

INVESTING AND THE MARKETS
WHAT TO DO NOW?
CLIENT CONFERENCE CALL – NOV. 2008

(Glenn Kautt) Hello, and thanks for listening in. As Michael just mentioned, due to our time limits we can't respond during this teleconference, but if you do have questions, please give us a call.

Let's get started by talking about the recent presidential election and what that could mean to you.

Many investors incorrectly assume stock market returns automatically go up when a Republican is elected. History actually shows the first-year annual returns for the S&P 500 have a greater probability of being higher under a Democratic President.

This is according to a nearly 60-year analysis of S&P 500 returns. We're using data generated by a colleague firm in the Zero Alpha Group, a business consortium we belong to.

Let me focus on this for a minute.

Since 1948, the S&P 500 has gained an average 15.8 percent during the first term under a Democrat as compared to 11.2 percent with a Republican. In fact, six of the seven *first* years after the election of a Republican president '52 to have had negative returns during a first or second term. Only George Herbert Walker Bush (Bush I) escaped this first year "jinx", while Carter was the lone Democrat to see negative returns in his first year.

Now, I realize the past is *not* a great indicator of future performance. Even so, the economic problems Mr. Obama faces are extreme, similar to those faced by Carter when he became president, so Obama could end up alongside Carter in the negative column if history repeats itself.

Some have argued the stronger first-year numbers under Democrats may be a delayed reflection of the preceding Republican president's pro-business policies. Well, while all this may be interesting, it sounds more like a political rhetoric to me, and it sure doesn't forecast the future very well. The bottom line is you *have* a long-term investment plan, and you should stick to it. Any "White House effect" based on who wins is an entertaining way of looking at the data, but hardly useful. In fact, betting on how an election turns out makes no more sense than any other investment gimmick, such as the "Dogs of the Dow"; which conference wins the Super Bowl; or whether hemlines go up or down. These aren't serious-minded investment strategies. This is entertaining talk at best. At worst, they're casino-style bets that have no place in the portfolio of

a serious investor. In fact, if presidential elections history illustrates anything, it's the danger of focusing on simplistic ways to manage your portfolio.

The best course of action is to keep costs and taxes as low as possible. Speaking of taxes, what *could* make a difference for you are significant changes in current tax policies.

Based on my reading of the proposals, the Obama tax plan, if *completely* implemented, might offset any positive stock market returns, particularly for higher income investors. Obama has proposed to raise income taxes, increase capital gains taxes, raise the Social Security tax and make estate tax provisions less attractive than those proposed by Republicans for high income folks.

Let's review the categories more closely by looking at Slide One found on our website.

At this moment, Obama publically supports making higher wage-earners pay Social Security taxes on more of their income. He has called for higher payroll taxes on those making more than \$250,000 annually. That would affect some of you listening.

Currently, the 6.2 percent payroll tax is now applied to all wages up to \$102,000 a year, which covers the entire amount for most Americans. Under the new plan, the tax wouldn't apply to wages between that amount and \$250,000. But all annual salaries above the quarter-million-dollar mark would be taxed under his plan.

Let's look at two examples shown as Slide Two on our website.

Say you are a business owner such as a doctor or manufacturer, making \$500,000 a year with \$100,000 in itemized deductions; and you have a \$1,000,000 portfolio with us, of 60% equity and 40% fixed income. According to our calculations, your federal tax would increase from about \$145K to over \$166K, a jump of over \$21K or a 15% increase.

If you were retired, living off a \$3M portfolio with only capital gains, interest and dividends, your tax would increase from about \$35K to nearly \$43K, a jump of over \$6,600 or a 19% increase. Ouch!

In both examples there is an alternative minimum tax, which is part of the numbers I gave you. Let's turn for a moment to the overall economic situation. Fortune Magazine recently characterized the current economic condition as being impacted by three major forces.

Let me review these: housing, consumer confidence and deleveraging.

Since the housing market is at the center of the entire financial situation, things won't get better until we see a sustained rebound.

Prices are still generally in decline for a pretty simple reason. From early 2000 until about 2006, home prices went up because money was relatively easy to obtain and consumer demand didn't slack off. Many experts believe easy credit launched the housing boom which gave buyers chances to buy housing with the biggest mortgage they could get, often well above their actual financial means.

