

# The Advantage Advisor

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## Market Commentary:

I had a client comment to me last month that I seemed so positive about the markets when so many others around were very negative. As I thought about that comment, it struck me that I might need to be a bit more forthcoming on exactly why that is so. Indeed, I am positive about the future of the markets and our client's portfolios. I know that may sound strange given all of the damage that has taken place and the abundance of negative sentiment that is out in the news media. However, if I turn my focus from where we are at present to where we can go from here, I can see a dramatically different side to the story.

What I would like to do with this newsletter is to explain as thoroughly as possible why I am optimistic and provide some specific data to back up that thinking. An analysis like this can grow cumbersome quickly. In order to help alleviate that as much as possible, I'll break things into three parts. The first will be a summary of my thinking and where I see the positives in the markets. The second will be a breakdown of many of the details that help me arrive at those conclusions. And the third will be a look at our current conditions and how I have our strategies positioned with all of the rest in mind.

The short take:

To begin, let me focus your thinking on a couple of items. First, in all of the history of the financial markets in the United States, there has never been a time when either the Dow or the S&P-500 did not recover from a bear market and climb back to a new all-time high. Remember how terrible things looked in 2001 after the bursting of the dot-com bubble and the terrorist attacks on 9/11? Five years after those events occurred, both the Dow and the S&P hit new

Market Statistics for November

Market Index	Closing Price	% Change
Dow Jones Industrial Average	8,829	-5.3%
S&P-500 Stock Index	896	-7.5%
Russell 2000 Stock Index	473	-11.9%
Shearson Treasury Bond Index	17,364	12.35%
Dow Jones World Stock Index	166	-6.8%
Nasdaq Composite Index	1536	-10.8%

all-time highs. Remember the 1970's recession, S&L failures, stagflation and the oil embargo? Same story there – the markets climbed well past their previous highs. The important thing right now is to avoid the trap of thinking that we will forever continue in this bear market and everything will eventually go to zero. The US economy continues to be the greatest driver of wealth in our world, and the US financial markets will recover from their current bear market.

There are some who are asking if the markets will ever really be able to recover from the current crisis. I understand that sentiment and the fear that inspires it. However, I think a much better question to ask is what will it take to keep the markets from recovering? Just consider what the US has been through in the past – The Great Depression, two world wars and several other smaller conflicts, the stagflation of the '70s, the cold war, Y2K, terrorist attacks in New York and abroad, even the threat of a bird flu pandemic! Even the worst of those things could only slow the markets down for a few years. In order to stop the growth of the financial markets, you would essentially have to stop the US economy. While we have our share of problems, I just don't believe that is a credible possibility any time in the foreseeable future, short of an act of God.

Second, all of the financial markets are trading at levels that are far below those that could be justified even by tough recessionary conditions in the US. The

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# The Economic Picture

The National Bureau of Economic Research (NBER) has officially pronounced the US to be in a recession, stating that it actually began in December of 2007. In keeping with their report, I have also adjusted our economic position into a stage 6 - recession environment. Technically, this jumps ahead of our indicators, shown below. The problem that we have encountered is that the absolute stampede into US Treasury Bonds has pushed their prices up to all-time high levels. This, however, does not reflect the reality present in the rest of the bond and credit markets where prices have gone in exactly the opposite direction.

We expected that the economic reports coming out of the October period would be bad, and we were not disappointed. GDP growth was revised downward to -0.5% as consumer spending fell to new lows. Manufacturing output also dropped sharply in response to the virtual shutdown of the automobile markets.

On the positive side, worker productivity continues to improve, which will be a big benefit to corporate profits. Higher productivity should also help to reduce the total number of job losses, with the exception of jobs in the financial sector. And the Federal Reserve and other central banks around the world are continuing their support efforts and implementing new tools and approaches.

