

December 2008

Monthly Investment Commentary

The magnitude of the bear market is apparent in that November's steep 7.2% loss for the S&P 500 (as measured by Vanguard 500 Index Fund) marks the index's best (least bad) showing in three months. Once again, all equity asset classes were down sharply for the month, with the magnitude of loss generally in line with market cap. The iShares Russell Midcap was down 10.2% in November, while the iShares Russell 2000 fell by 11.8%. Year to date the broad U.S. stock market has fallen almost 40%. The Vanguard REIT Index Fund fell by 23.4% in November, and is now down 46.4% for the year, while high-yield bonds (which have equity characteristics) were down 8.4% for November and 31.4% for the year. What was different in November is that fixed-income generally had a much better month. Vanguard Total Bond Market Index was sharply higher, with a 3.6% return, bringing their year-to-date return into the black (+1.7%). Looking overseas, Vanguard Total International Stock Fund lost 6.3%, and is down almost 50% year to date, and emerging markets (as measured by Vanguard Emerging Markets Stock Index Fund) were down 7.9% in November and 56.4% so far this year. The only good thing about 2008 is that it's almost over.

November Benchmark Returns (Preliminary)		
Large-Cap Benchmarks	Nov	YTD
Vanguard 500 Index	-7.2%	-37.7%
Russell 1000 (iShares)	-7.5%	-38.5%
Russell 1000 Growth (iShares)	-7.9%	-39.6%
Russell 1000 Value (iShares)	-7.2%	-37.7%
Mid-Cap Benchmarks		
Russell Midcap (iShares)	-10.2%	-43.8%
Russell Midcap Growth (iShares)	-10.3%	-46.4%
Russell Midcap Value (iShares)	-10.1%	-41.2%
Small-Cap Benchmarks		
Russell 2000 (iShares)	-11.8%	-37.3%
Russell 2000 Growth (iShares)	-12.1%	-41.6%
Russell 2000 Value (iShares)	-11.6%	-32.9%
Other Benchmarks		
Vanguard Total Int'l Stock Index	-6.3%	-48.3%
Vanguard Emerging Mkt Stock Index	-7.9%	-56.4%
Vanguard REIT Index	-23.4%	-46.4%
Vanguard Total Bond Mkt Index	3.6%	1.7%
Merrill Lynch High-Yield Bonds	-8.4%	-31.4%
Citigroup World Govt. Bonds Index	3.7%	3.5%
DJ-AIGCI (Commodity Futures)	-7.0%	-32.6%
JPMorgan ELMI +	-1.2%	-7.0%
Lehman Credit Bond iShares	4.2%	-8.4%
S&P Ntnl Muni Bond iShares	0.5%	-3.3%
Vanguard Prime Money Mkt	0.2%	2.6%

Amidst the Worst Bear Market Since the 1930s, Where Do We Stand Now?

In November, the bear market in stocks officially became the worst since the 1930s as the S&P 500 neared 750, more than 50% below its peak of just over a year ago. What started with the subprime mortgage crisis became a full-blown credit crisis and is now hitting the economy hard as both businesses and consumers are rapidly retrenching. Businesses are hunkering down, cutting spending, and laying off thousands of workers. The general population is suffering from falling portfolio and home values, and some fear for their jobs. The result is a sharp reduction in spending by businesses and households that is impacting corporate earnings. A key to breaking the downward momentum is the credit markets, which are still highly stressed. Businesses that have debt maturing are faced with unacceptably high costs to refinance their debt—if they can even get the refinancing. The unavailability of credit at reasonable interest rates is impacting businesses of all types, real estate owners, and municipalities. This puts particular stress on borrowers who don't have the liquidity they need over the short term, which translates into more defaults and

more losses for financial institutions. And with financing costs high, new business investment generally doesn't pencil out.

