical analysis can provide useful templates, instruction, and warnings, but it doesn't predict with precision.

### Stay The Course

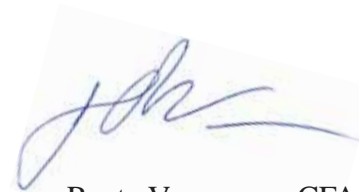
While some say stocks are currently reasonably valued, that could change quickly with a shift in the outlook for interest rates, inflation or earnings growth. Indeed, earnings growth is very likely to slow in the coming quarters. So, don't be surprised if the market corrects further in the months to come. A 10% correction is long overdue. That said, this is likely not the start of a new bear market.

Should we see the market correct further, we will not change our basic strategy but will continue to stay with the diversified portfolios we have carefully developed to meet each client's particular needs and investment objectives. Even in a market environment where there may be short-term and even violent market moves, portfolios that are appropriate and reasonable, should do just fine over time.

Sincerely,



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Director of Research  
Co-Portfolio Manager