



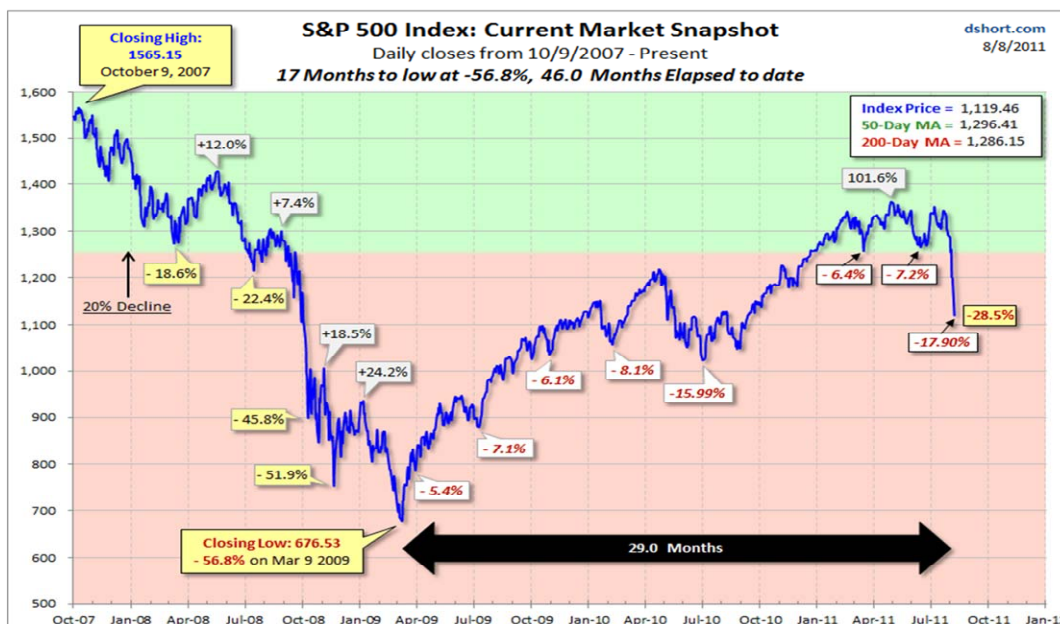
## Client Newsletter

### *Another Crisis of Confidence*

August 10, 2011

#### Perspective

The sharp stock market decline since the last week of July is being compared by some commentators to those painful days in 2008 and early 2009 when a recession grew into a full-blown credit crisis, culminating with a total market decline of almost 57%. So far, this correction is deeper than the 16% decline last spring/summer, though the market rallied to a 13% gain for the year. Here is a chart from dshort.com that provides an interesting perspective of the entire cycle thus far, from the top on October 9, 2007, to the bottom on March 9, 2009, and the recovery through Monday's decline. Though the recovery since the bottom in 2009 has been dramatic overall, there have been a number of sharp pullbacks along the way. This is normal and to be expected, but the current disturbance begs the question of whether the cyclical bull market is over and if we have entered another bear phase. We think the cyclical bull market remains intact at this point, though the odds of recession have increased over the past few weeks.



Though we disagree with the comparisons to 2008, it is interesting to note from the chart that the market levels before the current correction were about where they were in that fateful summer of 2008 - around 1300 on the S&P 500 Index. Another interesting, yet extremely painful, memory from the crisis was the general state of investor sentiment in March of 2009 at the market lows. At that point, fear was so pervasive that even the most sophisticated institutional investors were tempted to capitulate and sell their stocks. While we were far from optimistic at that point, here is what we wrote in the first paragraph of our Client Newsletter on Friday, March 6, 2009:

*We continue to be faced with an extraordinarily difficult market environment and the pervasive pessimism that goes with it. As investors ourselves, we understand that the powerlessness of watching the value of your investment assets decline creates a strong desire to “do something” about it – to somehow take control and end the pain. Going to cash may lock in losses, but at least it creates a certainty amidst a great deal of fear and uncertainty. These are the conflicting emotions that every investor faces right now - the certainty of locking in a set (albeit painfully lower) level of wealth, versus the uncertainty of possibly more near-term losses and the hope of better longer-term returns.*

The rest of the newsletter on that day was a review of various valuation statistics that would discourage any rational person from selling at those low levels, plus our admonition that the odds hugely favored investors who had the courage to stick with their plan. We couldn't be certain, and we were certainly worried and battle worn ourselves, but we made the right call. The market bottomed two days later on March 9 (see chart), and we have been on the jagged road to recovery ever since. Were we prescient? Obviously not, but the odds were heavily weighted for a sharp market rebound, so logic prevailed over emotions. Basically, we are paid to help clients make decisions that they find very difficult to make on their own.

