



JMH Wealth Management, LLC

Hitting the Reset Button

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Financial markets and the economy always feed off each other in a capitalist system and we tend to cycle toward extreme inflection points, overshooting on the upside and on the downside. Periods of apparent growth and profitability seem to mask quite a bit of excess and inappropriate behavior and that is where we find ourselves presently. The current mess can be attributed to greed, excessive leverage, and an amazing failure to act responsibly at virtually every level of oversight, beginning with the consumer and ending with government policy makers. Hitting the reset button involves flushing out those abuses in the economy, financial markets, and investor behavior, while working through the pain associated with trying to recover our balance and strength. The lessons are often harsh, but necessary, and can facilitate economist Joseph Schumpeter's creative destruction which sets the stage for future economic growth and innovation

The headlines are filled with the sad case of the apparent fraud committed by Bernie Madoff who has confessed to running a Ponzi scheme that destroyed possibly \$50 billion of investor money. None of the details are clear at this point other than his success at separating many sophisticated investors from their money. It's easy to call a foul in hindsight, but some thoughtful due diligence may have uncovered a number of red flags prior to sending money his way.

Under the category that investors foolishly only look at the return on their money, not the risk associated with achieving that return, his investors should have questioned how he was able to post astonishingly consistent positive quarterly and annual returns in defiance of market behavior over long periods of time. Hedge fund managers and funds of funds managers who placed money with Madoff are especially vulnerable to criticism for their due diligence failures. Investors should have questioned his black box approach to investing and his seemingly complete control over the custody, trading, clearing, administering, and reporting of investments to his clients. Many investors have been devastated by Madoff's alleged fraud and the personal stories of loss are indeed hard to hear. However, it should be a brutal reminder that every investment carries risk that must be acknowledged and if it looks too good, it's because it is. We probably all need to reset our risk control button.

The year of 2008 has been punishing to all investors and very few escaped from the pain of the biggest losses of their investing lives, even among the biggest and brightest. Consumer and investor perspective toward leverage is sure to reset more conservatively. Investor sentiment toward hedge funds, which we now discover did very

little hedging of risk, is sure to change now that many of those strategies and outsized returns have been exposed as having been due to leverage, which works wonderfully on the upside but can kill you on the downside. Redemptions have apparently been heavy at hedge funds and selling to meet those redemptions has triggered cascading declines in the financial markets over the past few months. Some forecasters suggest that nearly half of all hedge funds will be out of business a year from now, which coupled with pent up redemptions (many hedge funds are apparently refusing to return money at present) could make for a rough start to the early part of 2009.

We also have to worry about asset quality and leverage in private equity portfolios and the incredible number of deals that were structured with excessive debt burdens. High profile deals, such as Chrysler and Tribune have already unwound, and many more deals will blow apart as we move into the second year of probably the worst recession on record since the Great Depression. Private equity implosions will just add more strain to a financial and economic system already under considerable duress.

The past twelve months turned a lot of investing theory on its head. Building portfolios of low correlated asset classes simply didn't work, as the correlations of most investment classes converged amid the financial distress. Investors seemed to lose money in virtually every asset class except 10 and 30 year treasury bonds. The smart and sophisticated investment portfolios of endowments and pension funds, which had access to the best managers worldwide, didn't escape the carnage any better than the average investor. Their aggressive foray into alternative investments provided little insulation from the pain, and most probably performed no better than the traditional balanced investment portfolio.

Given the turbulence of the past twelve months, what do we do and how do we reset our investment portfolios in the context of the current economic environment? Since 1929, there have been thirteen recessionary periods and the mean and median durations were 13 months and 10 months, respectively. According to the government arbiters of the business cycle, the current recession began in December of 2007, so we are already a full 12 months into this one. But we are most definitely not in a typical recession and if we look at two of the worst ones on record, the mid-1970s and early 1980s, they both lasted 16 months. I tend to think, notwithstanding the aggressive interventions of the central bankers, this recession will exceed those in both duration and magnitude of economic decline. We have a heck of a lot of deleveraging and asset quality problems, including consumer loans and credit card debt, to work through yet. Even assuming this one lasts another 12+ months (the Great Depression was 43 months), we should be seeing improvement in the second half of 2009 as the financial markets anticipate the recovery by 6-9 months.

Robert Shiller, of *Irrational Exuberance* fame, who correctly called the tech and the housing bubbles has done some interesting work on stock market valuation using trailing 10 year earnings going back to the 1870s (yes, that is 1870s, not a typo). Updating his work with some estimates for December of 2008 results in a current price/earnings ratio of roughly 15 times earnings. The average and median 10 year

price/earnings multiples have been approximately 19 times earnings over the past 50 years and 16 times going back to the earliest data. We have to revisit early 1990 to find another price/earnings multiple with a 15 times handle according to Shiller's data, suggesting that there is considerable value for investors willing to look across the volatility of the next 12 months. Given the nearly 40% decline in stock prices in 2008, the valuation of the market has been reset to fairly attractive levels for long term investors. We've been bouncing around the past three months trying to put in a bottom in stock prices around the 800-920 level for the S&P 500 Index and notwithstanding the risk of another economic or political shock, now is the time to consider reconstructing your portfolio.

Markets are not driven by economic and fundamental factors alone. Rather, they act as emotional barometers of investor confidence and it should be noted that there is a much anticipated enthusiasm for the Obama presidency. Smart, aggressive policy action on a number of fronts early in the Obama presidency could help turn investor confidence more constructive, rally the markets, and firm up this bottom range in stock prices. However, we should brace for a lot more negative news flow for much of next year and the challenge for the financial markets will be to look past the further deterioration in the economic indicators.

In client portfolios, I am still pretty defensive. Our bond portfolios have been almost exclusively short term treasuries over the past few years, but I am now purchasing short term, high quality corporate notes which offer record spreads above treasury yields. Despite the purchase of selected high quality corporate notes, treasury securities will remain the dominant portion of our bond portfolios over the next year.

In our stock portfolios, strong exposure to consumer staples will remain the anchor to our holdings and our focus will be on companies with relatively low debt, good cash flow and consistent dividend growth. With every sector of the market knocked down over the past twelve months, our preference will be on the relative leaders most likely to participate in the economic recovery. In light of Obama's widely expected infrastructure and alternative energy emphasis, we will target companies that are the likely beneficiaries of those government objectives. Real estate and other financials have clearly reached valuations levels attractive to long term investors and selective investments in these areas seem appropriate.

We still live in a global world and while I expect the U.S. economy and markets will recover first, overseas investments, both developed and emerging market, will offer good long term potential. In sum, building high quality, well diversified portfolios of stocks and bonds is the goal and yes, there will be further pain and volatility. However, markets and people are resilient. The global business cycle will turn up and economic growth will resume. Investors will be rewarded as the recovery gains traction over the next 12-24 months and the financial system, along with investor behavior, will be reset to more sustainable, realistic, and appropriate levels.

Jeffrey