

Monthly Investment Commentary



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The magnitude of the bear market is apparent in that November's steep 7.2% loss for the S&P 500 (as measured by Vanguard 500 Index Fund) marks the index's best (least bad) showing in three months. Once again, all equity asset classes were down sharply for the month, with the degree of loss generally in line with market cap. The iShares Russell Midcap was down 10.2% in November, while the iShares Russell 2000 fell by 11.8%. Year to date, the broad U.S. stock market has fallen almost 40%. The Vanguard REIT Index Fund fell by 23.4% in November, and is now down 46.4% for the year, while high-yield bonds (which have equity characteristics) were down 8.4% for November and 31.4% for the year. What was different in November was that fixed-income generally had a much better month. Vanguard Total Bond Market Index was sharply higher, with a 3.6% return, bringing their year-to-date return into the black (+1.7%). Looking overseas, Vanguard Total International Stock Fund lost 6.3%, and is down almost 50% year to date, and emerging markets (as measured by Vanguard Emerging Markets Stock Index Fund) were down 7.9% in November and 56.4% so far this year. The only good thing about 2008 is that it's almost over.

Amidst the Worst Bear Market Since the 1930s, Where Do We Stand Now?

In November, the bear market in stocks officially became the worst since the 1930s as the S&P 500 neared 750, more than 50% below its peak of just over a year ago. What started with the subprime mortgage crisis became a full-blown credit crisis and is now hitting the economy hard as both businesses and consumers are rapidly retrenching. Businesses are hunkering down, cutting spending and laying off thousands of workers. The general population is suffering from falling portfolio and home values, and some fear for their jobs. The result is a sharp reduction in spending by businesses and households that is impacting corporate earnings. A key to breaking the downward momentum is seeing some improvement in the credit markets, which are still highly stressed. Businesses that have debt maturing are faced with unacceptably high costs to refinance their debt—if they can even get the refinancing. The unavailability of credit at reasonable interest rates is impacting businesses of all types, real estate owners and municipalities. This puts particular stress on borrowers who don't have the liquidity they need over the short term, which translates into more defaults and more losses for financial institutions. And with financing costs high, new business investment generally doesn't get done.

As we make decisions in the midst of this environment, we are considering the following:

- Have financial asset prices fallen to levels that take into account the severity of what we are experiencing and the potential for further deterioration?
- Regardless of long-term return potential, how much short-term downside exposure is there in portfolios?
- How should we trade off the short-term risk versus the long-term returns?

We address each of these questions below.

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Have financial asset prices fallen to levels that take into account the severity of what we are experiencing and the potential for further deterioration?

We believe many asset classes have already priced in a severe recession and a subsequent subpar recovery. (Caveat: day-to-day market moves continue to be so enormous that return relationships can change significantly in just a few days—meaning that our comments may become stale by the time they are read.) Here are some examples:

U.S. Equities: U.S. equities are now priced to deliver at least decent five-year returns. With the S&P 500 near 850, very good returns are possible over that span, but are not a sure thing. Our most pessimistic scenario assumes that five years from now, earnings are 30% below their 2007 peak. We believe this is a very pessimistic assumption. Even in this scenario, we project returns to be in the mid to high single digits—decent but not table pounding. In less pessimistic but still-conservative scenarios, returns would be over 10% and returns in the teens wouldn't require hugely optimistic assumptions. Moreover, we believe that forced and indiscriminate selling has resulted in significant pricing discrepancies within the stock market and that this is likely to result in a great environment for active managers. We have seen other instances when pricing discrepancies were significant after other severe bear markets (based on data that measures the valuation discrepancy between stocks). When we put all of these scenarios together, it looks to us like stocks are priced to deliver high-single-digit to low teens returns over the next five years, which offers pretty good risk vs. reward.

High-Yield Bonds: We recently upgraded our rating on high-yield (HY) bonds to a "4" on our rating scale of 1 to 5 (with 5 being the best). We now believe HY bonds are likely to deliver returns comparable to stocks over the next few years with potentially lower near-term downside risk. With yields of over 20%, high-yield bonds are priced to deliver a pretax average annual return in the teens over the next five years, even in the most dire scenario, which we consider reasonably possible. Based on analysis we've reviewed, even if cumulative defaults over the next few years approach 50% (which would be in excess of what occurred in the 1930s) and the recovery for junk-bond holders from these defaults is only 25%, returns would still be in the mid-teens. Generally, defaulted bonds recover about 40% of the original loan amount, on average, through asset liquidations or restructuring of the business, and have recovered about 32% following past default peaks, so a 25% recovery assumption is very conservative (returns are still good even under lower recovery rates). The math works because of the combination of very high interest income and the fact that the bonds which default are already trading at huge discounts to par (the average high-yield bond is selling for about 60% of its face value), which reduces the loss potential.

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Though many of these bonds will default, a highly diversified portfolio of high-yield bonds offers great long-term value and should be considered a nice complement to most portfolios (however they may be better suited for tax-deferred accounts due to their high level of income). If the stock market has a powerful rally, not unusual even within a bear market, high-yield bonds will almost surely lag. However, they should outperform if stocks go lower and look comparably attractive longer-term (though relative valuation levels have been changing rapidly, mainly because stocks have been so volatile).

