

## ABSTRACT FROM TALK STRATEGY MEETING:

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With the bear market now running for 17 months (and counting) and a recession (currently 15 months) that looks to be the longest since the Great Depression, we find that clients are falling into two extremes. The current environment, and stock market declines have clients feeling either like Chicken Little "The Sky is Falling!"; or they hold a more optimistic view that the US will recover.

- What's currently going on?
  - There is much uncertainty (fear) in the markets about:
    - A banking system not functioning properly
    - Credit markets that remain impaired
    - Housing prices which continue to fall
    - Employment which continues to deteriorate (lagging indicator)
    - Government policy which seems to be constantly changing
  - Result: no visibility of transparency of future, or path to recovery.
  - Bank stocks have led the declines. YTD, the banking sector is off over 50%, and is 85% lower since the bull market peak in October 2007.
  - Volatility, as measured by the VIX, (often viewed as a measure of fear) is at the highest levels in decades, however, volatility has eased since the crisis climax of Lehman Bros bankruptcy back in October. Easing volatility provides glimmer of hope.
  - Banks, the transmission mechanism of our economy, remain impaired in their ability and willingness to lend.
    - Due to bad loans (toxic assets) and increasing foreclosures.
  - With consumers and businesses unable to access credit (loans), the economy has slowed dramatically. GDP first turned negative in 4Q07.
    - For much of 2008, the debate was whether or not the US was in a recession. On December 1, 2008, the NBER (National Bureau of Economic Research) declared that the current recession officially began in December 2007.
    - Since WWII (1945), we have had 12 US recessions; the average US recession has lasted 10 months. Our current recession is now 15 months old and running.
  - Unemployment (lagging indicator) continues to rise as the economy deteriorates.
    - It is worth noting that unemployment will likely continue rising, even into the early innings of an economic recovery. It is a lagging indicator because businesses typically avoid laying people off as long as possible, and will similarly avoid rehiring them during recovery until current workforce can no longer support new business.
  - Housing prices continue to experience pressure in the midst of hard-to-get loans, rising unemployment and low consumer confidence.
  - In an attempt to stimulate the economy, the Federal Reserve has cut interest rates from 5.25% in September 2007, to 0% today. Rates will probably remain low for quite some time.
    - The rate cuts were inflationary at first, as the US was the only country easing interest rates
    - As the global economy declined, other countries began also cutting interest rates, and inflation ended. Deflation is now the current worry in the short term, but will quickly shift to inflation when economy begins recovery.
    - Oil prices were a large component of the inflation. From July 2007 to July 2008, oil rose 98% eroding consumer confidence; as demand for the commodity slipped in connection with a global recession, prices dropped from over \$150 down to now trade around \$40.
    - Despite a financial crisis that began in the US (housing & bad loans), the dollar has moved higher: the US is still viewed as the safest home in a bad neighborhood.
    - Consumer confidence has continued to decline in the face of falling home values, investment values and job security.

- Result: Consumers and businesses are hoarding money. The US consumer's saving rate has went from 0% (and even negative, meaning consumers spending more than they earned) to 5% in a very short time and is probably still rising.
  - Slowed consumer spending has hit corporate earnings. Consumer spending is responsible for over 70% of annual GDP.
    1. Earnings for the S&P 500 first turned negative during 3Q07 due to banks writing off bad loans. Bank write downs were solely responsible for negative S&P earnings growth through the middle of 2008. Then, during the latter-half of 2008, negative earnings began coming from all sectors of the S&P, as the slowing economy was being felt in all corners of business.
  - The government has attempted to offset a recoiling consumer by:
    - Expanding the money supply (M2)
    - Expanding its balance sheet with TARP, TALF, commercial paper purchases, etc...
    - And stimulus (deficit) spending
- Is the Sky Falling?
  - Survey: None of our guests believe that the "sky is falling." No one believed that selling out now, after having ridden the market this far, is appropriate.
- Future Outlook & Thoughts
  - Key Question: What expectations are reflected in current asset prices?
    - Earnings likely to recover slowly after recession ends
    - Process of rebuilding balance sheets will take consumers and corporations a number of years
    - Bad news and investing can be contradictory
      - Markets typically bottom before the economy
      - Markets often too pessimistic, overshoot both up and down; huge opportunity
    - Markets have already discounted a major economic slowdown and doomsday scenario, but can remain irrational for some time
    - Banking issues will continue to be a worry
    - Corporate earnings will remain weak
    - Unemployment will rise toward 10%
    - Government policy response will continue to be proactive and unprecedented in size
  - Our expectations:
    - Potentially prolonged global recession
      - But, are we at or near the darkest hour?
      - Recovery will be slow, but may begin late-2009
    - Deflation is the current worry (low oil prices are like a tax-cut)
    - Government will continue to intervene and spend
      - \$787 billion stimulus is expected to add 4% to GDP
    - A very dire picture and lots of bad news are already priced in and the economy will likely recovery at a slower pace than in the past;
    - But, market recovery could be VERY powerful.
    - Market typically bottoms 6 - 9 months before end of economic recession. New lows on market indices imply economic recovery in late-fall 2009 at earliest
    - Uncertainty remains high because credit markets remain dysfunctional (TALF seeks to help credit markets)
      - TALF (Term Asset-Backed-Securities Lending Facility) should help kick-start the securitization markets (loans for cars, credit cards, student loans, small business loans, etc). Commenced operation on Tuesday, March 3 2009.
    - Possibility for several more "head-fakes"

