Prepared Comments from 1/15/2009 Conference Call

A fellow planner shared the following story to illustrate a common investor dilemma. Assume that you live on Long Island and need to go to LA. You plan to go by car. You make it to Manhattan fine, but hit gridlock (despite it being mid-day on a weekday) on your way to the Lincoln Tunnel. It is so bad that folks on bicycles are making progress as you are stopped.

You may be tempted to trade in your car for a bike. You likely would make it to Jersey sooner than if you stick with your initial plan. But then what would you do.

If you had known about the gridlock ahead of time, you would have made different plans.

But you didn't know, and now you are in the gridlock, considering your options.

Once in the gridlock, making any progress (by bike) certainly feels better than the frustration you feel going nowhere in your car. This better feeling, however, will just as certainly abandon you once you emerge from the tunnel, facing 2,400 miles to go.

By the way, if it was clear to everyone that gridlock was going to happen at that time and place, that knowledge itself would likely have prevented the gridlock, for most people would have taken steps to avoid it.

Jumping out of the analogy, most investors did not expect 2008 to end up with 35 to 50% declines in stocks, 5% or so declines in bonds, and 20 to 30% declines in most balanced portfolios. What are your options today?

Switching to all cash or CDs would perfectly prepare you for 2009, …, if it is a repeat of 2008. What is the likelihood of that?

Stocks do not move based on expected economic news, they move based on unexpected economic news. Stocks fell in 2008 as we learned, unexpectedly, that 2008 and much of 2009 would suffer a very rough recession. That led to today's gridlock.

You should not be asking yourself how the economy will surprise us in 2008 and much of 2009, you should be asking yourself how the economy will surprise us in late 2009 and 2010.

I feel that the surprises will likely be positive. There is a $3 trillion bet in favor of that surprise. What amazes me is that most investors are ignoring that $3 trillion.

The US government passed a rescue/bailout bill of almost $1 trillion this past fall. The Federal Reserve Bank has bought over $1 trillion of securities. In the coming month, the government is planning to pass a further rescue/bailout bill of almost $1 trillion. I don't know how much our country is saving in 2009 due to the sharp decline in the price of oil, but I know that it is substantial. AND THAT IS JUST IN THIS COUNTRY.

Do you really think that $3 trillion can be spent without anyone noticing? I have one client refinancing their mortgage this winter. Pam and I are exploring doing this ourselves. Why is this? The Fed's $1 trillion purchases included treasuries and mortgages, which directly brought down mortgage rates. This was a pleasant surprise, and one that I expect will continue to surprise.

The upcoming stimulus bill is expected to help states and help with jobs. One reason that municipal bonds fell last year (falling more in price than their interest payments) is based on concern over the financial strength of states. The concern will be dramatically reduced if the stimulus is passed. This is a positive economic surprise for late 2009 and 2010. Current fear-led expectations for unemployment numbers do not incorporate the results of the imminent $1 trillion stimulus package with its jobs components. Don't you think that there could be a positive surprise to its impact?

We have already paid the price for the economic plight of 2008 and most of 2009. You've paid the price, don't you want to see the show?

And what a show it could be. In the past sixty years, on average, stocks rise 30% in the twelve months after bottoming. Why do they do this? They do this because investors think that up markets can't go down and down markets can't go up. Investors do not believe that trends can reverse. It is how our brains are wired, and it works very much against investors.

Just because stocks rise after bottoming, what are some reasons to justify a 2009 rebound?

1) Stocks are more attractive than bonds. The S&P 500 yields 3% today, 50% more than 10-year US treasury bonds. Even if the US economy fails to grow for ten years, you should still make more money in stocks that you buy today than a US Treasury.

2) The right people are on the job. The US government and central bank are joined by concerted efforts by foreign governments and central banks. They are working to restart global economic growth. This is one area where if you through enough money at it, you will get results. Even better, the incoming economic team is viewed by both Republicans and Democrats as highly qualified, with deep understanding of what has worked and not in the past.

3) Over $1 trillion dollars was moved into money market mutual funds in the past two years. Once stocks have had a quarter or two of recovery, stand back as the 'me too' investors join the crowd. By the way, money markets returned less than 3% last year, and are yielding much less than that, due to the Fed dropping the fed rate to essentially zero.

