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Perspectives

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The year 2008 tested the mettle of even the hardest investors, with fears of global recession becoming a reality and the subprime crisis leading to historic declines in the financial markets. We continue to believe that the recession will end only when governmental intervention and other factors thaw the credit markets and stabilize the housing sector. We also continue to believe, however, that the financial markets are likely to recover prior to the inevitable end of the recession. In the meantime, we remain defensively postured, adhering to the following disciplines: holding companies with sustainable competitive advantages that generate discretionary cash flow; avoiding the perils of market timing; staying committed to proper asset allocation and diversification; and capitalizing on opportunities presented by current market conditions.

REVIEW

While it is now universally understood that 2008 was one of the worst years in the history of the global financial markets, many investors are only now beginning to comprehend the totality of the downturn. In 2008, unlike almost all other down years, there were virtually no places to hide.

U.S. Equities. The S&P 500 Index, exclusive of dividends, was down 38.5% in 2008, its worst year since 1937 and its third worst year ever. The Dow Jones Industrial Average declined 33.8%, its worst year since 1931 and also its third worst year in history. The NASDAQ Composite Index fell 40.5% for the year, making 2008 the worst year in the history of the NASDAQ – even worse than 2000, when the “Technology Bubble” burst.

All sectors of the stock market finished sharply lower, including the “defensive” consumer-staples and healthcare sectors. Over 62% of all S&P 500 companies finished the year greater than 40% off their 52-week highs.

Along with the absolute losses suffered during 2008, volatility was the theme for the year. The Chicago Board Options Exchange Volatility Index, which measures the implied volatility of stock returns, doubled its previous record. Approximately 17% of all trading days ended with a 3% or greater move to the upside or downside. (Prior to last year, the highest percentage of trading days with moves of that magnitude had been 7%.) In October alone, the Dow experienced two of its six largest daily percentage increases

since its inception in 1896. It then promptly surrendered those gains in full. Of the 20 largest percentage declines in the history of the Dow, four occurred during the last four months of 2008.

U.S. Fixed Income. Consider some of the historic events that unsettled the fixed-income markets during 2008:

- The pervasive subprime crisis;
- The bankruptcy of Lehman Brothers Holdings, which had been in business for almost 160 years;
- The governmental takeover of Fannie Mae and Freddie Mac;
- The “breaking of the buck” for the first time in 14 years by a money market fund – Reserve Primary Fund, the nation’s first such fund;
- The reduction by the Federal Reserve of the federal funds rate from 4.25% to a range of 0%-0.25%, the lowest in history; and
- The announcement by the National Bureau of Economic Research that a recession officially began in December of 2007.

As a result of these and related phenomena, even the relatively “safe” fixed-income markets suf-

ferred. High-yield or “junk” corporate bonds fell some 26% during the year, another new record. Investment-grade corporate bonds also declined, with the Lehman Intermediate Corporate Index falling 4.8%.

Fearful of losing capital, investors increasingly sought out, and indeed insisted on, the safety of U.S. Treasury securities. As a result, Treasury yields plummeted, with the yield on 10-year and 30-year Treasuries dropping to 2.253% and 2.671%, respectively. So strong was the flight to safety that investors eventually were willing to purchase short-term Treasuries at a yield of 0%. Credit spreads – the incremental yield offered by corporate bonds over Treasuries – hit record highs as panic levels increased.

Commodities. During the first half of 2008, we wrote about the dramatic, seemingly unsupported rise of the commodities markets. By the end of the year, these markets too had suffered record losses as the fragile economy wreaked havoc on demand, and fears of inflation turned into fears of deflation.

The Dow Jones AIG Commodity Index lost 37% in 2008, its worst year in its 10-year history. The price of oil rose as high as \$145.29 per barrel in July, representing a 51% gain for the year at that time. By the end of 2008, however, oil had fallen to \$44.60, a 69.3% loss from the July high and a 54% loss for the year.

Gold, with the safety it theoretically offers, eventually managed a gain of approximately 5.5% for the year, but even the price of gold was unusually volatile during 2008, having a trading range of \$705-\$1,004 during the year.

Copper, corn, natural gas, and most other commodities finished the year sharply lower.

U.S. Dollar. Having endured a relatively steady decline since 2002, the U.S. Dollar began to rise in July. By the end of 2008, the Dollar had gained 4.5% against the Euro, 36.2% against the British Pound, and 30% against the Brazilian Real. It lost 19% against the Yen, one of the few currencies to which the Dollar surrendered value.

The Dollar’s rise during the second half of 2008 was largely attributable to the same forces that drove down Treasury yields during that period – a flight to perceived safety. Investors from all around the world sought shelter not only in U.S. Treasuries but also in U.S. Dollars, the world’s reserve currency.

