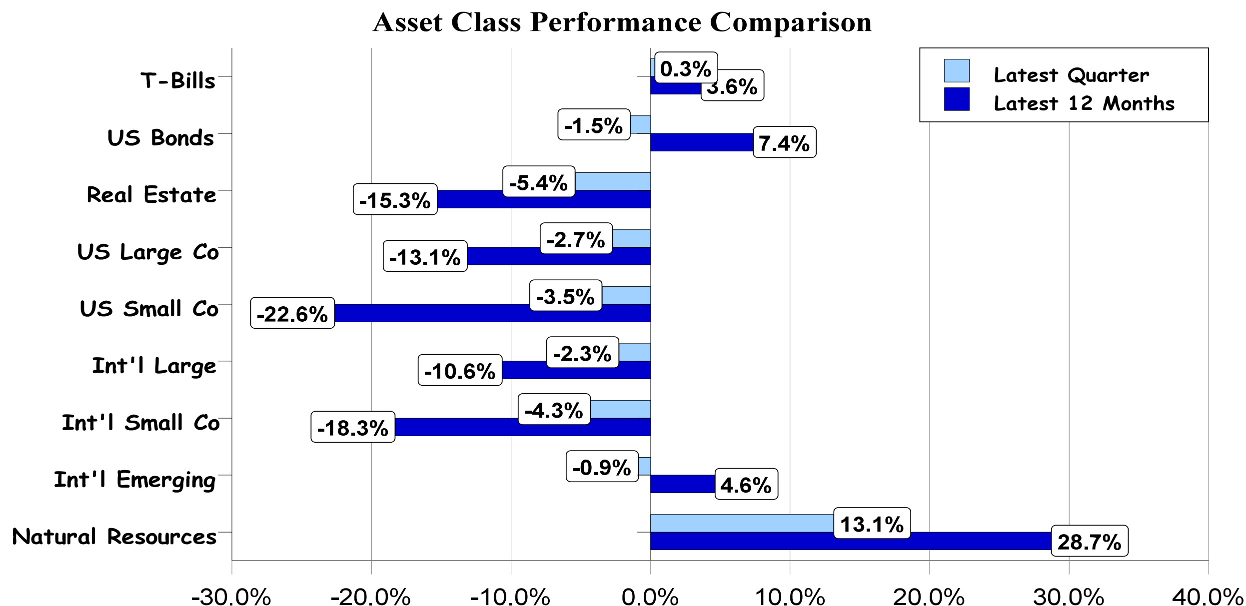
Maintaining a Long-Term Perspective in Turbulent Times

Dear Client:

When we wrote our "Steady at the Helm" letter in March following the collapse of the investment bank Bear Stearns, we were suggesting that in turbulent times it's generally unwise to make abrupt changes to one's portfolio allocation. Assuming that stock market risk has already been factored into the portfolio's structure through proper diversification, it's normally better to maintain a steady hand on the helm and ride through the storm. History has demonstrated that attempts to time the markets more often than not lead to disappointing long-term results. Nonetheless, it's quite unnerving to watch the value of one's portfolio behave like a roller coaster as the markets react to a continuing stream of bad economic news. The financial press, of course, stokes the flames of uncertainty and fear in an effort to grab audience share and any positive news gets overlooked or under-reported. I'm certainly not attempting to dismiss the significant economic challenges we're facing; rather, I'm suggesting that during times of great turmoil it's important to remember that our portfolios have been constructed with the *expectation* that the markets are volatile. Over the last hundred years, investors with a long-term perspective and patience were paid handsomely to take risk; those with little patience, or those who were reactionary, usually ended up paying the price of underperformance. Later in this letter, I'll discuss some important historic lessons of investing in some of the most turbulent times; first, let's take a look at the recent past.