As we make decisions in the midst of this environment we are considering the following:

- Have financial asset prices fallen to levels that take into account the severity of what we are experiencing and the potential for further deterioration?
- Does fundamental analysis matter anymore? Why are so many investors with decades of success getting their heads handed to them?
- Regardless of long-term return potential, how much short-term downside exposure is there in the portfolios we run?
- For our clients, how should we trade off the short-term risk versus the long-term returns?

We address each of these questions below.

Have financial asset prices fallen to levels that take into account the severity of what we are experiencing and the potential for further deterioration?

We believe many asset classes already price in the very severe recession and subsequent subpar recovery we believe is very possible. (Caveat: day-to-day market moves continue to be so enormous that return relationships can change significantly in just a few days—meaning that our comments may become stale by the time they are read.) Here are some examples:

High-Yield Bonds: We recently increased high-yield bond exposure in lieu of stocks based on comparable longer-term return expectations with likely lower near-term downside risk. With yields of over 20%, high-yield bonds are priced to deliver a pretax average annual return in the teens over the next five years, even in the most dire scenario we consider reasonably possible. Based on our analysis, even if cumulative defaults over the next few years approach 50% (which would be in excess of what occurred in the 1930s) and the recovery for junk-bond holders from these defaults is only 25%, returns would still be in the mid-teens. Generally, defaulted bonds recover about 40% of the original loan amount on average through asset liquidations or restructuring of the business, and have recovered about 32% following past default peaks, so a 25% recovery assumption is very conservative (returns are still good even under lower recovery rates). The math works because of the combination of very high interest income and the fact that the bonds that default are already trading at huge discounts to par (the average high-yield bond is selling for about 60% of its face value), which reduces the loss potential. We do our own work on this asset class but we have also had detailed discussions with dedicated high-yield bond managers and other bond professionals who we respect and who don't have a mandate to invest in the asset class. Even the most pessimistic and cautious agree with our analysis. Though many of these bonds will default, a highly diversified portfolio of high-yield bonds offers great long-term value and this is why we have established positions in both taxable and tax-deferred portfolios we manage (they are sufficiently attractive on an after-tax basis to own in all accounts, but since much of the return will come from dividends, it is preferable, where possible, to own it in tax-deferred accounts first). If the stock market has a powerful rally, not unusual even within a bear market, high-yield bonds will almost surely lag. However, they should outperform if stocks go lower and look comparably attractive longer

term (though relative valuation levels have been changing rapidly, mainly because stocks have been so volatile).

REITs: As we write this, REITs are down almost 60% since September 30. A decline of this magnitude was hardly fathomable. We have been assessing the REIT market for months and earlier in the year, with REITs down over 30% from their peak levels they began to look interesting. We did not invest at that time and as the economic risks became more alarming in the third quarter we put more weight on our most pessimistic scenario and also applied more negative assumptions in that scenario.

By mid-November REITs had fallen further, to levels that assumed commercial property prices would decline in excess of 30%. It is important to remember that, unlike residential real estate, commercial real estate values are supported by the income the properties generate; 90% of this income is required to be passed on to investors in the form of dividends. Even with a significant cumulative decline in REIT dividends of 20% over the next five years, REITs would still deliver returns of between 10% and 13% (assuming yields eventually decline over the period as the market becomes less stressed). We took an initial position in mid-November only to see prices fall further to a level that discounted a 40% decline in property value or, in terms of dividends, a 50% decline in dividends paid over five years (e.g., dividends in five years would be half today's level). REITs then returned over 25% in the next two days. (There was a time when REITs were considered less volatile than stocks—though we never viewed them that way.) We are not sure where property prices might be in five years or what level of dividend cuts is likely for REITs, but we do believe that the levels that are priced into REIT stocks are excessive. We are also not sure when REITs will be able to sustain a rally. Investment property is probably in for a couple of very difficult years. However, in the last very bad down-cycle for real estate (in the early 1990s) REITs began to recover several years before property prices bottomed. We believe it is very likely that equity REITs will deliver double-digit returns over the next five years.