So what happened?

The housing boom was aided by bundling mortgages together and selling them to bond investors. As the boom continued, the mortgages became lower and lower quality (all of the high quality borrowers already had mortgages). The bundlers didn't much care about the quality, as long as they got a commission. These bundled mortgages were sliced and diced to much that it was very hard to see what was in them, and largely as a result, the credit rating agencies took the easy path and gave most their blessing. Blessed pools of mortgages were bought by many investors, including hedge funds (who borrowed to buy these pools, using leverage) and banks (who used these pools of mortgages as assets, evidence of their stability). Then as housing prices began to fall, the value of these pools began to dive. This was aggravated by credit default swaps, derivatives in which one financial firm bet on the stability of another. These bets depended on someone to pay off the bet, but these someones began to go belly-up, or go AWOL.

In September, this came to a head, as the country's financial system had a cardiac arrest. The Fed and the government jumped in with dramatic actions. In October and November we found that the actions wouldn't solve things overnight, and that the problems were deeper than originally thought.

All of this caused investors to see their portfolios evaporate before their eyes. Many reacted by selling their falling stocks, which served to have stocks fall further, which reinforced the views of those who were tempted to sell their stocks (and who wasn't tempted).

In the past quarter, bonds moved sideways. Despite a rebound after hitting bottom in late November, stocks fell 20% or more during the whole quarter. Real estate fell almost 40% (most of this is commercial, and the economic news, and the availability of borrowing, on which commercial real estate depends, both were abysmal during the quarter). The average balanced fund fell over 14% during the quarter.

In all of 2008, bonds lost from 1 to 5% (junk bonds lost close to 20%). US stocks fell 35-40% and foreign stocks fell 40-50%. Oil, after cresting in July, fell sharply, and natural resource stock funds ended the year down almost 50%. The average balanced fund fell almost 27% in 2008.

What do I expect to happen in 2009, and why.

I expect that the multi-trillion dollar efforts by global governments and banks will begin to show positive results during the year. I expect that lowered mortgage rates will help slow the decline of housing prices. I don't have a good take on whether housing will bottom this year or next.

As the financial system stabilizes, as companies and individuals are again able to borrow money for productive purposes, expectations for the economy (the summation of government and corporate activity) will increase, as will expectations for company profits. This will lead to stock market gains, which, coupled with low money market, CD, and bond yields, will break the back of the 'sky is falling' investors. This will accelerate the stock markets' recoveries. How much occurs in 2009 and how much occurs after 2009 will depend on factors beyond my visibility. I do expect stocks to return 10% or more in 2009, large stocks, small stocks, US stocks, foreign stocks. I expect treasury bonds to lose money in 2009.

Let's get to the real critical question. Can you afford to keep invested in stocks? Your stocks lost 40% or so in 2008. You can't afford to lose that much again.

Twelve months ago the consensus, which I shared at the time, was that the economy would muddle through the housing and subprime problems. The surprise was on the negative side, and was significant. This caused stocks to tumble.

The consensus at this time, which I do not share, is that the economy is doomed to remain down for years and years. I strongly believe that the surprise will be on the positive side, and will be significant (given today's level of fear). This should cause stocks to shoot upward. This is the basis of my expectation for strong stock results in 2009.

To the question of whether you can afford to keep invested in stocks, I begin by asking how many dollars do you have invested in cash, money markets, CDs, and bonds. My second question is how many dollars do you plan to withdraw over the next five years. If you have enough cash and bond money to last five years, then you can go that long without selling any stocks. Do you really feel that trillions and trillions of stimulus spending will fail to have the global economy to recover in five years?

Again, we have already been blown off course. You have already paid the price. If your cash and bonds can handle your withdrawals for several years, then aren't you better off letting your stocks remain invested, in place to recover their value as the global economy recovers?

I have no illusions that it feels awful today. It feels foolish to keep money in stocks. Recognize that these feelings are hardwired into our brains, the result of centuries of lessons of creating trends where none really exist. Actually, the contrary is true. Stocks are much more likely to rise in the year after they have fallen over 30%. Admit that your heart is telling you that investing in stocks today is foolish, but that your head is telling you that investing in stocks today is smart. Recognize the conflict, and be very deliberate in how you resolve it.