Asset Class Performance Observations

Normally, I begin this section by discussing the returns over the latest quarter; however, I'll begin this time with a review of the returns over the last twelve months which are clearly visible in the chart below. Over the past year, most of the stock asset classes were down between 10% and 22%. The biggest loss was in US Small Co.'s (-22.6%) followed by International Small Co.'s (-18.3%), US Real Estate (-15.3%), US Large Co.'s (-13.1%) and International Large Co.'s (-10.6%). The only safe havens from the storm were Natural Resources (+28.7%), US



Bonds (+7.4%), Emerging Markets (+4.6%) and T-Bills (+3.6%). US Bonds benefitted from the "flight to quality" as investors sold what they perceived to be risky bond in favor of bonds backed by the US government and other high quality issuers. Other than bonds, profits were also made on energy related stocks as the price of oil surged from $70 to $145 per barrel. Some suggest that we're in an "oil bubble" which may deflate rather rapidly should "demand destruction" cause a significant decrease in consumption. In the US, we're already seeing a marked decline in gasoline consumption as consumers begin abandoning gas guzzling cars, shorten the length of vacation travel and even shift to public transportation. In past oil spikes, whenever the US consumer reduced energy consumption, the price of oil declined; this time, however, our conservation efforts are more than offset by the rising demand in the emerging economies where more than 3 billion people are just entering the automotive age. Our Natural Resource expert, Fred Sturm (manager of Ivy Global Natural Resources), stated in a recent report that the current "high-plateau price environment should hold until another round of scarcity concerns pushes prices beyond what we consider 'high' today." In other words, don't count on gasoline prices retreating significantly, if at all. The benefit of high energy prices, of course, is that alternative energy sources have become economically viable. Case in point: nearby Hull, Massachusetts, will soon become 100% energy self-sufficient after the construction of an additional four wind turbines (they have two already). Hull is now globally recognized as a model in the application of alternative energy technology. Our approach to Natural Resource investing is two pronged: (1) allocate funds to traditional energy companies as a means of capturing short-term returns and (2) introduce alternative energy companies in order to participate in the ultimate transition to cleaner energy. Presently, we recommend allocating 10% of equities to Natural Resources, including alternative energy.

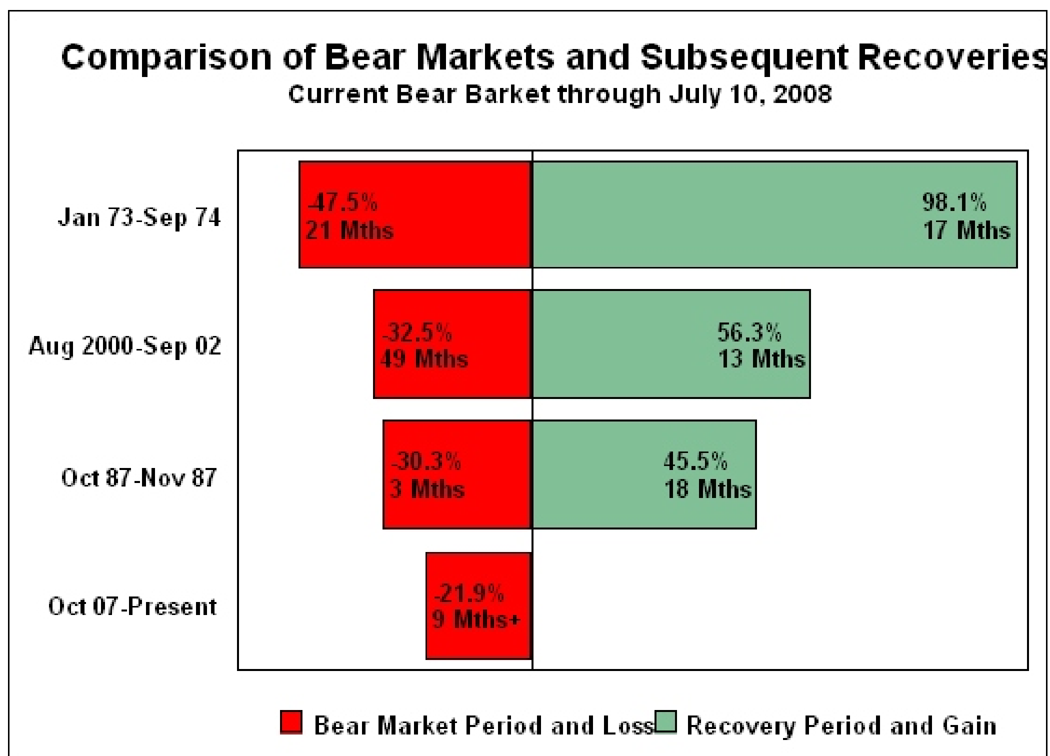
The latest quarter's returns are incorporated in the twelve month numbers and there were only a few bright spots. All of the stock asset classes with the exception of, you guessed it, Natural Resources were down between 1% and 5%. Even US bonds suffered from a spike in intermediate term interest rates with a loss of 1.5%. US Real Estate posted the biggest quarterly loss at -5.4%, followed by International Small (-4.3%), US Small (-3.5%), US Large (-2.7%), International Large (-2.3%) and Emerging Markets (-0.9%). Natural Resource stocks delivered a 13.1% gain and US T-Bills eked out a 0.3% gain. The quarterly returns and poor results so far in July reflect not only the concern about rising energy costs and inflation, but also the mounting concern over the health of the nation's banking system, especially in relation to the housing market. Without a healthy mortgage banking system, the availability of loans to home buyers would be constrained and the housing crisis would be prolonged. The two largest originators of new mortgages, Fannie Mae and Freddie Mac, have been hit hard by the housing crisis leading some to question their solvency. Given that Fannie Mae and Freddie Mac are Government Sponsored Entities (GSE's) and are the originators of about 70% of all new mortgage debt, the government was not about to let them fail. Just this week, Treasury Secretary Henry Paulson appeared before the Senate Banking Committee to outline his proposal for the government to provide a $2.25 billion line of credit to the two beleaguered GSE's as well as an option to purchase their stock, if necessary. Also discussed was the possibility of the Federal Reserve Bank becoming a "super watchdog" to oversee the financial markets in order to identify potential systemic problems before they reach the crisis stage. Ironically, the same Senate Banking Committee that is calling for *re-regulation* of the banking industry is the same Committee that pushed hard for *deregulation* in the late 90's. This unfortunate lesson in banking deregulating will likely end up costing the taxpayers an enormous sum. (A little aside on this matter. A primary proponent behind the Senate Banking Committee's push to deregulate the banking industry in the late 90's was its then Chairman, Phil Gramm, who subsequently became an *investment banker* with UBS Bank after leaving Congress in 2003. UBS Bank was at the center of the sub-prime controversy and was forced to write-down more than $37 billion in sub-prime related debt. Economist James Galbraith, of the University of Texas, had rather harsh words for the former senator, "Gramm's particular area [of expertise] is opening up financial markets to untrammeled dominance by speculative forces.....He's the sorcerer's apprentice of financial instability and disaster.")