U.S. Equities: U.S. equities are also now priced to deliver at least decent five-year returns. With the S&P 500 at 850, very good returns are possible over that span, but are not a sure thing. Our most pessimistic scenario assumes that five years from now, earnings are 30% below their 2007 peak. We believe this is a very pessimistic assumption. Even in this scenario we project returns to be in the mid to high single digits—decent but not table pounding. In less pessimistic but still-conservative scenarios returns would be over 10%, and returns in the teens don't require hugely optimistic assumptions. Moreover, we believe that forced and indiscriminate selling has resulted in significant pricing discrepancies within the stock market and that this is likely to result in a great environment for active managers. We have seen other instances when pricing discrepancies were significant after other severe bear markets (based on data that measures the valuation discrepancy between stocks). We recently looked at the performance of our equity models after the last two periods of severe price discrepancies (1991 and 2001). In both cases our equity portfolios outperformed their benchmarks by over roughly three-and-a-half percentage points per year for the next five years.

In addition to these asset classes, emerging-markets equities and almost the entire bond market except for U.S. Treasuries also look attractive from a long-term value standpoint.

Does fundamental analysis matter anymore? Why are so many investors with decades of success getting their heads handed to them?

Unless one is close to 100 years old, today's economic and investment environment does not fall within their professional frame of reference. It is clear that most professionals were slow to grasp the economic implications of the credit crisis. As a result, their analysis of companies they held was not recalibrated quickly enough to adjust for the economic damage to company fundamentals. And some got caught in stocks that were nearly or totally wiped out, such as Fannie Mae, Freddie Mac, Bear Stearns, and AIG. Second, an entire generation of investors have been taught again and again to buy on weakness. We believe this experience created tension that made it difficult to sell holdings that had already been hit hard even as they began to understand the implications to the underlying businesses. Third, and possibly most important, the financial markets are being hit by technical factors that have resulted in a disconnection between pricing and fundamentals. Leveraged investors—mostly hedge funds—are being forced to reduce debt and to meet redemptions, resulting in massive and indiscriminate selling to raise cash. This has been going on for several months. Investment banks, insurance companies, and public pension funds have also been forced to sell to raise cash for a variety of reasons. Mutual funds have also been selling to meet massive redemptions. The hedge fund liquidations in particular have contributed to the dysfunction in the markets. As hedge funds have had to raise cash they have unwound short and long positions. So they have bought the “worst” stocks (those that they sold short) and sold the “best” stocks (those that they owned long). Empirical Research estimates that hedge funds have eliminated almost all their leverage. In total, Empirical estimates that hedge funds, and to a lesser extent mutual funds, have resulted in \$1 trillion of selling, about 7% of the entire equity market and “almost 10 times the effect of mutual funds alone in their worst years.”

This may be an overused phrase, but we don't think that most veteran investors suddenly “woke up stupid.” We do believe most were blindsided by the severity of a situation that in their lifetimes has never occurred. We believe that most made some bad mistakes. And we believe the markets are highly dysfunctional at present so that good fundamental analysis is not being rewarded in the short term. We believe the smartest stock pickers, who have an intelligent and disciplined process and who do their homework, will be rewarded again and are probably being set up for a period of significant outperformance. We don't know when good fundamental analysis will be rewarded again—it may be months away. However, we have no doubt that good analysis will matter again. In that regard it is worth noting that in times of market stress it is not unusual for this sort of breakdown to occur and that is why valuation discrepancies become extreme in bad bear markets. However, this time the breakdown appears particularly bad.

Regardless of long-term return potential, how much short-term downside exposure is there in the portfolios we run?

