

# MARKET NEWS

*Keeping our Clients Informed*

January 19, 2009



## A Year of Change

2008 will certainly go down as a year of change. Whether it is by choice politically or forced financially, things will definitely be different as we move forward. 2008 will also be remembered as the year that permanently changed Wall Street.

We would sum up 2008 as the year in which the U.S. received a massive margin call. Across the economy, wary lenders demanded that borrowers put up more collateral or sell assets to reduce debts. For years, the U.S. economy has been borrowing from cash-rich lenders from Asia to the Middle East. American firms and households have enjoyed readily available credit at easy terms, even for risky bets. No longer.

The aftermath has left us with tighter lending standards, a financial system under-capitalized, and trillions of dollars worth of securities (at issue) that no one seems to be able to correctly value. The result is a slowing global economy that hasn't found a bottom. Throughout most of the year stocks proved remarkably resilient to the bad news. That changed dramatically in the fourth quarter.

Going through the numbers, all of the major stock averages were down substantially at the end of the year. The S&P 500 was off 38%, NASDAQ down 40%, Dow Jones 30 down 33% and the Russell 2000 off 34%. European and Asian markets fared even worse, declining between 45 and 50%.

As we've written over the past year, bonds didn't offer much of a hiding place either. Most issues saw their prices decline as risk was re-priced in the market place. There is still no market for a wide range of asset-backed bonds. Even the normally boring municipal bond market took a hit when the bond insurers lost their AAA ratings. Treasury bonds were the only exception to this retraction as investors sought safety over anything else.

Many lessons can be learned from the experiences of last year. Among other things, those lessons include the dangers of excessive leverage, the interdependence of our financial institutions, the importance of

transparency in the markets, and the unintended consequences of government policies.

It is yet to be seen how the regulatory landscape will be changed as a result of the past year, but it surely will. There are two observations that can be made regarding the financial system regulatory environment. The first is that it is highly unlikely that government regulations can keep up with the speed of evolution in the markets. Some of the most significant trading venues today were only niche markets a few years ago. Secondly, it is unclear how many of these problems can be legitimately attributed to a failure to regulate.

Government's never ending desire to get bigger would have us believe that the solution to avoiding this kind of pain in the future is increased regulation. However, it's interesting to note that if you were to rank the severity of problems in the system, you would find that the most affected companies and industries are also the most regulated.

We believe systemic changes in the financial markets are what is most needed, not increased oversight. An obvious and necessary change is for investors to require issuers of asset-backed bonds to continue to have some culpability after the securities are sold. Underwriting standards would be greatly improved. Also, markets that are large enough to pose an economic threat should be transparent and have a central clearinghouse that would allow others to gauge the inner dealings. Accounting rules should better address how to handle pricing securities that don't have a liquid market.

These are not necessarily regulatory changes in oversight, but instead are changes to the way Wall Street does business. These types of changes do need to be initiated through legislation. There are plenty of oversight rules in place. The problem seems to be how well the overseers are doing their job, which leads us to the next subject – scandals.

## Show me the Money

Times of stress always expose the weaknesses in a system. So it goes with the current market crisis. Among all of the bad news in the financial markets, one of the most shocking developments was the self-

disclosed Ponzi scheme run by Bernard Madoff. The reported 50 billion dollars in losses was yet another blow to the already shaken markets. Not only are these losses the largest ever of this type, but they impact an amazing array of individuals and institutions.

One of the more surprising elements of this case was the apparent failure by the securities examiners to catch this scheme in the twenty-plus years it continued to grow. Throughout those years there were a number of clues that something was amiss. The most obvious clue was the remarkably consistent returns by the fund. These supposed returns spanned both good times and bad. This time period included the collapse of Long Term Capital, the global currency crisis of the mid 1990's, and the bursting of the tech bubble in which the overall market lost half its value. During those same times the fund reported double-digit returns year after year. This incredible performance is what allowed the fund to attract so many assets.

The secretive nature of the fund's investment techniques led other managers to question the ability of Madoff to generate such consistent returns. Several people went so far as to raise these questions directly with the securities regulators only to be dismissed. Now that the scam is out in the open, fingers are being pointed in every direction.

How could this have gone on for so long? While the details are only now emerging, there are two factors which could account for the ability of Madoff to deceive so many people. First, investor greed led many people to suspend their critical thinking because they wanted to believe that this was easy money simply there for the taking. Secondly, Madoff owned both the fund management company and broker/dealer that held the accounts. This meant that he was both reporting the performance and generating the statements to back up those performance claims.

The two lessons from this scheme are: 1) The importance of asking hard questions when your investment manager is always making money regardless of the market conditions, and 2) the need for checks and balances in monitoring your portfolio performance.

You should always be concerned when your managers' performance is *radically* different than their benchmark over time. This means they are doing something very different than that benchmark. While this can be good when the benchmark (aka, market) is going down, that strategy should not work when the benchmark is going up. Conversely, a strategy that is greatly over-performing in up markets should get clobbered in a down market. Managing risk should be accomplished through asset allocation and not changing

strategies within an asset class. When investors see this, they should be prepared to ask a lot of questions and get specific answers. Your investments should never be a "black box".

