

# 2008 Economic and Market Summary

## Overview

The U.S. economy and equity markets were nothing short of disastrous in 2008.

The credit bubble that had been building in America for arguably the last two decades finally burst and sent consumers into record mortgage defaults, foreclosures, and bankruptcies. Corporate America fared no better as some of the country's best known names, including Linens 'n Things, Mervyn's, Circuit City, Frontier Airlines, KB Toys, Mrs. Fields, Pilgrim's Pride, and the Tribune Company all filed for bankruptcy protection.

At the heart of the carnage was the financial industry where institutions were forced to take massive write-offs on highly leveraged risky derivatives once homeowners began to default on their mortgage loans. Some of the more notable casualties included Countrywide ('07), Washington Mutual, Merrill Lynch, Lehman Brothers, Bear Stearns, AIG, JP Morgan Chase, and Wachovia. Some of these companies filed for bankruptcy and others were saved through government supported consolidation. AIG was actually bailed out with taxpayer dollars; a highly unpopular move with the public.

The year began with the real estate and financial markets continuing their hangover which began in 2007, compounded by millions of mortgage interest rate "re-sets" which increased mortgage payments dramatically. Homeowners simply could not afford these higher monthly payments and could no longer make the payments. According to some reports home prices fell nationwide by roughly 20%, and home prices on the coasts fell by as much as one third or more. Credit Suisse has now forecast that 16% of all mortgages in the U.S. will be foreclosed in the next three to four years. How bad will it get? How long will it last? Of course no one knows, but history shows us real estate cycles typically last longer than stock market cycles, and are often measured in decades or more, not in years. Consequently we expect this real estate correction may last many, many years in various parts of the country. In other words, don't hold your breath.

What sparked the crises? That will be debated for years, but we're certain that highly leveraged derivatives including credit default swaps played a major role in bringing down the system. During the real estate boom of the early 2000's the financial industry created a new kind of investment instrument that packaged millions of new sub-prime mortgages and included "insurance" against default. These investments were then sold to institutions around the world as "investment grade" products often times as a replacement for money market funds (bad idea). The ratings agencies did not rate these investments properly and major financial banks and brokerage companies purchased hundreds of millions of dollars of these ultimately bad loans. Once the loans were exposed as high risk ("junk bonds") it was too late. Mortgagees were defaulting driving real values down and there was little to no market for these investments as sellers outnumbered buyers in droves. That equals disaster.

Meanwhile commodity prices continued to rise rapidly into early 2008 as the global economic growth was running full throttle. China and the other emerging markets were doing all they could

to actually moderate growth (sign of a peak). The price of oil climbed to nearly \$150 per barrel and the price of gas at the pumps was over \$4.00 all across America by summer.

All of these events came together in early Fall with the realization that this financial crises was of monumental proportions; the stock market fell roughly 20% in just one week; and investors actually questioned the solvency of the system including money market funds. Growth came to a grinding halt as financial institutions were now simply trying to remain solvent and subsequently stopped making loans almost overnight. Not only did this interruption in the flow of capital kill off any remaining hope for overall corporate growth, but it led to a decrease in demand for materials and commodities thus the prices of these asset backed investments began falling.

Despite all of the bad news in 2008, we will most certainly remember the presidential election where Barack Obama won a close Democratic nomination race with Hillary Clinton, and then went on to win one of the largest electoral landslides in recent history over Republican nominee John McCain. Obama won using a “grass roots” platform the likes of which has never been seen in U.S. politics. According to the polls, most Americans are now “hopeful” heading into the New Year despite the significant setbacks experienced and substantial challenges ahead.

President Bush will leave office with the lowest presidential approval rating in history; certainly a factor in President-elect Obama’s overwhelming victory. In defense of Bush, while I certainly did not agree with many of Bush’s decisions during his presidency it is important to point out that he inherited a plethora of problems that had been building for years if not decades and the result was going to be ugly no matter who was in the Oval Office.