### **Evolving Investment Management Approach**

However, we did recognize that the 2008/09 credit crisis changed the financial world and our fundamental approach to managing risk and returns in the years ahead. Basically, we became convinced that some of the conventional approaches to diversification would not work as well in a “new normal” world where deleveraging by households and governments would be a dominant headwind resulting in slower economic growth, lower investment returns compared to historical averages, and a greater frequency of financial shocks and severe market reactions. We expected that many of these disruptions would be caused by policy errors by politicians and central bankers. They have not disappointed us so far.

Our response has been to further evolve our investment philosophy and process to be even more risk management focused, using a modular construction process and expanding the diversification set to include four broad asset classes. These include the traditional core positions in domestic equities, foreign equities and global fixed income, as well as a 20% to 30% allocation to “alternative investments”. These alternative investments are designed to improve the consistency of returns by investing in areas like commodities, hedging strategies and global tactical managers to generate returns that are differentiated from the market beta exposures of our core managers. Also, our current client portfolio strategies emphasize the use of “flexible mandate” money managers who are given more latitude in seeking returns

with a variety of investments that emerge as market conditions change. Overall, we are seeing that these portfolios are more stable and better able to withstand sudden market shocks.

### **The Current Environment – Eroding Confidence in Leadership**

In spite of all the angst over the S&P downgrade of U.S. debt securities, the market rioting over the past two weeks is more of an investor response to the sudden emergence of new negative information on three main issues:

1. Eurozone debt – renewed concerns over the inadequate measures being taken by the Eurozone authorities to deal with the sovereign debt problems of the larger southern countries (France, Spain and Italy);
2. A soft patch in the U.S. economic expansion - the surprising spate of soft economic data showing a slowing of growth in the U.S.; and
3. Anger and dismay worldwide with American politicians - the widespread disappointment in the debt ceiling debate circus and gross inadequacy of the ultimate “debt ceiling deal” struck by our political leaders. In fact, it has been noted by many economists and commentators that the downgrade was more about the lack of political will and dysfunction than about U.S. economics.

These topics are being covered extensively by the media and other researchers, so we won't opine further on just how we think these problems will be addressed. We'll know soon enough this fall, as the markets are sending a very clear message to the policy makers who control our destiny. Meanwhile, the general lack of confidence is likely to weigh on the markets and create a very rocky environment.

Though worrisome, the current environment is very different from the summer of 2008:

- Based on forward earnings, the stock market is selling for between 11 and 12 times earnings, a bargain compared to the high teens multiples for the summer of 2008. In their “Price Matters” investment approach, *RiverFront Investment Group* estimates that the market is now 30% to 40% below its long term trend line, its mean return; this type of valuation opportunity is very rare. Eventually, the markets always revert to the mean.
- Unlike the summer of 2008, American corporations are flush with cash. The next step is to invest in production and people.
- Oil prices have fallen sharply to around \$81 per barrel versus over \$100 in 2008, thereby freeing up consumer income for growth-producing consumption and further debt reduction.
- Banks have substantially repaired their capital ratios and are much healthier than in 2008, and the egregious offending investment banks on Wall Street are dead and buried.

- Most importantly, financial market liquidity is expanding rather than contracting. The depths of the 2008/09 market drops were driven by a liquidity shortage by over-levered investment banks and brokers and exacerbated by hedge funds facing a tsunami of redemptions. Those risks are much lower now.

## **Conclusion**

Clearly, serious challenges remain for an economy that is in repair mode. The housing market is still in the doldrums and reducing unemployment remains a long-term process, but the good news is presently being ignored. Are the economic and liquidity risks comparable to those that caused the market crash in 2008? Far from it, in our view.

Admittedly, the restoration of confidence is critical to the resumption of the economic expansion and a return to more stable markets. Much depends on the policy responses and economic data that surface in the coming weeks. A potential silver lining is that the downgrade and market turmoil will serve as a wake-up call – possibly the loudest yet – that now is the time to get our fiscal house in order.

Finally, all of our clients should find comfort in knowing they are investing according to an investment plan that has been tailored to their long-term goals and is adaptable to changing market conditions. Market volatility is a constant at some level and sometimes frightening. However, throughout our firm’s nearly thirty years of history, the best course for our clients has been to stay with the plan. That’s not to say that the plan can’t be altered when personal or institutional circumstances dictate, but wholesale deviations from the plan have generally had negative long-term consequences.

As always, we welcome your opinions and questions.

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