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Market Commentary

What Now? A Look at 2009

Surveying the wreckage of last year leads naturally to some basic questions as to the best course to follow in 2009. Does one double down, increasing exposure to risky assets to do better than simply recouping last year's losses? Or, perhaps everything truly is different this time and the best thing to do is reallocate to cash and perhaps gold. Between these extremes is the tried and seemingly tired method of rebalancing to strategic targets. The operating assumption there is, of course, that the original strategic targets were chosen based upon a realistic assessment of potential long term rates of return and risk. The virtue of rebalancing is that it enables an investor to be (as Warren Buffett famously advised) "fearful while others are greedy and greedy when others are fearful", without actually having to hold those convictions. Opportunities now exist in many types of assets that heretofore were extremely overvalued. How does one take advantage of the opportunities served up by this chaos and still maintain a disciplined, long term investment plan?

It is helpful to generalize the key characteristics of the various asset allocation buckets commonly used. The role of cash and bonds is liquidity, safety of principal and income – in that order (people who forgot this paid dearly last year). Stocks, of course, are for longer term growth. Our rule of thumb is that a minimum time horizon for equity investments would be five years. Given this, a stock and bond portfolio can be looked upon as a "liquidity ladder", with bond maturities approximately corresponding to expected holding periods. So in a simplified example, assume a portfolio requires a 5% annual distribution and is allocated 5% cash / 25% bonds / 70% stocks. The 5% cash can be thought of as the current year's distribution, the 25% in bonds would cover the following five years and the stocks would provide growth necessary to allow the needed cash flow beyond year six.

Options for the Liquidity Bucket

Based upon this model and the risk that an economic recovery could take 3-5 years, preserving near term liquidity to match anticipated distributions should be a priority. However the current environment offers choices within the "liquidity" and "growth" buckets. Fixed rate Treasury bonds offer safety and liquidity but very little income and no protection against inflation. However, **TIPS**, the inflation-protected Treasury bonds offer comparable yields to fixed rate treasuries before accounting for the inflation adjustment. Similarly, **high quality municipal bonds** have higher yields than Treasuries on a pre-tax basis, meaning they can even be used as substitutes for Treasuries in tax-exempt portfolios. Finally, **investment grade corporate bonds** have traded at 8%-9% yields, offering close to equity rates of return.

Options for the Growth Bucket

The key decision for 2009 is between stocks and credit opportunities that offer stock-like returns. However, a broadly diversified portfolio of traditional high yield bonds is currently a risky proposition. Even though the indexes report 19% yields, the concentrations in the sure-to-default c-rated issues and poor outlook for recoveries means that credit losses on the high-yield universe over the next couple of years could be well in excess of 10% per annum. One strategy we are pursuing is allocating to equity managers who have the expertise and experience in purchasing debt securities where the risk / reward potential is superior. Additionally, the mass liquidations of hedge funds have created pricing dislocations in **distressed debt**. Some consideration should be given to reallocating a portion of equities to some of these opportunities given that a recovery in the equity markets is unlikely without a recovery in the credit markets.

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Bank loans (also called leveraged loans because the main reason they are cheap today is that hedge funds and other investors typically bought them with leverage) offer much better risk-return characteristics than traditional high-yield bonds. Bank loans refer to senior, floating rate lines of credit that have been securitized (a dirty word these days, but these are single-issuer obligations, not exotic CDOs or CLOs). These obligations have seniority in the capital structure, meaning in case of a default they have to be paid back in full before junior creditors or stockholders receive a dime. The S&P / LSTA Leveraged Loan 100 index currently has an average bid price of 65, 5 year maturity and a coupon rate of Libor + 240 (2.4 percentage points). This translates to a low current income yield (5%-6%) but a 15%-16% yield to maturity. Default rates in bank loans are historically lower than high yield bonds and recovery rates are higher with 75 cents on the dollar being a 10-year average.

MLPs refer to publically traded Master Limited Partnerships that hold energy infrastructure assets. Traditionally this has been regulated oil and gas pipelines with federally mandated rates and essentially no exposure to commodity prices. As the vehicles became more popular, other more commodity price-sensitive assets were placed into the structures. Like REITs, MLPs are exempt from corporate income tax provided they distribute 95% of their net income as dividends. However, a key difference from Real Estate Investment Trusts is that these publicly traded securities issue a K-1 to investors and the income is potentially subject to UBTI for non-profit entities. Due to accelerated depreciation, a majority of the dividend has historically been treated as a return of capital rather than ordinary taxable income. From 6%-7% dividend yields in 2007, these securities have fallen to the point where they have 9%-11% dividend yields for the larger MLPs and often over 15% dividend yields for the riskier smaller companies.

Subprime and Alt-a Mortgage-Backed securities fueled the housing bubble with their unbelievably lax underwriting standards. It is therefore difficult to believe that these securities offer any value. Nonetheless, we believe this is the case on a select basis. These securities were structured with tranches (literally "slices") with different priories of loss exposure. The first-loss pieces of these securities are largely wiped out, but value often remains in the senior pieces which are trading at discounts that enable 15%+ rates of return off of very pessimistic default projections.

The Economy is a Going Concern

Eventually the economy will recover and current pricing levels virtually guarantee the outperformance of risky assets over Treasury bonds over a 5-10 year time horizon. Our best guess is that the US economy will begin to grow again late this year or early next year. The overhang of the credit bubble will likely translate into an anemic recovery. Risks of a prolonged Japan-style downturn are real, but if forced to quantify this, we would put the probability at 20% or less. The current stimulus plan will help, as simply will time. There will not be an "all-clear" signal notifying investors that it is the time to buy stocks again, rather one should continue to own the equity of high quality companies that can weather a longer than expected downturn. Given the level of declines a 40%-50% rally in stocks sometime over the next few years would not be surprising. If history is any guide, the rally would occur before it was obvious the economy had recovered with the bulk of the gains happening over a very short time. The probability of anyone successfully timing an entry point to catch this is about nil. Therefore maintaining strategic allocations, while incorporating some of the adjustments discussed above, remains the best course of action.

We invite you to contact us for a review of your current portfolio holdings. We will conduct an independent analysis of **what you own**, **the costs to own it** and **whether you should continue to own it**.

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