Never underestimate the need for checks and balances. Whether it is intentional or not, mistakes can happen. You should always know what controls are in place to protect your assets and accounts. A good example in our business is the role of the custodian, which for our clients is Schwab. We report positions, performance, trades, etc to our clients at least every quarter. What we send out can be independently verified by the statements and trade confirmations our clients get from the custodian. In the Madoff case, his company was generating both, which as you can see is a major conflict of interest.

We reconcile our portfolio balances and activities to Schwab's reports every day using software that is completely independent from theirs. So if there is ever a difference, our staff identifies why and what to do about it the same day. While rare, the differences are almost always due to timing of payments. We adhere to the principle put forth by Ronald Reagan as he would say about arms treaties, "trust but verify."

Another troubling aspect of the Madoff case is the fact that no one really knew what his fund owned. Even the other investment advisors directing their client assets to him didn't know what his fund was doing or what investments it owned. As investment managers ourselves, we cannot imagine putting our clients in that situation. This is every bit as egregious as Madoff's thievery. Unlike Madoff and the many financial advisors who kept their clients in the dark, we believe it is important for you to understand the strategies we are employing and know what securities you own.

## So What Do I Own?

We attempt to send out commentaries and articles on a regular basis because we want you to understand the activity occurring in your portfolio as well as the securities it contains. You may have noticed a few consistent investments in the core area of the equity portion of your portfolio, and we want to alleviate any confusion as to what these core mutual funds and exchange-traded funds are designed to achieve. Some focus on capturing the broad market while others are more focused.

While each client's personal situation is different, we include these few common investments and strategies in almost all of our client accounts because they are broadly diversified and thus less volatile. However, we want to stress that we do not use "cookie-

cutter” accounts in which each portfolio contains the same investments in the same amounts. We simply include these investments as the backbone of your portfolio due to their well-diversified nature and then structure the rest of your portfolio around these investments based on your individual circumstances. The exposure to these holdings will vary from one client to the next, as it should, but we still wish to take this opportunity to explain exactly what these common investments are and what they seek to accomplish.

#### SNXSX – Schwab 1000 Select Index Fund

Indexing is an important component of any diversification strategy, and that is what this mutual fund from Schwab is accomplishing. The Schwab 1000 consists of the 1,000 largest companies in the United States, and the index is designed to be a measure of large-cap stocks. What is large-cap and why would you want a large-cap mutual fund? Market capitalization is a measure of public consensus on the value of a company, so bigger companies carry the investor sentiment that these companies will continue to survive and thrive. Large cap companies also became large for a reason, usually attributable to significant competitive advantages and domination in their respective markets that will most likely continue. Therefore, your equity portfolio is heavily weighted in large-cap indexed assets because these stocks are proven strong performers.

We chose this particular large cap mutual fund because it has very low fees and high diversification across a very large number of companies, thus reducing risk. You might wonder why we chose a fund run by Schwab, but the company that operates the fund is generally unimportant because the fund is not actively managed by a portfolio manager. In other words, the fund owns a set of stock and the fund changes value as the stocks it owns change value. No one at Schwab or any of the other following companies are buying or selling securities in the fund each day. This is a positive situation because it means you do not have to rely on a portfolio manager to perform. You must simply rely on the companies contained in the fund to perform.

#### MDY – Standard and Poor’s MidCap 400

The large, mid, and small-cap indexed components in your accounts can be seen as the building blocks of a diversified equity portfolio, and this S&P MidCap 400 exchange-traded fund is the main mid-cap element. We use MDY because it carries the inherent advantages of being an ETF; low fees and simple trading rules. This particular ETF consists of 400 mid-cap companies chosen based on their size. While mid-cap companies have proven their worth and are still quite large relative to all companies in the country, they are smaller than

their large-cap counterparts and thus carry slightly more risk. However, with higher risk comes higher reward, and this mid-cap holding tends to outperform large-cap holdings during periods of growth. But even with this somewhat increased risk due to smaller companies, this ETF avoids company-specific risk by diversifying across many mid-cap companies.

#### SWSSX – Schwab SmallCap Index Fund

The final portion of your main equity holdings will be this small-cap indexed fund. This fund invests in 1,000 of the largest stocks that can still be classified as small-cap. Many of the stocks in this category will eventually grow to be re-classified into the mid-cap and large-cap groups. While this mutual fund carries more risk than the large or mid-cap holdings, the fund is sufficiently diversified across 1,000 companies, thus reducing the risk intrinsic to investing in small-cap stocks. While we wish to avoid the high risk of investing in individual small-cap companies, we take advantage of the high possible returns of small-caps by investing in this well-diversified fund.