That action drove prices higher in every market and price range for a while. Because of constantly increasing prices, even those with good credit got caught up in the emotional frenzy to "make money by flipping a house every two years." Economist Robert Schiller has written extensively about housing booms and busts all the way back to 1880. He mentioned this current *emotional* buying cycle in papers dating as far back as 2003.

Now the *opposite* side of the emotional cycle is in high gear. With prices falling, buyers figure they should wait to buy, but sellers are rushing to sell now before prices go lower. Obviously, both behaviors push prices down.

Consumer Confidence is the second issue. All large financial firms, such as banks and insurance companies rely on customers perception they're in good business shape for the long term. At the same time, it's obvious even the strongest firm couldn't repay all its long-term obligations on short notice. That's generally ok, as long as everyone believes the firm is financially sound. Yet just a tiny crack in the foundation of confidence can bring a whole institution down. You may remember the classic movie starring Jimmy Stewart you'll see on TV every holiday season: "It's a Wonderful Life."

It depicts a depression era bank-run, where a rumor start the vicious circle of withdrawals and falling confidence which resulted in the bank's failure, sort of. If you haven't seen the movie in a while, I highly recommend it. There really is a strong message in this movie. It's a great lesson on having confidence about the future, and how our personal actions have a great deal to do with how the future actually turns out.

Could this turn into a depression? I think not, as shown in Slide 3. Government intervention is well underway, there is FDIC insurance which was recently raised to \$250K per account, unemployment in the depression was 28%, while today its 6.1%. 44% of all mortgages were in default, as opposed to 6.4%, which is still a large number and intense protectionism did not help other countries during the 1930's. In fact it may have helped precipitate WWII, while today countries all over the world are working together with a coordinated response.

Thus, Washington's giant bailout is intended to squelch this crisis of confidence in the financial and housing sectors. Wednesday's announcement by Treasury Secretary Paulson indicates they won't be buying troubled assets directly, but will continue to inject capital into the financial sector and broaden the reach of the \$700 billion bailout plan to support non-bank consumer credit institutions, such as credit card and auto loan companies.

We shall see how this intervention plays out in the coming months, but I don't expect a sharp rebound in consumer confidence in the next few months.

Deleveraging is the other issue. Lots of financial firms figure have too much debt. They're right. The paradox is that if they all try to do the right thing and pay down debt at the same time, it makes them all worse off. To get the money to reduce debt, they have to sell financial assets. Hedge funds have been doing the same thing for some time.

Those actions drive prices down, reducing the value of the assets the institutions still hold. So, even after they've reduced debt, their debt ratios are no better than before, and they have to sell more assets, driving prices down further, and so on. Even very conservative equity mutual funds which have no debt have seen substantial liquidations as investors panic and run to cash, which isn't a smart thing to do right now.

This vicious circle is different from the consumer confidence problem I mentioned earlier in that it's based on real dollars, not crowd psychology.

So, what breaks economic down-cycles? Well, massive federal intervention is the only action that has worked to date. The Depression was a huge downward cycle, with the New Deal and the economic activity from World War II as its antidote. On a smaller scale the Resolution Trust Corp. stopped the savings and loan crisis of the late 1980s. Now Washington is debating the biggest intervention ever, reasoning that's what is needed for this crisis. Even with all this intervention, however, based on the indicators we see, this down cycle has a way to go, possibly through 2009 and into 2010.

Let me turn this over to Cal.

(Cal Brown) We all know how bad this market has been over the past year, so I don't want to dwell on it. We want to focus on what we should do.

Remember that for a couple of weeks, even CD's and money market funds weren't safe, if you exceeded the \$100K FDIC limit. One money market fund actually "broke the buck." Now, with the rescue plan, FDIC limits are temporarily at \$250K, but this expires in 2009.

So, where do we go from here? What do we do now?

In the recent memo I wrote to all clients, "A Tale of Two Realities," I discussed the two realities in the investment world: 1) the reality of business fundamentals such as *real earnings* and *real dividends*, and 2)

the reality of *expectations* and *speculation*. I trust this information helped you somewhat, and today I want to focus on the expectations and speculation part, which is all about the future.

I recognize that no one, not even I, can foretell the future. Also, I know that looking back into history doesn't guarantee anything about the future, but let's take a look at some historical facts—because that's all we've got!