### **Market Summary**

The U.S. equity markets showed losses rarely seen in history as the Dow Jones Industrial Index lost approximately 32%, the broader based S&P 500 Index lost 37%, mid-cap stocks lost 36%, and small-cap stocks lost 34%. The growth oriented NASDAQ lost 40% and global equities lost even more - the EAFE Index down 42% and emerging markets down 52%. As expected in a bear market, value outperformed growth (down 36% vs. down 43%) but that’s not much consolation.

The financial services sector lost 51%, real estate lost 40%, and the energy sector was down 38%. The precious metals sector, often a safe haven when the markets are in turmoil, was even down 30% as commodity prices tumbled. Healthcare was one of the leading sectors only losing 24%, but that’s hardly impressive.

Bond markets also struggled as a “flight to quality” took on an added dimension during this market panic. Many corporate bonds lost money as investors doubted the company’s ability to pay their debt obligations. High-yield bonds got hammered. Many municipal bonds even lost money as local and state governments reported historical monetary deficits and the possibility of default. At the crises’ high point in September, investors even questioned the safety of “money market” accounts which are backed by the FDIC, which had reportedly been significantly drained by the bailing out of Indy Mac Bank. While an all out panic was avoided the damage had been done.

Diversified global balanced funds lost an average of roughly 30% according to Morningstar, Inc. indicating that traditional asset allocation and diversification strategies did not protect investors from serious losses as they have done so well in the past. Even the famous Yale Endowment Fund (the best performing large university endowment) lost approximately 26% in the second half of the year alone. Evidence that almost no one was immune to steep losses in 2008.

### *HedgeFund Nightmare*

If all of that was not bad enough.....it was reported that former NASDAQ Chairman Bernie Madoff had been guilty of running the largest Ponzi Scheme in history totaling 50 billion dollars – give or take (emphasis on “take”). After Madoff’s arrest we learned that numerous financial institutions such as Credit Suisse had significant exposure to Madoff’s so-called “hedge fund” and many charitable organizations will now be forced to close their doors due to the losses they sustained. Hundreds and perhaps thousand of individuals lost nearly every dollar they had saved.

While I do not expect to see other hedge fund disasters in the neighborhood of the Madoff case, I do expect to see more fraudulent cases brought in the coming year. More widespread however, I expect we’ll see many hedge funds close their doors do to underperformance and incompetence. These largely unregulated investment managers were/are allowed to leverage their portfolios in many cases by significant percentages with the goal of boosting returns, but exposed themselves to tremendous and often inappropriate amounts of risk as modest movements against a large position can and did bring down the whole fund.

Expect to see greater regulation for hedge fund managers in the coming years although I expect they will continue to be lax enough to allow for fraud and negligence going forward. As always, one should do the necessary due diligence before investing in any manager, and in cases where lower levels of regulation are present, more due diligence is necessary.

We did not invest heavily in hedge funds or other direct investments, but those in which we did invest (e.g. direct real estate investment) have done very well for us despite the market turmoil. Furthermore we do not believe we have any tangible exposure to the Madoff scandal. I believe one of the reasons for that success can be found in an old saying we follow, “One should invest in ‘good’ investments run by ‘great’ managers, rather than a ‘great’ investments run by ‘good’ managers”. A word to the wise is sufficient.

### **Looking Ahead**

#### *Economic Stimulus Packages*

Barack Obama and his economic dream team will continue to support a financial stimulus package the size and scope of which the world has never seen before – not even during the New Deal of the 1930’s. Consequently we will most certainly see an increase in the size of government and while this will hopefully stave off the possibility of another depression it will assuredly add to the size of annual deficits and debt causing inflation somewhere down the road. I believe at this point it’s simply a matter of the “lesser of two evils”.

### *More Bad News*

Despite all of the new money flowing “into” but not necessarily “through” the U.S. system, we’ll most likely see a continuation of the bankruptcies and corporate consolidations in 2009 and maybe even beyond. We’ll also likely see millions more mortgage foreclosures and personal bankruptcies as many Americans will simply not be able to dig out from the hole they’re in. More bad news is just around the corner – you can count on that. Hopefully much of this bad news is already priced into the market, but we just don’t know how much worse it will get.