The Bear Market of 2008

The stock market officially entered a Bear Market phase in early July as the S&P 500 had fallen by more than 20% from its record-high peak on October 10th of last year. The decline began last fall once the realities of the sub-prime loan debacle sunk in and the economy showed signs of slowing. From October to the end of 2007, the S&P 500 had fallen by about 6%. With the housing crisis deepening, a flash point occurred on March 17th when the Federal Reserve was forced to rescue the sub-prime laden investment bank Bear Sterns from bankruptcy. At that point, the S&P 500 had fallen 18% from its October peak. Through the rescue of Bear Stearns and by pumping massive doses of liquidity into the banking system, the Fed hoped to re-instill confidence in the credit markets. In addition to these historic measures, the Federal Reserve was attempting to stimulate economic growth by lowering interest rates and the US Treasury hoped to spur-on consumer spending through the tax rebate checks. As a result of these stimuli and apparent regained confidence in the banking system, between mid-April and mid-May, the stock market recouped much of its six-month loss by surging more than 12%. Perhaps that four-week calm was simply the eye of the storm passing through as further bad news beset the economy in late May. With consumer spending still under pressure, the additional constraint of persistently high gasoline prices began to take its toll. In early June, consumer confidence reached a 25-year low raising the odds of a prolonged recession. The seeds of a "perfect storm" for the economy were in place; falling home prices, a banking system at risk, a spike in oil prices, rising inflation and the threat of further conflict in the Middle East (not to mention the current cost of the wars in Iraq and Afghanistan).

Lessons from Past Bear Markets?