I'm going to focus on three items:

1. Market Timing vs. Buy and Hold
2. Stock Picking (or finding the best Money Managers) vs. Passive Investing
3. Asset Allocation

Millions of Americans think that there are investment professionals out there who have information or special knowledge that is unknown to the market (that's the rest of us), and these people can use this knowledge and information to produce returns in excess of the market. After all, that's what brokerage firms and mutual funds have been telling us all our lives in their advertisements and sales pitches.

Most brokers on Wall Street believe that successful investing involves *beating the market*. The evidence, however, is overwhelming that this assumption is without foundation. This may be counter-intuitive to you, but the evidence clearly demonstrates that no one individual and no firm can consistently, persistently beat the market.

(Now, please look at chart #4, “Determinants of Market Performance”)

Investors have been told that money managers add value by either market timing or stock picking. But academic research in 1986 and confirmed in 1991 demonstrates that Asset Allocation—not market timing or stock selection—is the key determinant in portfolio performance.

Market Timing vs. “Buy and Hold”

Many clients and prospective clients ask many versions of this question:

Is it a good time to be in the market?

Variations include: Should we get out of the market? Or, is this a good time to invest? Or, my portfolio value is going down, shouldn't we do something? Whatever the questions, they all fall into the category of “market timing.”

Proponents of market timing believe that avoiding market declines (such as the current bear market) can substantially increase an investor's return. Maybe the best opportunity to prove this was before and after the crash of 1987. Were investors or professional advisors able to predict this in advance and act accordingly? Better question: how have they performed since?

We now have 20 years of data to answer this question.

(Take a look at the next two charts, #5 and #6,

“Best & Worst Surviving Market Timing Newsletters from the 1987 Crash”, and “The Best Newsletters Performed the Worst during the Subsequent 20 Years since the Crash”)

A recent study in the Hulbert Financial Digest (October 2007) examined the long-term performance of market-timing newsletters in existence since 1987 and compared their performance at the time of the crash to their subsequent results over the next 20 years. These newsletters advise their subscribers when to get in the market and when to get out. People want to avoid negative markets, but take advantage of rising markets.

During the three months that encompassed the Crash of 1987, the S&P 500 Index lost 29.5%. However, the best newsletter produced a positive return of 26.8%. On average the 10 best newsletters were down only 4.8%.

But what has happened since then?

Well, out of more than 100 newsletters that existed in 1987, only 38 remain today—the rest performed so poorly they went out of business.

Of those that survived, the one with the best performance in 1987 actually *lost money* during the 20 years following. By contrast, the newsletter that did the *worst in 1987* has done the best since then, *earning 21% per year* for 20 years!

Market timing exposes investors to high levels of risk, with no real probability of high returns. And you might miss some very good up days.

(next, please refer to chart #7, “Performance of the S&P 500 Index, January 1970 – December 2007”)

Look at how your return suffers if you miss the best day, or the 5 best days, or more over a 38 year period. In the past month, we have had two of the best days in the entire history of the stock markets (up over 10% each day); if you miss those days, you can never get them back.

Downturns are a normal part of the market cycle, and historically have not significantly affected the market’s continued long-term performance. Here is some idea of the frequency of declines since 1928:

<u>DJIA Average Declines</u>	<u>Average Frequency of Declines</u>
5% or more	happens about 3.3 per year
10% or more	about once a year
15% or more	about once every 2 years
20% or more	about once every 3 years

What are the chances of a gain or a loss, if you look at one year holding periods, five years, and ten years, since 1926? (look at chart #8, “**Holding On: The Case for Long-Term Investing**”)

1 year = 72% up
5 years = 87% up
10 years= 99% up (only down period, 1929-1938)

Another thing to consider is the duration and severity of Bull and Bear Markets (see chart #9, “**Bull and Bear Markets, S&P 500 Index**”). Going back to 1925, Bear Markets just don’t last that long—although it seems very long while you’re going through it, and even though a 40% loss is very painful, the subsequent Bull Markets not only last a lot longer, the increase is much more substantial.

But what do investors actually do? They get out at the wrong time.

(Now, please look at the next chart #10, “**Realized Cumulative Investor Returns**”).