A stage 6 environment leads us to be extremely

Current Economic Position:  
Stage 6 - Recession

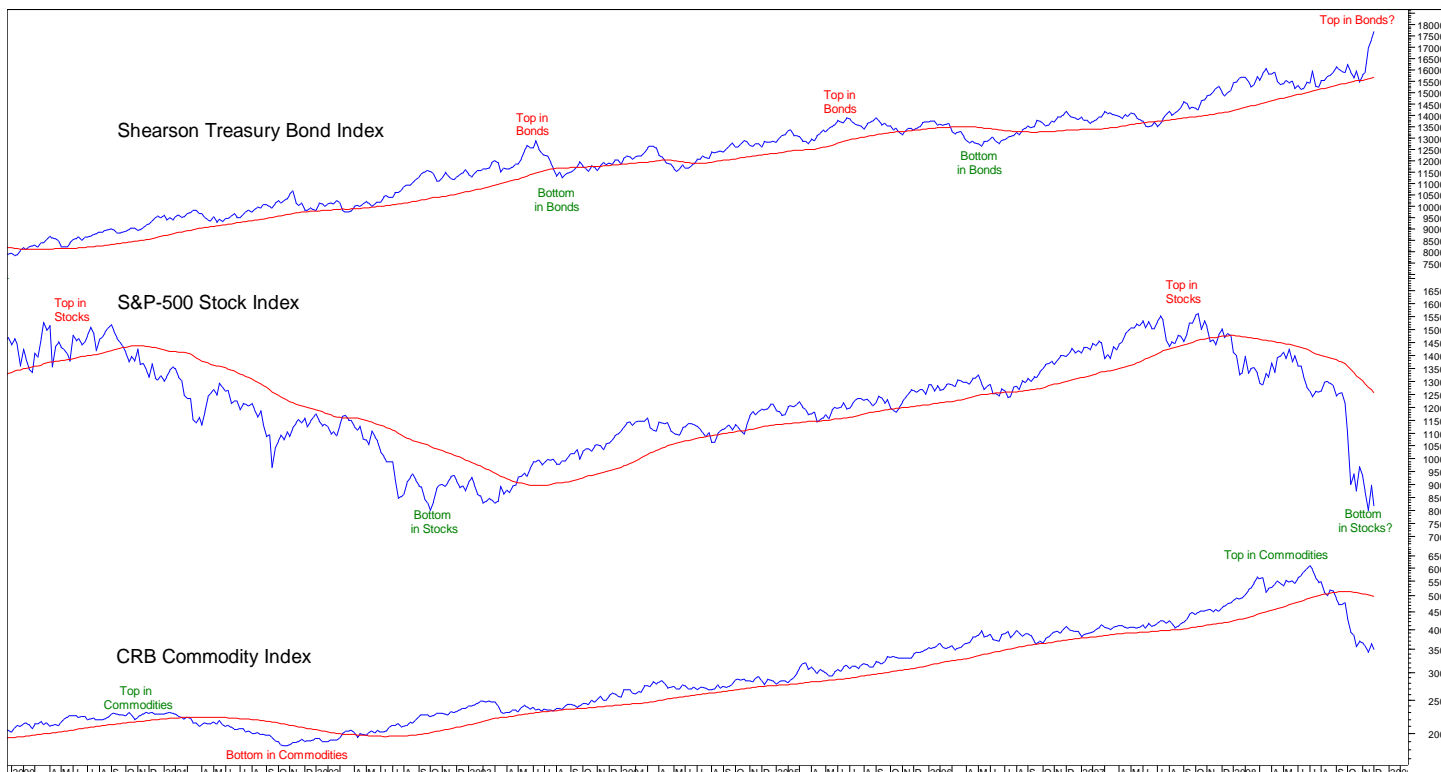
## Economic Indicators

	Latest	Prior
<b>Growth</b>		
<b>GDP</b>	- 0.5%↓	+2.8%
<b>Productivity</b>	+1.1%	+3.6%
<b>Employment Cost Index</b>	+0.7%	+0.7%
<b>Capacity Utilization</b>	76.4%	75.5%
<b>Inflation</b>		
<b>Consumer Price Index</b>	- 1.0%	+0.0%
<b>PCE Deflator (Personal Inc)</b>	- 0.6%	+0.1%
<b>Implicit Price Deflator (GDP)</b>	+4.1%	+1.3%
<b>Sentiment</b>		
<b>Consumer Confidence Index</b>	44.9	38.8↑
<b>Unemployment Rate</b>	+6.5%	+6.1%
<b>Personal Income</b>	+0.3%	+0.1%↓