According to a recent CNN poll roughly 25% of Americans polled said they were planning on buying stocks during this correction, half reported they are staying put, and 25% said they were selling all stocks. Sounds like a stalemate to me. Another CNN poll showed recently that almost 60% of Americans expect America to enter a “depression” in the coming year. Now that’s a lot of pessimism already out there in the public. Another CNN poll reports roughly 1/3<sup>rd</sup> of Americans are pushing retirement plans back, 1/3<sup>rd</sup> feel they are unaffected, and 1/3<sup>rd</sup> feel they’ll never be financially able to retire. Emotions and conviction often lead to a self-fulfilling prophecy, and in this case consumers may choose not to spend or save fearing the worst and that will just deepen this recession. In other words, the bigger your bubble (e.g. tech stocks, real estate, easy-credit, etc.), the more greed ultimately leads to panic, and the deeper and longer the bursting will be. Buckle up.

### *Taxes*

Prior to his election Obama indicated he would most likely raise the Capital Gains Tax to 20%-25% and raise income tax brackets for those making \$150-\$200k and above. He has now concluded that raising taxes would not be wise in the short run, thus I believe we’ll see most of those plans to raise taxes shelved in 2009. Furthermore Obama is now being advised by his new cabinet that tax cuts are more likely to help us get out of this crisis and he is considering this tactic in addition to his trillion dollar stimulus plan which concentrates on restructuring the financial system, rebuilding American infrastructure and schools, and increasing the production of alternative energy sources.

### *US Growth Going Forward*

U.S. growth is expected to be slow if at all existent in 2009 with further declines in productivity likely. Furthermore our own government forecasts economic growth in 2010-2011 to be modest as well. Of course predictions are not guarantees and no one knows with certainty. Open the newspaper and you’ll see the more optimistic pundits calling for an economic rebound in late 2009 which could mean a stock market rally early in the year. I think this is probably overly optimistic. Those in the most bearish camp call for this recession to last several more years resembling more of a depression with the stock market losing roughly 80% of its value from peak to trough (we’re about half way there now). My guess, and it’s only a guess, is that the eventual reality will lie somewhere in between. Patience and prudence will be rewarded.

### *Deflation vs. Inflation – the new debate*

The U.S. government has chosen to print money, a move only conceded in the worst of possible economic scenarios (a place we are no doubtedly in now). We all know that when you print money and increase the money supply, relative to other currencies, that the value of your currency will eventually fall and the byproduct of this action will be inflation. The good news is

that many of our allies are doing the same so in relative terms the consequences may not be as severe as otherwise possible. But make no mistake; we'll all feel the negative effects of inflation in the coming years even if we go through a period of deflation first.

### *Global Economy*

We continue to see an increasing correlation between global economies from the developed countries to the emerging markets. The new era of constant and instant communication has no doubt enhanced this rising correlation and economic and market interdependence. This is the "new economy". We all need to accept it and adjust to succeed or even survive for that matter.

Is America's run of economic dominance over? Are emerging markets the new frontier of economic creativity and productivity? Will China rule the world 50 years from now? I just don't know, but I will say that it appears a major power shift may be beginning to emerge and America's glory years may be behind it if it does not adapt quickly.

America led the world since the late 1800's and early 1900's with its industrial revolution and innovation, and continued through the Second World War where Americans were seen as world leaders, liberators, and even heroes. And as all countries and economies do, America is moving through its growth cycle and I submit we appear to be moving toward the mature phase of our existence. I'm not sure we're there yet as I hope we have significant innovation, productivity, and value to contribute to the world. On the other hand China, India, Russia, and Brazil (the BRIC countries) and other emerging markets countries are now poised, despite considerable challenges, to lead the world in the increasing expansion of their economies, and I expect that's where much of the world's investment dollars will flow in the coming decade.

### **Investment Perspective Revisited**

As mentioned earlier, the traditional benefits of equity diversification were little consolation as a flight to safety in treasuries or cash was one of the only profitable investments in a year of epic conflict between greed and fear.