DALBAR studies investor behavior and released the annual update of their “**Quantitative Analysis of Investor Behavior**” research report—you can Google this and read it yourself. Within the pages of this annual report are several eye-opening facts, but the most important among them is this:

Based on an analysis of actual investor behavior over the 20 years ended December 31, 2007, the average equity fund investor would have earned an annualized return of just 4.48% – underperforming the S&P 500 by more than 7%.

Another way to look at this is cumulatively—over the 20 years ending in 2007, the average stock investor earned a return of only 140%, while a simple buy and hold strategy in the S&P 500 Index returned 833% .

Why is this? People invest when it feels good—when the market is going up; but when things go bad for a while, they sell and get out—when the market is going down. Another term for this is “Buy High, and Sell Low.” It’s also called market timing.

The final risk of market timing I want to mention is how quickly markets recover. You can see this in the Bull and Bear Markets chart. But also, a recent T. Rowe Price communication stated this:

In the 12 bear or near-bear markets since 1957, the S&P 500 on average, recouped one-third of its principal loss in just the first 39 days after the bottom.”

Now, we don’t know when the bottom will occur (or even if it has already occurred), but you do not want to be out of the market when it starts back up. This is my greatest fear for clients who want to bail out at this point.

Let me close this section on market timing by quoting Mark Hulbert, who has been publishing the Hulbert Financial Digest for over 25 years, which tracks the results of the advice given by investment newsletters.

He developed his own “Market Timing Popularity Indicator” 15 years ago. It measures where these advisors are on the market timing vs. buy-and-hold spectrum.

Quoting now,

Historically, some die-hard adherents to buy-and-hold eventually give up the faith—when things get bad enough. And when this conversion does take place, a bottom is probably not that far away.

Take the end of the last bear market, some five years ago. Just a few days prior to the ensuing bull market taking off, one of the newsletter arena’s staunchest supporters of buying and holding declared that he had changed his mind and that he now believed it was essential to be a market timer. My column reporting this change of heart appeared on March 11, 2003, the exact day of the successful retest of the market’s bear market low.

So, when most of them have thrown in the towel, it has coincided with the market bottom. In early October of this year, Hulbert said that hadn’t happened yet. So, we’re watching and waiting for capitulation.

Stock Picking vs. Passive Investing

The second way Wall Street claims to “beat the market” is by supposedly having some special knowledge or process that enables them to buy the good stocks and avoid the bad stocks. How have they done?

First, they start with their foot in a hole, as all of their trading costs and other expenses create a hurdle that puts them 2-3% behind the index before they have any gains at all. This is very difficult to overcome.

Second, their performance continually fails to beat their benchmark (**see chart #11, “Actively Managed U.S. Stock Funds Fail to ‘Beat the Market’”**). Large-cap, Mid-cap and Small-Cap funds on average persistently lag in performance. You would think that active managed funds could have out-performed the indexes this year, but they haven’t. According to an October 2nd article in the Wall Street Journal:

In theory, mutual funds run by stock pickers should beat index funds in a down market. The reasoning is that savvy managers, combing through financial statements can avoid the worst performers and bulk up on the winners. An index fund, meanwhile, has its hands tied. Unfortunately for investors, in this past year’s bear market, most mutual fund managers have fallen short. In some parts of the mutual fund world, the performance of actively managed funds compared with the indexes has been nothing short of abysmal.

Enough about mutual funds. What about major U.S. Institutional Pension funds? They can afford to hire the best and brightest money managers. In a study of 192 large corporate pension plans from 1988-2005, a broadly diversified index portfolio of 70% stocks and 30% bonds out-performed 85% of all the large pension plans in the study. Even a more conservative passive index portfolio (60/40) out-performed more than two-thirds of the pension plans (**see chart # 12, “Large Pension Plans Likewise Perform Poorly vs. Index Portfolios”**).

Third, what about the persistence of the best performing money managers? Well, fund managers who perform well for a period of time, typically do worse than average in subsequent periods (see **chart #13, “Very Few Top 100 Growth Fund Managers Stayed in the Top 100 the Next Year”**). On average, less than 1 in 5 repeat (only 17% do). How can you know which ones will repeat? Here’s some bad news: you can’t.

Another way to look at this, in that same chart # 13, is to study top quartile funds—most of the time (84%) they drop into the lower half in subsequent periods. Meanwhile, the worst funds (bottom quartile) jump into the top half (87% of the time). Do you want to buy the worst managers and hope for a rebound?