Since the end of World War II, there have been six Bear Markets with an occurrence of about one in every ten years, with an average duration of twenty-four months and with an average decline in stock prices of 32%. In my investing lifetime, I've experienced three Bear Markets, including the 1973-74 Bear Market which was the most serious stock market decline since the Great Depression. The seeds of another perfect storm were in place in 1973: rising inflation (12% at the time), high interest rates (the prime rate was 10% and climbing), a sudden spike in oil prices resulting from OPEC's embargo and our country at war (Viet Nam). While there seem to be many similarities, there are important distinctions: (1) inflation is now relatively low (still only around 4%), (2) interest rates are near historic lows (the prime is now 5%) and (3) the global economy is much larger and more

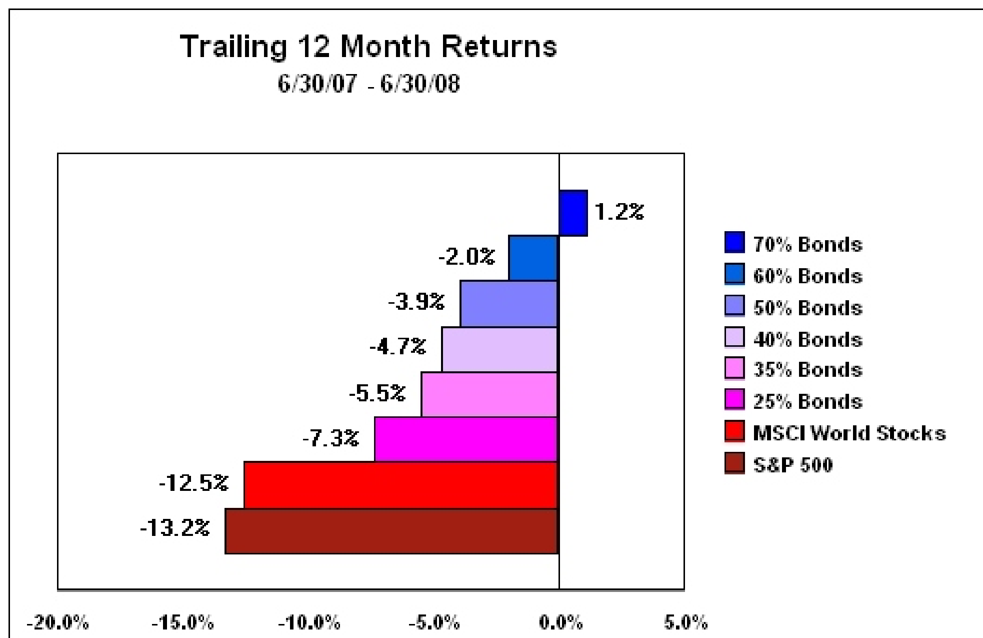


diverse than it was in 1973 when the US was the dominant player. All of these factors should help to limit the duration of our current recession and Bear Market. On the negative side, high oil and energy prices do pose a serious obstacle to a quick turnaround and our banking crisis is another economic headwind that was not present in 1973. The fact that our country is at war also presents a major impediment (not to mention the incalculable cost in precious human life). While there is no way to predict the duration of our current Bear Market given the vast array of uncertainties, we know that this will not be the short three month version such as in 1987. Will it be an "average" Bear Market of twenty-four months and a 31% stock market decline, or a more serious downturn such as we experienced in 1973-74?

Before dwelling too much on the negative, the right-hand side of the chart above also needs to be addressed and is probably the most important lesson from the past. Note that in all three Bear Markets, stocks more than made up for their entire loss within eighteen months from their low points. Even following the worst financial collapse in modern history, the Great Depression, stocks recovered their full value in less than four years from the bottom. *The only losers during Bear Markets are those forced to sell their stock positions as a result of poor planning or poor diversification.* At Aequitas, we take great care in helping our clients establish diversified portfolios which are designed to dampen downside volatility while also allowing for participation in the upside when the recovery occurs. One of our tenets in planning for clients is to assure that sufficient dollars are invested in high quality bond funds so that it should not be necessary to sell stocks to meet cash flow requirements during a prolonged market downturn. For retired clients, our goal is to establish a bond allocation sufficient to provide for their cash flow needs for a period of at least ten years. As students of history, we know that Bear Markets have occurred about once in every ten years and that it is important to factor such risk into each investor's long-term investment plan.

How are Client Portfolios Weathering the Storm?