#### DLN – WisdomTree LargeCap Dividend Fund

Like the Schwab 1000 fund, this ETF also focuses on the large-cap portion of the stock market. However, the WisdomTree LargeCap Dividend fund chooses companies based on their dividend rather than their size. Basically, WisdomTree looks at the total universe of stocks, and then chooses 1,200 with steady and high dividends. Then, WisdomTree takes the top 300 large-cap companies from this list, resulting in a group of well-known companies with high dividend payouts. The fund accomplishes two goals; it includes only large-cap and thus less risky stocks, but it also provides a healthy cash flow due to substantial dividends. Investing in dividend-paying stocks has historically proven to be a winning strategy in the stock market because dividends have historically made up half of the market’s total return. This fund allows us to capitalize on that strategy without exposing your portfolio to the risk of individual companies.

#### DON- WisdomTree MidCap Dividend Fund

This ETF is very similar to the WisdomTree LargeCap Dividend fund, except it focuses on the mid-cap portion of the market. It operates by again looking at the list of 1,200 dividend-paying stocks, removing the 300 stocks included above in the WisdomTree LargeCap Dividend fund, and then taking the next large chunk of stocks that would classify as mid-cap size. These companies have reliable dividends and the ETF is diversified across more than 600 companies.

#### DES – WisdomTree SmallCap Dividend Fund

Again, this ETF follows a dividend philosophy, but it contains small-cap stocks from the list of all high-dividend paying stocks. While any small-cap fund is more risky than the mid-cap or large-cap holdings, the fact that these stocks can afford and are willing to pay a dividend despite their small size is a great sign of financial strength. Therefore, we believe this ETF will provide the opportunity to receive income through dividends, reduce the risk that might be present in other small-cap stocks, and potentially make larger gains than are possible with large or mid-caps.

#### DWM – WisdomTree Dividend Index of Europe, Far East Asia, and Australasia Fund

This is a dividend-weighted fund that includes dividend-paying companies in the industrialized world outside of the United States. It is comprised of over 2,300 companies from 21 countries, including 16 developed European countries, Japan, Australia, New Zealand, Hong Kong and Singapore. As you can see, this is a highly diversified ETF with the intention of gaining international exposure while reducing the risk of adverse events in individual countries. While the fund contains large, mid, and small-cap companies, 70% of the companies are large-cap. Thus, the fund includes the most successful companies from each of the countries. We believe diversifying outside of the United States is a smart idea because it reduces the risk of being invested in only one country, and it also allows investing into foreign markets that are expanding.

#### EFA – MSCI Europe, Australasia, and Far East Asia Fund

This indexed ETF is very similar to the WisdomTree international dividend fund, however the MSCI Europe, Australasia, and Far East Asia (EAFE) fund includes companies based on size rather than dividends. It consists of companies from the same 21 countries as the WisdomTree fund, but it simply ranks companies based on size and chooses the largest. This fund also avoids emerging markets, and it is well diversified. While we could have chosen to only include the WisdomTree fund or the MSCI fund, we chose to include both a dividend-weighted and capitalization-weighted international fund in our accounts to attain increased diversification and less risk.

#### EPP – MSCI Pacific ex-Japan Index Fund

This ETF is unique in that it diversifies your portfolio into the Far East Pacific regions of the globe. It includes companies from 9 countries: China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand. So why does the fund

exclude Japan? The simple reason is that the fund is attempting to focus its attention more southward than Japan, but also Japan is included in many other MSCI international funds and this fund provides an opportunity to diversify away from Japan. While this fund is more risky than the very large and extremely diversified global funds listed above, the MSCI Pacific ex-Japan ETF provides an opportunity to get invested into a region that shows great growth potential.

#### ILF – S&P Latin America 40 Index Fund

So what about this side of the globe? We are diversified in the western hemisphere as well. The S&P Latin America 40 ETF represents major companies from the Mexican and South American markets. The index draws from the four major Latin American countries: Argentina, Brazil, Chile, and Mexico. South America has recently shown great growth, and as these markets become more developed and industrialized, they will grow even more. We chose this particular fund because it includes only the very largest 40 companies from a region that could otherwise be more risky. These 40 companies are the strongest members of their respective segments of the market in Latin America and South America.

#### SDS – UltraShort S&P 500

The UltraShort S&P 500 exchange-traded fund is one of our most important hedging devices because it seeks to provide the opposite of the S&P500, times two. So, the ETF attempts to protect against losses on your core equity holdings by returning twice the opposite of the market. For example, if the S&P500 moves down 3% in one day, the UltraShort fund moves up approximately 6%. SDS is a great hedging tool during difficult market times because it moves upward as the general market posts losses. SDS alleviates some of the downward pressure on your equity portfolio.

#### Summary of Portfolio Positions

In response to the difficult economic conditions this year we have made significant changes to our equity allocations. First of all we have greatly reduced our equity allocation overall. Next we have reduced or eliminated the company specific risk by moving away from individual stocks and using indexed ETF's. Lastly, we have spread our equity exposure around the globe to help reduce the volatility of any one currency.

Of course, the previous equity descriptions do not include the fixed income allocations present in our client portfolios, such as bonds or alternative fixed income. These also serve to reduce volatility and provide income during these difficult times.