↑=revised up, ↓=revised down

Source: Moody's Economy.com

cautious and conservative in our investment approach. We expect high volatility (which we have certainly been seeing) and markets which seem to move with little sense of direction. There is a good side to this, however, and that is that the stock market bottom also occurs during a stage 6 environment. While we don't know how long this stage will last, we do know that the markets, both stocks and bonds, are already pricing in absolute worst case scenarios. That means that anything less than horrible news is likely to generate a positive response in the marketplace moving forward.



Source for data: Investor's FastTrack

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stock markets are trading as much as 70% below fair value levels, and bonds are trading at discounted levels that have never been seen before in our history. In fact, the high yield bond market is trading at a level which assumes that 30% of those bonds will go into default within the next twelve months. The highest actual default rate in US history occurred in 1933 (during the depression) and was only 15.4%. At this point in time, 17 months into the worst credit crisis in history, the **current high yield default rate is...3.4%! That means** that high yield bonds are trading at as much as a 60% discount to their fair values based on current default levels. Even if defaults doubled to 7%, those bonds are still trading at a 40% - 50% discount. Investing in a well diversified portfolio minimizes the impact of individual defaults and leaves us with huge potential gains with limited downside – not a bad place to be.

So, after looking at the resilience of the US economic engine and the incredible values that the stock and bond markets are presenting, it is difficult not to be positive on where we are heading. Remember that investing is about seeing where the markets will be going, and getting positioned to be there ahead of the crowd. Consider that even if it takes 5 full years for the markets to recover to their fair value levels, that represents a return of 11.2% per year for stocks and 9.9% per year for bonds. And there is a kicker for the bond market. That 9.9% does not include the income that would be received on those bonds – and current yields are as high as 10% even for higher quality bonds. That means that from these levels, bond returns could easily outstrip stock returns, and the bond markets should lead the way out of the bottom of the current bear market. If you will recall, that is exactly what occurred in 2003.

In addition to these, there is another aspect to investing in the present environment that further reinforces my positive outlook. Over the past several years many new investing tools have been developed that are designed to accentuate the movement of a host of market indices. For example, one can invest in an exchange

traded fund (ETF) that moves by 2 or even 3 times as much as the S&P-500 stock index. I have recently made use of these tools on the downside to help hedge our portfolio exposure to the market. I fully intend to make use of these tools on the upside to as well. I am often asked how the Strategic Allocation Strategy was able to outperform the markets so dramatically from 2001 through 2007. The answer is through the use of those leveraged trading tools. And now, because there are more available to us than before, we can put them to use in our other strategies as well. As we move forward through our economic cycle, we can use these tools to adjust each portfolio to be more aggressively postured – when the time is right. This provides an even greater opportunity to outperform the markets on the upside as well as protect it from the downside.

So, if concerns over the financial markets might cause someone to consider a strategy of pulling their money out of the markets and sticking it into a secure CD or money market fund, they also need to consider the other side of the coin. The best CD rates in the nation right now are just over 4% while the national average is less than 2%

Just as those overpriced bubbles burst and prices fell dramatically, our underpriced **“negative bubble” will also burst and prices will move higher.** The financial markets will recover, and we will be ready.

- and it is likely that interest rates will remain low for an extended timeframe. Consider again that even if it takes 5 years for the markets to get back to fair value, even

the best CDs will underperform the markets by an average of 6% to 7% *per year*. That is an exceptionally **high price to pay for the safety those CD's would provide.**

From its peak in October of 2007 through the end of November 2008, the S&P-500 has posted a loss of 43%. Our average client portfolio has fallen by just about half that level and even our most aggressive portfolios (which include my own personal accounts) are down by less than that amount. Looking forward, as we eventually move into an expanding economic cycle, we will be able to take advantage of those new investing tools when appropriate to boost our gains on the upside as well. It has been a painful process, but

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*(Market Commentary, continued from page 3)*

because we have been protected on the downside we are in a far better position to gain on the upside when the markets do finally turn that corner.