This is why we continue to believe there is a better way.

3. *Asset Allocation*

The evidence clearly shows that active management is inefficient, costly, and counter-productive. It is very difficult—if not impossible—for professional money managers to consistently beat the market over time. There is an abundance of logical, mathematical, and empirical evidence to support this fact.

Thus, we firmly believe you invest using passive funds and index funds. They are low cost, which is a significant advantage. Second, as I have shown, most active managers cannot consistently out-perform these benchmark funds. And if you find one who does, chances are he/she will under-perform next year.

Next, you don’t just own the S&P 500 Index. Most of you have an allocation of bonds as well as stocks.

On the stock side, you own not only the large-cap growth stocks in the S&P 500 Index, you also have value stocks, and small-cap stocks, both growth and value. In addition, you own international stocks—large-cap, small-cap, growth and value, plus emerging markets.

Many studies have shown a carefully engineered portfolio of these various components, which are for the most part non-correlated with each other, can actually enhance returns and reduce risk over time.

Granted, it doesn’t always work in these short-term time horizons, such as 2008. However, in this next chart I’m going to show you data beginning with a bad bear market like this one—1973 to 1974, S&P 500 down 50%. It demonstrates conclusively the asset allocation I just described has out-performed the index. And do it with lower volatility. (see **chart # 14, “Global Strategies Earned More With Less Risk”**).

Once you’ve got this set up, do you just “buy and hold”? You might be surprised at my answer: No!

I’m going to send it back to Glenn to let you know what we’re going to be doing. Glenn?

(Glenn Kautt) On a selected client and account basis, we are:

Executing tax-loss trades where appropriate.

Implementing two new asset investment categories, TIPS and emerging markets. We are considering two others categories due to their significant decline in price; a broad commodities index fund and real estate investment trusts. We should make a determination on those early next year.

Reviewing, or in some cases, finishing your financial blueprint, which helps you and us understand your future financial situation. It includes cash flow modeling, tax modeling, and has Monte Carlo simulation built in to test for just the kind of market downturn we are now experiencing. This is of vital importance for those who are within 5 years of retirement as well as those who are retired.

We are reviewing each portfolio for rebalancing. Basically, you are in one of two general categories: either you are in an accumulation or no-use mode; or you are in a draw-down situation. The strategy for rebalancing is different for these different modes. We are completing a rebalancing analysis for each client in the draw-down mode first, and will be talking with you in the next few days, weeks or months, depending on your review cycle or what we determine from our analysis.

I have negotiated a lower trading price from Schwab. The maximum mutual fund trade cost was \$49.95. It's now 25 bucks. That might not seem like a huge savings, but could add up to several hundred dollars across all your accounts for rebalancing, tax-loss trading and new investment implementation, even in the next few months. This cuts Schwab's revenues considerably, but they're trying to help as much as they can. To give you an idea about that, we will process approximately 3,500 trades before the end of the year. We estimate this will reduce Schwab's revenues over \$100,000.

Speaking of savings, I mentioned earlier about potential significant changes to the tax code. We are carefully reviewing all your taxable accounts to see what changes will have to be made if and when changes to capital gains, dividends or any other investment related law is passed. This is an extremely fluid situation, and I can only tell you we are monitoring it as it unfolds and will act accordingly.

We are looking to see if the overall portfolio design is appropriate. Remember I mentioned the financial blueprint to understand your future financial situation? Well, depending on the outcome, modification to your design may be warranted.

Let me say in closing this is a tough time, emotionally. My retirement plan is 100% in the same equities you're invested in, and, yes, my account has taken the same trip down yours has. I'm not happy. My consolation is this: it took only months for the typical Monitor Group equity portfolio design to recover from the severe bear market which occurred from 2000 through the first quarter of 2003. In fact, if you were in cash and stayed there for only two months after the market bottom in 2003, you missed out on a 19% recovery. If you stayed in cash for the remaining 7 months until the end of 2003, you missed out on a recovery of 53%.

We're in the same boat you're in, and we are doing everything we can do, except panic and jump overboard. We going to carefully analyze the opportunities and dangers out there in the coming days, and make studied investments in fixed income and equity categories which will minimize your financial risk and maximize your long-term financial situation.

Thanks for listen in and we hope to be speaking with you soon.