International Markets. As bad as it was in the U.S., it generally was worse – often far worse – abroad. With international policymakers lagging behind their U.S. counterparts on the pace of easing interest rates and using fiscal stimuli, the international financial markets were hit particularly hard.

While the U.S. Dow was down 31.9% for 2008, the Dow Jones World Index, excluding the U.S., was down approximately 46% for the year (in U.S. Dollars). The MSCI EAFE (Europe, Australasia, and Far East) Index lost 43.4%, and the MSCI Emerging Market Index lost 54.5%, reflecting the fact that many of the emerging markets that once boasted sizable gains were among the hardest hit last year. Key indices in China and Russia were down more than 60%. Internationally, the theme was the same:

there were virtually no places to hide in 2008.

ANALYSIS

In our prior newsletters and other client letters, we have sought to provide in-depth analysis of the current downturn, including historical perspectives and our advice on how to manage portfolios during these difficult times. In this newsletter, we offer a direct question-and-answer session, in which we attempt to address some of the fundamental questions posed by the current crisis.

Q: Is there a new investment paradigm? Is the time-honored strategy of “buy and hold,” made famous by “common-sense” investors like Warren Buffett, dead?

A: There is a misperception about what some call the “buy and hold” strategy – when properly executed, it is not the equivalent of “buy and forget.” While we fundamentally remain longer-term investors, we use a time horizon of three to five years for each of our holdings. We actively assess and reassess our holdings on a regular basis, and we follow a strict sell discipline. In fact, we believe that our time horizon actually separates us from much of our competition.

We have been discussing a trading-range market for years now, and, as a result, our portfolio turnover has increased over the past five years. While we endeavor to keep our turnover relatively low in order to decrease tax and transaction costs (and increase net returns), our large-cap portfolio strategy averaged more than twice as much turnover over the past five years as over the previous seven (34.3% v. 15.4%). In other

words, our average holding period has fallen from over six years to slightly under three years. Similar observations can be made about our other equity portfolio strategies.

Yet, while our process continuously evolves as environments change, our philosophy remains constant: to seek out companies with sustainable competitive advantages that generate discretionary cash flow and rely less on debt. We believe that the latter attribute in particular will become an increasingly important differentiator as credit markets remain tight.

We cannot help but recall the last “new paradigm” in investing, also known as the Technology Bubble, when stocks whose corporate names did not end in “.com” were discarded, and the word “bond” was met with a dismissive shrug. It did not take long for that new paradigm to disappear and for the more rational historical paradigm to re-emerge.

Q: As 2008 progressed, you became increasingly defensive in your tactical strategies, but why did you not completely exit the equity markets prior to the dramatic collapse that occurred last Fall?

A: First, it is important to observe that the disintegration happened exceedingly fast. As recently as the last trading day of August, the markets were navigating the recession in an orderly fashion, with the S&P 500 down less than 15%. Then Lehman Brothers’ sudden bankruptcy transformed an ordinary-appearing cyclical correction into a full-blown crisis of confidence in the entire financial system without precedent. Following the

failure of Lehman Brothers in mid-September, the S&P 500 fell 35% until it bottomed on November 20, a period of just eight weeks. In the first three post-Lehman weeks alone, the S&P 500 fell 22%.

Few, if any, investment strategists or market pundits predicted anything close to what occurred in time to avoid the damage. Moreover, there was virtually nowhere to hide – only Treasuries rose in value. Even money market funds were perceived to carry risk.

There are two components to every investment decision: when to sell and when to buy. Even if one is fortunate enough to time an exit correctly, that decision can only be judged once a decision to reenter the markets is made. If one repurchases at or above where one originally sold, one has only created transaction and tax costs. As Warren Buffett has said, “the Market Timers Hall of Fame is an empty room.”

To illustrate, after declining through November 20, the S&P 500 then rebounded 24% before pulling back earlier this month. How many investors who had exited the markets beforehand had the courage to buy at or around the lows of November?

Q: Does diversification through asset allocation still work? Is Modern Portfolio Theory outdated?

A: In bear markets, two things tend to go up: correlations and volatility. In other words, on a short-term basis, diversification often seems to fail when investors need it most; but there is nothing to indicate that diversification will fail to work over full cycles as it has in the past.

The perceived demise of Modern Portfolio Theory, which calls for the use of diversification to optimize portfolio returns, is perhaps fueled by the extraordinarily high correlations that occurred this past Fall when almost every asset class declined. Even gold, so frequently touted as a safe haven, declined 30% from its March high of \$1,003 to its November low.