With respect to the stock market (including foreign stocks and REITs) it is impossible to know what the near-term downside might be from here (this is not to say that the downside is unlimited, however). The S&P 500 at 752 was down more than 50% from its peak just over a year ago and is also down more than 50% from its March 2000 peak—almost nine years ago! Most valuation measures we look at suggest the market is cheap to very cheap. It is entirely possible that we have seen the bottom. But, we can't say for sure and we wouldn't be surprised to see stocks go lower. The

S&P at a level of 700 prices stocks to return over 10% in our most pessimistic scenario. We believe that is an extreme but still possible scenario. So what's the lowest level we could imagine? The S&P at 600 would be 20% below the low we've seen so far, and while we can't rule it out, stocks would be very undervalued at that level (or below). In that scenario we expect all equity asset classes to see similarly large declines. With respect to bonds, we believe most bond market sectors have already been severely hit and have much less downside from current levels. Wherever the markets bottom it is important to remember that they will not be frozen at that level. In fact, given the price declines already experienced, from an even lower point (and from current levels for most asset classes), we expect returns to be quite exciting.

Bear markets are challenging because they offer great long-term return opportunities at a time when investors are least willing to think long-term (because major losses have sapped their capacity to take any more short-term risk). Instead, the best investment opportunities are presented at a time when short-term risk appears to be very high and investors are heavily motivated to avoid it (and this is what creates those opportunities).

For our clients, how should we trade off short-term risk versus the long-term returns?

This is a critical question. We take our responsibility seriously and have been working long days and weeks carefully weighing the important decisions we make.

We recognize that virtually all investors, including our clients, are deeply pained by portfolio losses experienced in recent months. The magnitude of any long-term opportunities becomes meaningless if investors can't make it to the long term. Recognizing this, we have decided to take a middle ground in this environment. We believe all equity asset classes are now priced to deliver good returns, with some priced to deliver outstanding returns over a five-year horizon. In light of this belief and as long-term investors we believe it is important to maintain equity exposure. However, for now we are holding off overweighting equity asset classes for two reasons. First, we are sensitive to the psychological impact to our clients of increasing equity exposure only to see more declines in the short term. In this environment we assume any equity buys we make will be followed by more weakness—that is not a prediction but rather an acceptance that we can't predict what will happen in the short term. Second, we believe that the economic risks are high. With credit markets nearly frozen, resulting in elevated borrowing costs and limited credit for businesses, we believe the economic risks remain to the downside and that a recovery might not begin until late in 2009 or possibly into 2010. That suggests that we may not need to be in a hurry to get more aggressive (though this could lead us to miss an opportunity).

If the valuations get even more extreme (attractive), at some point we may decide to swing at the fat-pitch opportunities being presented. We also know that in bear markets stocks can experience quick and powerful rallies of 20% and sometimes more. If we see such a rally in the near term we may reduce equity exposure in favor of further increasing exposure to high-yield bonds or other attractive asset classes, in some portfolio strategies. But, with respect to overall exposure to equity-type asset classes, for now we intend to keep more powder dry.

Closing Perspective

There is no sugarcoating the very serious challenges to the global economy. That being the case, it is important to remember that markets almost always bottom while the headlines are still grim and fundamentals are still weak. Almost every bull market that started from a period of economic weakness was well underway while corporate earnings continued to decline and unemployment continued to rise. A good way to get whipsawed is to wait until it feels safe. At that point stocks are likely to be much, much higher and it will be psychologically more difficult to commit to investments at much higher prices. This is a clear and unequivocal lesson of history.

We believe investors are very likely to capture good returns over the next five years. We also believe equity asset classes are more likely than not to bottom within the next six months, if they haven't already. But in the meantime we make no claim to know what the next few months may bring. Being a long-term investor would be easier if we could all come back in five years and check our portfolio values without worrying about what happened along the way. Since that is not the way the world works, we reiterate again the importance of being in the portfolio strategy that is right for you. That means assessing your ability to ride through any potential further losses in the coming months. Being able to sleep at night is an important part of that assessment.

—Litman/Gregory Research Team (12/1/08)