INNOVEST
PORTFOLIO SOLUTIONS

Memo

TO: INNOVEST CLIENTS

CC:

FROM: INNOVEST

DATE: MARCH 9, 2009

RE: MARKET UPDATE FOR CLIENTS

We continue to be faced with an extraordinarily difficult market environment, one that is probably testing your patience and confidence. We wanted to share with you our most current thinking about the overall environment and our recommended investment positioning.

Perhaps the biggest question we are being asked is whether we've fully factored in the extent of economic damage that is now becoming apparent and being reflected in the form of major declines in the stock market. The short answer is that we are confident we have.

We understand that the powerlessness of watching the value of your wealth decline creates a strong desire to "do something" about it – to take control and end the pain. Going to cash may lock in losses, but at least it creates a certainty amidst a great deal of fear and uncertainty. These are the conflicting forces that every investor faces right now: the certainty of locking in a (albeit painfully lower) level of wealth, versus the uncertainty of possibly additional near-term losses and the hope of better longer-term returns. We want to give you perspective and information on the markets and to make sure you can accept the current risk levels in your portfolio (versus switching to a more conservative posture).

It is also important to understand that a great deal of economic uncertainty could take a further toll on stocks in the near term. What we have done about this ambiguity is to make assumptions that are so negative that we believe we have a good margin of error on the downside, and a high degree of confidence at least in the lowest end of our longer-term forecasted return ranges. Our work in this area has included an intense focus on identifying the most negative scenarios that we or other experts can envision, and factoring those possibilities into our analysis. So while we are never confident in predicting the short-term, we are confident that our scenarios fully take into account the possibility of a lengthy and extremely poor economic environment (where the decline in earnings is comparable to the Great Depression). Based on that analysis, the stock market can still earn good returns from current levels over a five-year time horizon. It may also help to note that we are not alone in this assessment; even some very negative investment professionals, now forecast positive multi-year returns for stocks. Importantly, however, capturing these positive returns will require maintaining that longer-term focus through what may continue to be a very trying period.

As we look forward into this continued, very scary economic decline, we must remember that markets do their best to see into the future and reflect that future in their prices. So, the key question is, "What is

priced into stocks today?" The two metrics described below suggest that the market is cheaper than it was in early January of this year (which should be no surprise since stocks have declined since then)

- **P/E Ratio:** Back in late December/early January, P/E ratios were at 15X. Currently the ratios are down to 12X normalized earnings (using the S&P 500's recent price of 700). In the past, this valuation level has been a good entry point for *long-term* investors into the stock market.

- **Risk Premium** (which is the comparison of stock returns to a "risk-free" return—we use the S&P 500 and Treasury Bills): Based on this measure, stocks are coming off of their worst nine-year return relative to T-Bills ever, including the Great Depression period. This data strongly suggests that stocks are not expensive. Annualized returns were double-digit over multi-year periods after those time periods with the lowest risk-premiums.

It may seem impossible to imagine a market rally from here. It can happen, and it will at some point. By definition, investors are the most pessimistic at a market bottom. There is a huge amount of cash on the sidelines, which is a hugely positive factor. When everyone is hugely pessimistic there are few investors left to sell. Then, as bargain hunters start to step in, a powerful rally can develop. Our expectation is that we could see several rallies and declines before we move on to another bull market.

So while we are confident that stocks currently offer good longer-term return potential, we do not know what might happen in the short-term. This uncertainty creates a dilemma that is very important to understand. Stocks could drop further, perhaps substantially, or they could rebound sharply. If we try to predict short-term moves and invest accordingly, we have to consider the consequences of being wrong. If investors go to cash now, the market could rebound sharply before they could get back in. It is possible that we could see a rally of 20%-30% before concrete signs of sustained economic improvement begin to appear. The market is forward-looking and nearly always reaches a bottom well before the economy begins to recover. If the stock market begins to anticipate an economic rebound, we could realize in a short time period a material portion of the positive multi-year return potential that we believe exists. At that point we would need to decide whether the market's turn was going to be sustained, and get back in, or continue to wait and risk losing further upside. If we did get back in, we could be whipsawed if the upswing proved to be temporary, as commonly happens during severe bear markets.

On the other hand, if we remain invested, our analysis gives us confidence we will earn a good return over the next five years, independent of what the short-term brings. We also know that we will continue to see tactical opportunities amidst the near-term weakness, and that active managers will have opportunities to add value by buying stocks and other assets that have been oversold due to fear rather than fundamentals. Longer time horizons have the highest value when short-term fear is greatest, because that is when the greatest opportunities are created. However, episodes like these are also when a long time horizon is the most difficult to sustain.

Like you, we find this environment gut wrenching. Nonetheless, we are focused, thinking clearly, and analyzing data and information every day to make sure we understand the risk and opportunities as fully as possible. We believe that if we continue to stay intellectually honest, work extraordinarily hard to make deeply informed and rational (rather than emotional) investment decisions, over the longer term that work will pay off in the form of good returns on your behalf.

As an example, so far this year our move into high-yield bonds has added very significant value as these funds are up slightly while the stock market is down more than 20%. In addition, our active managers have, on average, outperformed the market. The net result is that while our portfolios are down, they are outperforming their benchmarks. Of much more importance to us is the longer-term potential that we believe is priced into portfolios.

With that said, we leave you with a final thought from Warren Buffet in his annual letter to shareholders of Berkshire Hathaway:

…"Amid this bad news, however, never forget that our country has faced far worse travails in the past. In the 20th Century alone, we dealt with two great wars (one of which we initially appeared to be losing); a dozen or so panics and recessions; virulent inflation that led to a 21.5% prime rate in 1980; and the Great Depression of the 1930s, when unemployment ranged between 15% and 25% for many years. America has had no shortage of challenges.

Without fail, however, we've overcome them. In the face of those obstacles – and many others – the real standard of living for Americans improved nearly seven-fold during the 1900s, while the Dow Jones Industrials rose from 66 to 11,497. Compare the record of this period with the dozens of centuries during which humans secured only tiny gains, if any, in how they lived. Though the path has not been smooth, our economic system has worked extraordinarily well over time. It has unleashed human potential as no other system has, and it will continue to do so. America's best days lie ahead."

As always, we greatly value the trust and confidence you place in us to manage your investments.