I know it is hard, but now is the time to focus on what is ahead and not get caught up in the negative crowd mentality of the moment. Remember the stampede into and then out of internet stocks? Remember the calls for \$1,000 per barrel oil and the price bubble there? What we are experiencing now is the same type of thinking, just with a negative focus. Just as those overpriced bubbles burst and prices fell dramatically, **our underpriced “negative bubble” will also burst and prices will move higher.** The financial markets will recover, and we will be ready.

Some details and examples:

In November, the S&P-500 hit a level **that hasn't been seen since the first quarter of 1997.** Is it reasonable in any sense to believe that the US economy is now at the same level as it was back then? Just for reference, in 1997, the output of the US economy as measured by Real GDP (our primary economic measuring stick) stood at \$8.5 Trillion. As of the 3<sup>rd</sup> Quarter of 2008, that figure was \$11.7 Trillion – and yes those are inflation adjusted figures. That means the economy grew a total of 37.7% over that timeframe (approximately 2.8% per year).

Since our economy has grown, the financial markets should also reflect that growth. Actually, they should reflect a multiple of that growth because of the impact of higher worker productivity and the ability for companies to earn higher profits with less expense. In fact, worker productivity (units of output per worker hour) grew by 34.2% since 1997. As a result, corporate profits grew by an astonishing 83.6% over that timeframe. So not only did the economy grow in real terms **by almost 38% since '97, corporate profitability also grew at an even faster rate.** Since both the economy and corporate profits are significantly higher than in 1997, it is simply not reasonable for the financial markets to show no growth over that same timeframe.

I wrote extensively last month about the general

price level of the stock markets and how things appear to be extremely undervalued. If anything, the activity that took place during November has served to stretch those levels even further. If we consider a very negative scenario in which profits decline by 10% in 2009 while interest rates rise to 4% (from their current level below 3%), then the S&P-500 should be trading at a level of around 1,536 or more than 71% higher than where it ended November. (In case you are wondering about just how valid that market model is, consider that it also showed the S&P-500 to be overvalued by 103.6% at its peak in March, 2000.) Clearly, stocks have been pushed down to unrealistic levels given the underlying fundamentals.

Turning to the bond market, we find even greater discounts and unrealistically low prices. This is a result of two major factors: First, panic selling due to the sudden onset of the credit crisis; and second, the lack of a liquid marketplace in which to trade and determine prices for credit instruments. Because of sheer panic in the credit markets, investors sold their bond holdings indiscriminately and without concern over what price they would get. They simply wanted out of the bonds and were willing to dump them at whatever price was available. This mass selling led to a second problem, which was how to determine a fair value for those bonds that were *not* being sold in fire-sale liquidations. Unfortunately, because of the accounting rules currently in place, the only way to put a value on these bonds was to use the last price that they traded at in the open market – one which we know was lower than it should be.

To illustrate let me give you an example: Imagine that you and your neighbor own homes that are essentially identical. Your neighbor is suddenly transferred by his employer to another state and must move there immediately. In order to facilitate his move, he is forced to sell his house as quickly as possible and as a result he sells it for 30% less than his original asking price, simply to get out of the property. Using the same accounting rules that apply to investments in the bond market, your own home would suddenly lose 30% of its value (on paper). But since you have neither the need nor the desire to sell, you did not really lose that value.