Of course, each client has an individual set of financial goals and a unique tolerance for risk, so the answer to the above question varies. We know, however, that the primary way to control portfolio risk is to establish an appropriate allocation to Fixed Assets (bonds) and Equities (stocks). Our clients arrive at their individual asset allocation targets after careful planning and counseling. In the chart below, I've compiled results of a few representative client portfolios over the twelve month period ending June 30th. While not coinciding exactly with the current Bear Market time frame, the relative performance comparisons are nonetheless instructive. During this twelve month period, a portfolio invested 100% in globally diversified stocks would have lost 12.5%. At the other end of the risk spectrum, a representative 70% bond investor (30% in stocks) experienced a 1.2% gain - quite a difference! A representative 50% bond investor's loss was limited to 3.9%, or about one-third of the 100% stock loss, and a 25% bond investor's portfolio fell by 7.3%, or about 60% of the full stock market loss. Bonds, of course, provided positive returns over the past twelve months which helped to minimize each portfolio's decline. The dollars allocated to



bonds should also shorten the recovery time at the end of the Bear Market. For example, following the 1973-74 Bear Market, it took a 100% stock investor seventeen months to reach full recovery; a 50% bond investor recovered fully in just nine months (partly due to the fact that the initial loss was limited). While we believe that allocating more to stocks will deliver higher returns in the long-run, each investor has an individual tolerance for risk that must be addressed in the portfolio's design.

An Optimist or Pessimist, or Both?

I'm often asked what I think will happen with the stock market. When the markets are volatile on the downside, such as now, sometimes I'm asked, "Should I sell?," or perhaps, "Is it time to buy?" Of course, no one can predict the future and I profess to have no unique skill at prognosticating. The best we can do is to look at the lessons of history and implement proven practices that have worked for investors in good times and in bad. One of the most difficult questions I'm asked is, "What do you think will happen in the future?" This question is much broader than the ones about the stock market and much more complex. When asked that question, my reply usually falls somewhere toward the middle along the spectrum of being a pessimist or an optimist. If I listen to certain news networks, or read certain headlines, I might feel that the world is coming to an end; if I dig a little deeper, I can always find some positive news which provides for optimism. On balance, I'd say I'm more optimistic than not which probably reflects how most of our clients feel as well. In relation to investing, one's view of the future is often reflected in his or her portfolio structure. If a client is particularly pessimistic, we might end up agreeing to an asset mix of 80% to 90% in bonds with a healthy dose of Natural Resource stocks to hedge against inflation (I'd always argue for at least 10% to 20% in stocks, even for the most pessimistic person). If a client is optimistic and sees great investment opportunities in developing economies, for example, we might end up agreeing to a portfolio allocated 70% to 80% in stocks with a higher allocation to emerging markets and, perhaps, alternative energy stocks (I usually argue for 20% to 30% in bonds since I'm not 100% optimistic). In looking at our client wide asset allocation as of the end of 2007, I found the average mix to be 45% in bonds and 55% in stocks. As an aggregate measure, and in keeping with this analogy, 55% in stocks might indicate a slight leaning toward optimism while the 45% in bonds is there just to hedge our bets, or to dampen the volatility during Bear Markets.

Closing Thoughts

On the topic of being optimistic, I've enclosed a Boston Globe interview with Ken Heebner, the renowned portfolio manager at Capital Growth Management in Boston. Ken's track record is exceptional and he's often made money by making big bets on specific stock sectors and by being contrarian (i.e., investing differently than the herd). While the financial press is particularly pessimistic these days, Ken sees the world differently and offers an interesting view on some current investment opportunities.

Finally, last week Sir John Templeton passed away at the age of 95. Sir John was a pioneer in international investing having founded the Templeton Growth Fund in 1954 which was one of the first funds to invest in Japan in the mid 1960's. One of Sir John's disciples and associates, Mark Mobius, reflected on his life, "Sir John was born in Tennessee in the US and attended Yale University where in 1934 he graduated with a degree in economics in an era when the US and the world [were] going through economic turmoil. His witnessing of the great depression and the stock market crash certainly influenced his philosophy of frugality and hard work. His study as a Rhodes Scholar at Oxford University and travel all over the world opened his mind to the great global investment opportunities. He taught us that in order to find the best investment opportunities, you must open your mind to all possibilities around the world." Amen.

All of us at Aequitas hope that you have an enjoyable summer.

Sincerely,
Warner A. Henderson