Notably, over the past decades, Modern Portfolio Theory has evolved to encompass asset classes that did not exist at the time of its introduction, fueled by Wall Street “innovation” and the attention-grabbing returns of pioneers such as Yale University’s David Swenson. Even these alternative asset classes failed to provide investors protection during 2008, with the HFRI Equity Hedge Index down 26.1%.

Yet, over extended periods, diversification historically has been the key to investment success, and alternatives to diversification generally have not fared as well. True enough, Treasury securities and cash did offer some shelter during 2008, but investing exclusively in Treasuries and cash instead of a diversified portfolio has been a far less effective strategy over the longer term. In fact, after taxes, investing in cash equivalents generally has returned less than the inflation rate (and therefore has led to economic losses) over the long term. Thus, we are not prepared to declare the death of Modern Portfolio Theory and the virtues of diversification based on the correlations that occurred last Fall.

Q: Financial markets have been routed over the past several months. Surely there must be opportunities amidst the rubble. Where are you finding them?

A: Back in October, investment-grade corporate bonds represented a compelling bargain, though the Lehman Intermediate Corporate Bond Index has since returned over 26%. Still, high-grade spreads between investment-grade corporate bonds and comparable risk-free Treasuries are near past historical peaks, and we expect there to be increasing demand for high quality corporate paper.

The dividend yield on the S&P 500 has surpassed the yield on the 10-year Treasury note for the first time in 50 years, implying that the risk-reward ratio in stocks looks favorable despite the unusually opaque earnings picture. An investor with a multi-year time horizon who is saving for retirement or other long-term goals should be accumulating equities at what are likely to be, in hindsight, extremely attractive prices.

While emerging-market equities carry higher risk, they appear to offer a good risk-reward profile, with valuations below those of developed markets. Developing-country economies should continue to grow faster than their developed counterparts, as local monetary policy and fiscal stimulus aid recovery. Emerging economies are also the furthest removed from the epicenter of the current financial crisis, the U.S. housing market. We maintain a prudent allocation to emerging markets where appropriate.

Gold holds some intrigue in the current circumstances. Monetary and fiscal policy are very loose, creating the potential for future inflation once the economy recovers; demand for physical gold is high throughout the world; and the dollar probably will trend

lower longer-term. If the economy surprises to the downside, gold is likely to decline less than financial assets, and if policy is perceived to be successful in re-inflating the economy, gold should move higher in anticipation. We currently are evaluating opportunities to add exposure to this asset class in our equity and mutual fund portfolios.

Finally, we note that cash and cash equivalents are yielding close to zero on a nominal, pre-tax basis. According to Morgan Stanley, U.S.-based cash as a percentage of U.S. equity market capitalization is at a record 40%. This figure significantly exceeds the previous peak of 27%, which was reached in 2003. More than \$4.6 trillion in cash in money market funds, equity mutual funds, and S&P 500 corporate balance sheets is now earning very little or nothing, intensifying the pressure on holders to seek a higher return on capital. Eventually, much of this cash again will find its way into riskier assets, including those mentioned above, driving prices higher.

CONCLUSION

We consistently have written that the current downturn can end only when the strength of the credit markets is restored and the housing sector has been stabilized. The U.S. government and other governments around the world are fixed on these two missions and appear ready to take such further actions as are necessary to accomplish them. Eventually, the economy will recover, and history has shown that the financial markets are likely to recover before, and in anticipation of, the economic recovery. While we await these recoveries,

we are committed first and foremost to the strategic principle of attaining investment objectives over appropriate time horizons using proper asset allocation and diversification techniques, consistent with Modern Portfolio Theory. That being said, we remain defensively postured in our equity portfolios, favoring companies with sustainable competitive advantages that generate positive cash flow, thereby relying less on the credit markets. Tactically, our growth focus is on companies that are likely to benefit from capital spending programs, particularly in light of projected global infrastructure development. Additionally, we see opportunities in the emerging markets and in investment-grade corporate debt. We also have taken defensive steps in our mutual fund portfolios by increasing our exposure to absolute-return and market-neutral strategies to provide a hedge against further market volatility.

In closing, we note that while the recession of 2008 dealt a serious blow to the financial markets, those markets have seen some of their most significant gains in the months following recession lows. The S&P 500 has increased 34% on average during the 12 months following the lows of each recession since 1949. The Dow has increased 23.2% on average in the year following a year in which it dropped between 30% and 40%. In providing these figures, we do not seek to predict the ultimate outcome of 2009. We seek only to remind our clients of the importance of having a longer-term perspective and of not allowing fear to dictate their investment management strategies.