Developing an appropriate and prudent investment strategy is a challenging process to be certain. Maintaining the discipline necessary to be successful over the long-term while making modifications along the way is even harder. When does modification become market timing? How patient must we be when everything seems to be burning down around us? These are difficult questions to answer with accuracy and confidence, but are necessary conversations in the light of the turmoil we now face.

Given the recent financial events and challenges facing our nation, now is a great time to reassess one's goals and objectives, time horizon, and risk tolerance. You will also need to step back and look at the big picture as opposed to concentrating on the headlines you see, read, and hear every day. For most of us, our retirement fund ("nest egg") is a relatively long-term asset built for funding a relatively long-term need (income during retirement). Thus a long-term perspective is most prudent (I'll explain in more detail below). That being said there are still elements of short-term cash flow that need to be considered as well. Let's walk through a simple case study to demonstrate this dynamic.

Case Study – let’s look at a 65 year old couple with a \$2 million dollar net worth of which \$1.5 million is allocated as their investment portfolio or “nest egg”. The couple expects to spend approximately \$75,000 annually not counting Social Security. This couple may choose to begin their allocation design with the following “baseline” model portfolio and may choose a more aggressive or conservative strategy based on their individual needs and circumstances.

Cash/Money Market: 10% = \$150,000. Covers 2 years of expected annual expenses.

Fixed Income (bonds, treasuries, CD’s, etc.): 30% = \$450,000. These funds target an intermediate term time horizon, and protection of principal is paramount. Funds should cover approximately 6 years of expenses not including gains.

Equities (stocks, real estate and most alternative investments): 60% = \$900,000. These funds target a longer term time horizon of ten years or more and allow one to take some added risk in exchange for the opportunity to benefit from more growth while accepting greater volatility and the experience of short-term temporary paper losses. It is this additional time horizon that allows investors the necessary patience to wait out the down turns. Funds should cover roughly the last 12 years of expected expenses.

Conclusion: This is admittedly an over simplification, as it’s intended to show the need for investors to consider both macro (big picture) and micro (specific allocations to stocks, bonds, and cash) issues when building an appropriate investment strategy. It is only after considering both elements of the strategy that one can understand the methodology of its construction and why it may be considered in their best interest in meeting such a long-term financial need.

Bottom Line: the portfolio described above covered the expected expenses of our couple for approximately 20 years in retirement. The long-term assets were allowed to fluctuate greatly from time to time as they were invested for the “back-end” of retirement’s cash flow needs. No panic or worry was necessary during bear markets and panics as this couple knew they would be withdrawing money invested in money markets or cash equivalents first (years 1-2), bonds second (years 3-8), and stocks and other equities last (years 9-20).

Result: proper analysis and diagnosis, followed by prudent recommendations and portfolio design, developed with both the short and long term in proper perspective, followed by discipline and patience equal a successful recipe for meeting the goals and objectives of investors delivering as much peace of mind as can be reasonably expected.

### **Portfolio Management Analysis**

Looking back over the United States’ history of equity market performance we see long market trends called secular bull and bear markets. The U.S. stock market has experienced several long-term bear markets including annual average returns of negative 1.1% from 1906-1921, negative 10.6% annually from 1929-1942, negative 1.5% annually from 1966-1982, and now roughly negative 3.7% annually from 2000-2008 (although these figures do not reflect any gains from income such as dividends). In hindsight we now believe the major market corrections of 2000-2002 and 2008 indicate we are in the midst of the next such secular bear market. These bear

markets average roughly 12-15 years in duration which may mean we're only half way through this one, but we are not so bold as to draw such a conclusion. Could be more, could be less.

#### *U.S. Fixed Income Investments*

We remain bullish on short to intermediate term high quality bonds and U.S. Treasuries. While we acknowledge that interest rates may remain low and even fall in the near term, which would be most profitable to long-term bond holders, we see too much risk in longer duration investments thus our preference for 1-7 year maturities with low duration or interest rate risk.

