

Market Review and Outlook—January 12, 2009

Adversity Makes You Bitter, or Better. As investors, we had more than our share of adversity in 2008. US stocks fell more in 2008 than they had in any of the prior seventy years, since the Great Depression. There is plenty to be bitter about; unlike the bear market at the start of the decade, this market tumble was not preceded by a stock market bubble, and was not predicted by the vast majority of market seers (including Mallard).

So what have we learned—how can we be better off after this pain? First, we are still standing. Our portfolios have fallen sharply, yet our focus on the stock/bond balance permitted our clients to limit their losses. It is true that the losses would have been limited further had bonds actually made money in 2008, but at least they lost much less than stocks. The 2008 market decline has made crystal clear to me that the best strategy in the face of market declines is to avoid the temptation to sell into the drop and strictly adhere to the DON'T SELL LOW rule. Clients' cash and bonds are maintained in order to provide enough value in the portfolio to assure adequate money for expected withdrawals. In this manner, we don't have to sell stocks at today's low prices. In a weak stock market, I consider the DON'T SELL LOW rule to outweigh the 'stick to the target stock allocation' guideline.

The troubles in the housing industry, and with subprime mortgages and their derivatives, snowballed in 2008, ultimately bringing down Bear Stearns and Lehman Brothers, and seriously wounding Fannie Mae, AIG, and Merrill Lynch. We painfully learned that the financial engineering applied to subprime mortgages had spread globally. These weapons of financial mass destruction wreaked havoc well beyond our shores. The damage was actually worse overseas; in Iceland, the government had to step in to prevent all three major banks from going bankrupt.

Energy was another top story in 2008, leading the path upward for the first half, and then leading the descent in the second half. In its wake, emerging markets, which often have large exports of natural resources, saw their markets fall even more, down over 55% in 2008. There were very, very few safe places for investors to hide. Gold fell over 28%, as the global recession and collapse of oil prices ended inflation fears for the near future.

The numbers below, all through 12/31/2008, show the widespread pain suffered by investors. Even the five- and ten-year figures are terrible. Turn the page to see what silver lining is available to us.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Taxable Money Market	+0.47%	+2.67%	+4.23%	+3.34%	+3.45%
Intermediate Term Bond	-0.28%	-4.47%	+1.04%	+1.72%	+4.05%
Intermediate Muni Bond	+0.48%	-1.31%	+1.70%	+1.83%	+3.28%
Large-Cap Core Stock	-21.99%	-37.23%	-8.99%	-2.88%	-1.72%
Mid-Cap Core	-25.09%	-38.53%	-9.61%	-1.32%	+3.79%
Small-Cap Core	-25.95%	-36.21%	-10.08%	-1.52%	+4.36%
International Stock	-21.27%	-44.24%	-7.73%	+1.27%	+1.73%
Real Estate	-38.71%	-39.92%	-12.83%	-0.67%	+6.82%
Natural Resources	-35.45%	-47.83%	-7.06%	+8.39%	+9.28%
Science/Technology	-24.54%	-44.71%	-12.12%	-5.16%	-4.12%
Multi-Cap Growth	-24.02%	-41.90%	-10.33%	-2.65%	-1.30%
Multi-Cap Value	-22.53%	-38.16%	-10.14%	-2.11%	+1.83%
Balanced	-14.37%	-26.85%	-5.01%	-0.62%	+1.04%

The data in this table comes from Morningstar and the Wall Street Journal's Quarterly Fund Analysis Markets Data Center. Information herein should not be construed by any consumer and/or prospective client as a solicitation to effect, or attempt to effect transactions in securities, or the rendering of personalized investment advice for compensation.

As I do each January, I review the accuracy of my predictions for the past year, and then share my predictions for the upcoming year. On January 14, 2008, the MARKET REVIEW AND OUTLOOK suggested that 1) US stock returns would be healthy, 2) overseas stocks would be weaker than in the US, 3) growth and value would be within 4%, led by growth, 4) real estate results would be modest, lower than US stocks but better than foreign stocks, 5) bonds would provide stable results, and 6) high-yield bonds would outperform US bonds, while foreign bonds would keep pace.

On an absolute basis, my predictions were terrible. I did have some relative successes. Foreign stocks were weaker than US stocks. Growth and value did stage a horse race (with results within 4% of each other, which is astounding given the magnitude of the losses), although value lost less than growth. Real estate results (losses) were between US and foreign stocks. Bonds did not provide stable results, yet their results were dramatically better than stocks. High-yield bonds lost an incredible 26%, while foreign bonds kept close to taxables, falling 6.5% versus 4.5% for taxable bonds.

Predictions—My primary theme for 2009 is that we have much more economic pain ahead of us, but that we have punished stock prices enough, that the future economic pain is already more than fully reflected in current stock prices. For this reason, I see strong results for 2009, especially in the areas hardest hit in 2008 (stocks, and high-yield bonds). Stocks had a strong December 2008. I am hopeful that this was a preview of the full 2009 results.

Sector	2008 Prediction	2008 Actual	2009 Prediction
Large-Cap US Stocks	Up 7 to 9%	-37.2%	Up 10% or more
Smaller US Stocks	Up 7 to 10%	-37.8%	Up 10% or more
Non-US Stocks	Up 3 to 6%	-44.2%	Up 10% or more
Growth vs Value	Within 4% of each other, led by Growth	Value -38.2%, Growth -41.9%	Within 2% of each other
Real Estate	Up 4 to 7%	-39.9%	Up 6% or more
General Bonds	Up 4 to 6%	-4.5%	Up 4 to 6%
High-yield bonds	Up 6 to 9%	-26.2%	Up 8% or more
Non-US bonds	Up 4 to 6%	-6.5%	Up 4 to 6%

Investors in 2009 should come to recognize that it is insane to invest much in Treasuries yielding less than 2% while stocks are yielding over 3% (and will eventually resume growing their businesses). While ‘when’ is in question, there is no doubt that stocks will recover, and that will provide a tailwind to stock results for several years. **A full stock market recovery will require both dramatic economic changes, and dramatic investor sentiment changes.** The global governments and the central banks have already taken steps and continue to take significant steps to push the economics forward—eventually several billion dollars of stimulus will have the desired effect.

This brings us to the confidence of investors. We run a risk of having the double bear markets this decade permanently scaring investors out of the markets for many, many years, much as the Depression did. I am skeptical that investors will be satisfied with money market and bond annual returns of 4% or less while future stock annual returns (as I expect) come in at twice that level (or more). Unfortunately for many of these investors, I suspect that they will not come to this realization for one to two years, and will have missed over half of the recovery.

2009 Gameplan—Look at your total money market and bond balances. How much are you withdrawing annually, how many years can you go before this will be exhausted, before you have to sell any stock or stock funds? For most retirees this is at least five years. Given the table presented on the first page, investors should be well rewarded for patiently drawing down their cash/bonds, while letting their stocks recover.

One primary theme for 2009 is to avoid selling any stocks or stock funds, by drawing down your cash and bonds as needed. This should enable you to recover your losses sooner. All stocks look good to me—US, foreign, large, small, growth, value. Maintain balance within your stocks, but avoid shifting money from stocks to cash/bonds. For bonds, avoid low-yielding treasuries in favor of high quality corporate bonds, and for a bit of a boost, consider using high-yield bonds. Let’s hope for the recovery to be well under way by the next January report, for stocks to do much **better in ‘09.**