- “Head-fakes” last 2 months (avg) and rise between 15% - 35% (avg 19%). The “holiday rally” (11/16/08 – 1/6/09) was a head fake
- “Head-fakes” desensitize investors, causing many to get out of the market, and miss the initial recovery (which is the most powerful phase of a new bull market).
- Stocks are currently as oversold as in October when market collapsed, indicating that sentiment is very bad (bad sentiment is bullish indicator).
- Despite new index lows, the number of stocks making fresh lows has been declining; this trait is typical in the latter innings of bear markets.
  1. “Bang” (expanding number of stocks making new lows) vs. “Whimper” (declining number of stocks making fresh low).
  2. Bear markets typically end with a “whimper”, not a “bang”
    1. 1930s was a series of “bangs” and “whimpers”, but this is probably not what is likely to occur today. Difference: policy response has been proactive, whereas the Great Depression was created by the Government denying a problem and actually raising interest rates during the slowdown and failing to initiate proactive policy response.
- Catalysts for powerful market recovery:
  - Reversion to the mean concept:
    - Recent market performance (2008 & current) and even the last decade is way below historical trend; does that suggest that future returns could be VERY large?
      1. Once-in-a-generation type event; outside expected range of returns
      2. 10-year rolling periods suggest recent decade is WAY below trend
      3. Years following extremely poor returns are often very large
  - Lots of money sitting on the sidelines, waiting to be invested
    - Money market funds at highest levels since the creation of money funds
    - We too, have been holding higher levels of cash in client portfolios
      1. CRITICAL DECISION: when to reinvest cash
- Considering lots of bad news already reflected in market prices, reversion-to-the-mean concept, and lots of money on the sidelines, the biggest risk (in our view) is missing the start of new bull market.
  - We are currently watching many leading indicators to provide guidance when money should be deployed:
  - Leading indicators:
    - Credit markets function more normally
      1. Must see credit spreads revert closer to historical trend. They have improved since October, but have further to improve.
      2. Good borrowers have access to credit
        1. Again, spreads have narrowed (moved back in right direction), but still suggest markets are stressed
    - Less-bad economic news
    - Inflation remains tame
- Where do we see opportunities:
  - Corporate & Municipal Bonds: have attractive yields
  - High Yield Bonds: high total return potential, even under very conservative assumptions
    - Have added positions to client accounts
  - Stocks approaching “fat-pitch” valuations
    - Near-term outlook remains uncertain for equities
  - Looking to swap tame funds into more aggressive holdings: gain better up-market capture when new bull market begins.

- A Path Forward
  - Recapitalize the banking system by removing toxic assets from bank balance sheets and injecting new capital.
  - Increase availability of credit to worthy borrowers and enable homeowners to refinance.
  - Stabilize home prices and ease foreclosures.
  - Restore confidence in credit markets.
- Client portfolios have been holding up much better than markets (especially recently) due to above-normal levels of cash, and active fund managers who are adding value over their indexes.

### **Retirement Strategies: Are Recent Events Life-Altering?**

- Negative thinking can be detrimental: Need to review facts of individual situation
  - Market decline affects clients differently
    - Young: collapse not that impacting
    - Deep into retirement: collapse not that impacting
    - 55 – 70 age is hardest hit: few years away, or into retirement
      - Depends on money saved, amount of loss and time to retirement
      - Options include working longer and/or cutting expenses
  - Longevity: I could outlive my savings
    - Probability of 1 member of couple living to 91 is 50%
    - 75% chance one will live to 86, and 25% chance one will live to be 96
    - Means period of life in retirement likely to be 15-25 years
  - Retirees cannot financially protect well against:
    - uncertain timing of death, risk of disability, need for long-term care, inflation, and/or exposure to health care costs
    - Why? Limited financial resources or ability to earn \$\$
  - Accentuate the positives (review facts, not emotions)
    - Social security benefits
    - Retirement plans (pensions)
      - Both reduce need to use investments to cover expenses in retirement
  - Review budget
    - Determine withdrawal rate from investment portfolios needed to cover expenses
      - Target a withdrawal rate of less than 4% annually
      - If withdrawal rate is higher, can you cut expenses & or increase savings now?
      - Can you continue to work a little longer?
    - Withdrawal rate can help guide what investment objective should be (what asset mix is needed to obtain required rate of return (withdrawal rate + inflation + real return)
    - Consider dynamically adjusting (validating) withdrawal rate every 5 years as life changes
      - Be slow to boost withdrawals during good years as rainy days are inevitable
  - Rebalancing is critical: helps remove emotion from investment decisions
    - Disciplined. Maintain “buckets of time” perspective
      - Think of your portfolio like buckets of time: how much money is needed over the next year; 2-5 years; or 5+ years? (Cash = 1 yr, Bonds = 2-5yrs, Stock = 5+)
- Conclusions:
  - Critical to maintain long-term horizon perspective
  - Review original financial goals; has anything changed that should change investment objectives? Look past economic/financial market events
  - Maintain “buckets of time” investment allocation concept – flexibility and discipline (manage risk)
  - Consider lowering withdrawals during “rainy days” to leave \$\$ for asset value recovery; reduce expenses
  - Rebalance portfolio periodically as pre-planned allocation targets get out of balance; “manage by the numbers” (unemotional)