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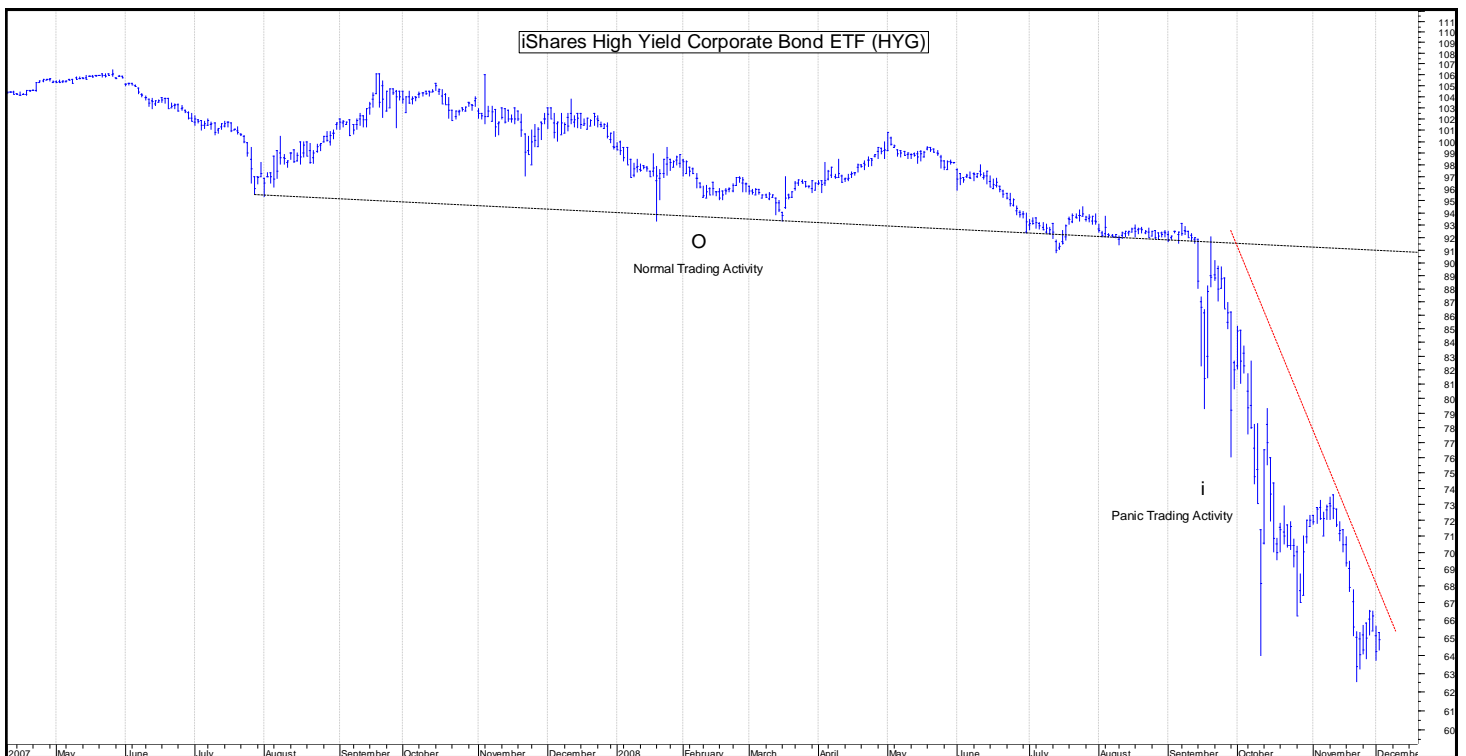
You know that if you simply wait for a better time, you could sell your home for the full asking price.

This is the same principal that has occurred in the bond markets. Because banks and financial institutions must carry their investments at market value, their NAV's have dropped dramatically even if they had no intent whatsoever to sell those assets. In fact, if those bonds are carried to maturity, then the holder will suffer no losses whatsoever. The high yield bond market was hit especially hard by this. To illustrate, I've included a chart of the iShares High Yield Corporate Bond ETF, which we recently purchased in our Bond Strategy. As you can see in the chart, there is a long, fairly stable period which represents normal trading activity within the marketplace. Then, in mid-September prices fell off a cliff as panic selling settled into the marketplace. From that point forward, the trading has been exceptionally volatile, even violent in nature. That volatility does appear to be slowing now, and the signs of a technical bottom in the high yield bond market are definitely present.