REITs: As we write this, REITs are down almost 60% since September 30. A decline of this magnitude was hardly fathomable. We have been assessing the REIT market for months and, earlier in the year, with REITs down over 30% from their peak levels, they began to look interesting. By mid-November, REITs had fallen further, to levels that assumed commercial property prices would decline in excess of 30%. It is important to remember that, unlike residential real estate, commercial real estate values are supported by the income the properties generate; 90% of this income is required to be passed on to investors in the form of dividends. Even with a significant cumulative decline in REIT dividends of 20% over the next five years, REITs would still deliver returns of between 10% and 13% (assuming yields eventually decline over the period as the market becomes less stressed). We are not sure where property prices might be in five years or what level of dividend cuts is likely for REITs, but we do believe that the levels which are priced into REIT stocks are excessive. We are also not sure when REITs will be able to sustain a rally. Investment property is probably in for a couple of very difficult years. However, in the last very bad down-cycle for real estate, (in the early 1990s) REITs began to recover several years before property prices bottomed. We believe it is very likely that equity REITs will deliver double-digit returns over the next five years.

In addition to these asset classes, emerging-markets equities and almost the entire bond market except for U.S. Treasuries also look attractive from a long-term value standpoint over that time period. If REITs underperform domestic equities again, and stay depressed (relative to equities) for more than a few days we may consider adding some REIT exposure to portfolios. In the meantime, we will continue to patiently watch the asset class.

Have financial asset prices fallen to levels that take into account the severity of what we are experiencing and the potential for further deterioration?

With respect to the stock market, (including foreign stocks and REITs) it is impossible to know what the near-term downside might be from here (this is not to say that the downside is unlimited, however). The S&P 500 at 752 was down more than 50% from its peak

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just over a year ago and is also down more than 50% from its March 2000 peak—almost nine years ago! Most valuation measures we look at suggest the market is fairly cheap. It is entirely possible that we have seen the bottom. But, we can't say for sure and we wouldn't be surprised to see stocks go lower. The S&P at a level of 700 prices stocks to return over 10% in most pessimistic scenarios. We believe that is an extreme but still possible scenario. So, what's the lowest level we could imagine? The S&P at 600 would be 20% below the low we've seen so far, and while we can't rule it out, stocks would be very undervalued at that level (or below). In that scenario, we expect all equity asset classes to see similarly large declines. With respect to bonds, we believe most bond market sectors have already been severely hit and have much less downside from current levels. Wherever the markets bottom, it is important to remember that they will not be frozen at that level. In fact, given the price declines already experienced, from an even lower point (and from current levels for most asset classes), we expect returns to be quite exciting.

Bear markets are challenging because they offer great long-term return opportunities at a time when investors are least willing to think long-term (because major losses have sapped their capacity to take any more short-term risk). Instead, the best investment opportunities are presented at a time when short-term risk appears to be very high and investors are heavily motivated to avoid it (and this is what creates those opportunities).

How should we trade off short-term risk versus the long-term returns?

This is a critical question. We take our responsibility seriously and have been working long days and weeks carefully weighing the important decisions we make.

We recognize that virtually all investors, including our clients, are deeply pained by portfolio losses experienced in recent months. The magnitude of any long-term opportunities becomes meaningless if investors can't make it to the long term. Recognizing this, we believe it is important to take a balanced approach to risk and return in this environment. We believe all equity asset classes are now priced to deliver good returns, with some priced to deliver outstanding returns over a five-year horizon. In light of this belief, and as long-term investors, we believe it is important to maintain equity exposure. However, we are balancing this with each investor's tolerance for risk. First, we are sensitive to the psychological impact to our clients of increasing equity exposure only to see more declines in the short-term. In this environment, we assume any equity buys we make will be followed by more weakness—that is not a prediction but rather an acceptance that we can't predict what will happen in the short term. Second, we believe that the economic risks are high. With credit markets nearly frozen, resulting in elevated borrowing costs and limited credit for busi-

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nesses, we believe the economic risks remain to the downside and that a recovery might not begin until late in 2009 or possibly into 2010. That suggests that we may not need to be in a hurry to get more aggressive (though this could lead us to miss an opportunity). If you have any questions about the risk vs. reward balance in your portfolio please do not hesitate to contact us.

Closing Perspective

There is no sugarcoating the very serious challenges to the global economy. That being the case, it is important to remember that markets almost always bottom while the headlines are still grim and fundamentals are still weak. Almost every bull market that started from a period of economic weakness was well underway while corporate earnings continued to decline and unemployment continued to rise. A good way to get whipsawed is to wait until it feels safe. At that point, stocks are likely to be much higher and it will be psychologically more difficult to commit to investments at higher prices. This is a clear and unequivocal lesson of history.

We believe investors are very likely to capture good returns over the next five years. We also believe equity asset classes are more likely than not to bottom within the next six months, if they haven't already. But in the meantime we make no claim to know what the next few months may bring. Being a long-term investor would be easier if we could all come back in five years and check our portfolio values without worrying about what happened along the way. Since that is not the way the world works, we reiterate again the importance of being in the portfolio strategy that is right for you. That means assessing your ability to ride through any potential further losses in the coming months. Being able to sleep at night is an important part of that assessment.

- CB&T Investment Team 12/2008

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