Some experts predict a treasury bond bubble as so many investors have piled into the relatively safe investments, consequently some forecasters predict that when the equity markets and economy rebound investors will rush out of treasuries creating little demand and over supply, causing the price of treasuries to fall perhaps dramatically. Despite this risk we continue to believe that treasuries make up an important piece of most investors portfolios and we should not be caught on either side of extremes as in the example above (i.e. holding too many or too few treasuries).

#### *International Fixed Income Investments*

We continue to hold international bond funds in our portfolios. Furthermore we believe holding the bonds of other countries in their own local currency is one of the more attractive hedges we can make against the U.S. Dollar. This makes the volatility in these funds more noticeable than most fixed income funds, but we feel the currency hedge component is worth the added fluctuations. As a result, we make money on interest payments with the possibility of appreciation or depreciation of those bonds based on whether or not interest rates are rising or falling and whether or not a bond's local currency is strong relative to other global currencies.

#### *U.S. Equity Investments*

With valuations hovering near their lowest levels in decades one might suspect this is a good time to buy. They may indeed be right and I suspect the longer your time horizon the more accurate that philosophy will be. One should however consider that if earnings estimates continue to fall and the PE Ratio remains the same, then the underlying price of the stock must fall by the same amount as the earnings. Thus if earnings of a given company are projected to decline by 20% over the coming year, then the price of its stock must fall 20% assuming the PE Ratio remains the same. So, yes....stocks could continue to fall in 2009. While we make no predictions about the stock performance over the coming year, we do feel that investors with a long-term time horizon, patience, and discipline will most likely be rewarded for buying stocks now. And yes, while they may even be cheaper in the coming months (or even years for that matter), stocks for the long run continue to be an attractive investment.

#### *International Equity Investments*

We've already discussed U.S. growth prospects going forward compared to an even slower European economy as compared to the explosive growth of the emerging markets. Consequently we believe the emerging markets may offer the greatest opportunities once this global recession eases. Again, we're not saying that the U.S. will be unattractive but rather many countries such as China, India, Brazil, Russia, etc. will most likely grow their economies much faster than that of the U.S.

### *Alternative Investments (Commodities and Real Estate)*

While the possibility of deflation in the near term continues to exist we do not expect significant increases in the prices of most commodities including oil and gas, and most precious metals over the coming months. We do however believe strongly in owning such alternative investments given the expectation of their long-term diversification benefits (despite not reaping such rewards in the current cycle). We also believe commodity prices will once again rise dramatically when the next great global bull market begins – of course we do not know when that will happen.

And as was mentioned earlier, we believe most U.S. real estate (residential and commercial) will most likely not be a strong relative performer for the foreseeable future and this may be the case for many years to come. International real estate especially in certain emerging markets however looks more attractive once the current crises passes as high demand, marginal supply and more reasonable valuations look attractive and suitable for investment.

### **Final Thoughts**

2008 will no doubt go down in history as one of the most memorable years in American history, from the election of our first African-American president to the meltdown of our financial markets and resulting widespread investor panic. Nearly all investment asset classes, styles, and strategies lost money in 2008 and diversification only minimized the damage. Almost everyone's net worth declined and the rest of the world was no exception. The interconnectivity of the new global economy was verified as virtually every country's financial markets lost money.

Despite the despair of the recent events, the fear and greed that still floats thick in the air, and the unfathomable reality that the American consumer is still living beyond his or her means, there is oddly enough a sense of hope out there. America, as she always has, will come out of this recession and market meltdown stronger than she was before as it citizens and the corporations they run become more efficient and more effective in producing the goods and services that are demanded globally.

Things will likely get worse before they get better as we may actually only be in the early innings of this game as some experts argue, and consequently the recession and bear market may drag on for some time, but it's all part of the refining process where excesses are removed from the equation, sometimes very painfully. That's how capitalism and free market economies work.

We maintain that the benefits of diversification through effective asset, style, and strategy allocation, are significant and meaningful and worthy of our pursuit as investment managers. Furthermore we continue to recommend all clients reassess, clarify and prioritize their financial goals and objectives, time horizon, and true tolerance for risk during this remarkable time.

Thank you for your continued trust and support.

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