Another example of just how out of line things have gotten in the bond market can be seen in closed end mutual funds. These funds have a fixed number of shares and trade just like stocks on the major exchanges. Because they have a fixed number of shares, their price

can fluctuate to be higher or lower than the underlying value of their investment portfolio. This price difference is known as the premium or discount to NAV (net asset value). High yield bond funds typically trade near or at a slight premium to NAV due to their high dividend payouts. Right now, however, those funds are trading at discounts of as much as 20% below their NAV, and with dividend yields as high as 18%. The only plausible reason for such a discount is the panic selling that has been so evident over the past few months.

Yet another area that should be considered is the housing market. According to the S&P/Case-Schiller Home Price Index, housing prices nationwide declined by 16.6% over the past 12 months. However, buried within the news release was the fact that there are now many metro areas whose prices have fallen to below the forecast long run price level. We forecast the long run index level based on historical price gains adjusted for inflation. Based on that forecast, the US National Index is currently 12.6% overvalued. As a reference to how far things have come down, that index began 2008 almost 31% overvalued. However, there are several significant metro areas that are actually fairly valued or even undervalued such as Dallas (-8.4%), Atlanta (-7.9%), Charlotte (-2.1%), and Denver (-1.7%).



*(Market Commentary, continued from page 5)*

While house prices in many areas are back into reasonable levels, those areas that experienced the fastest appreciation remain overvalued such as New York (+43.6%), Washington DC (+42.6%), and Los Angeles (+38.5%).

To get an idea of the trend of house prices over the past year, I also took a look at the National Association of Realtor's report of median sales prices nationwide. What I found was that of the 153 metro areas that they track, 59% of them saw house prices bottom out in the first quarter of 2008. Only 28% of the areas reported continuing declines through the third quarter of 2008. As you can guess, the vast majority of those continuing declines were found in the highest priced regions such as New York, California, Washington DC, and Florida. What this shows is, with the exception of those areas that were extremely overpriced, the housing correction may well have found its bottom for the majority of the US. Stabilizing home prices will be yet another boost for both the US economy and the financial markets.

One final area of consideration is that of energy prices. Over the past several months, the price of crude oil has fallen by more than \$100 from its peak of \$147 a barrel. Gasoline prices have followed suit, and we may well see prices under \$1.50 before the end of the year. Falling energy prices translate directly into savings for consumers and businesses alike, reducing their expenses and freeing up cash to be spent elsewhere. For the moment, consumers appear to be holding on to those savings, mainly due to concerns over the slowing economy. **However, it won't take too long before that extra money gets put to work in buying new things – especially if we see any kind of recovery in the economy over the next few months.**

Current Conditions:

At present we remain cautious, as can be seen in

our portfolio holdings. Right now, I prefer to be defensive and hedge against further losses rather than being more aggressive when it is not yet warranted. The time will come when we can employ those techniques and trades that will allow us to greatly exceed the returns of the broad market. Right now, however, is still the time for patience as we wait for economic conditions to ripen. I do intend to become a bit more active in trading as I feel that the markets are going to move in a wide sideways pattern for at least the next quarter. However, that will be only a portion of our overall positioning. Warren Buffet made an astute observation that bear markets enable the transfer of wealth from the active to the patient. We want to be on the receiving end of that transfer, so I will balance the active trading with the patient waiting for an economic recovery.

At present, our Stock strategy is in a hedged position that effectively reduces its market exposure to only 25%. Similarly, our Strategic Allocation strategy is hedged to provide only 33% exposure to the market. Our Bond strategy has effectively a 25% cash position, and our Current Income Strategy is holding approximately 20% in cash in the form of money market funds. While those hedged positions do provide protection from downside losses, they also reduce the potential for upside gains. As such, we are watching very closely for signs that we can scale back the hedges and begin to increase our exposure to those assets that have the greatest recovery potential. Patience is crucial (just as Mr. Buffett said), and it does help to know that we **don't have to pick the bottom exactly because we can always pour on the gas as the economic conditions improve and risk levels decrease.**

Overall, I am optimistic about the markets and where we will go from here. This has been the worst bear market since the Great Depression itself, but **Ben Bernanke himself pointed out that, "...there is an order of magnitude difference between current conditions and that of the depression". It may yet take some time to get through this recession, but we will get through it, and the upside looks exceptional.**