A Limited Liability Company

First Quarter 2009 Review & Commentary

Overview

If you will recall, the Review & Commentary for third quarter of 2008 was delayed and expanded in order to cover the *profoundly negative* results of October, instead of ending in September as would traditionally be the case. This quarterly report will follow the same format, although this time it is for the much more pleasant reason that April was a *profoundly positive* month and including it provides a more accurate picture.

Equities (Stocks)

Domestically, Large Cap US stocks lost just over 9.8% for the first quarter, but bounced right back with a 9.8% return in April. Riskier equity asset classes had even more dramatic snap backs with the average Mid Cap fund losing 8.2% for the quarter, but gaining 13.5% in April and the average Small Cap fund losing 12.6% for the first quarter, but gaining 15.9% in April.

The same rebounding theme carries overseas as well. International funds had an average loss of 12.7% for the quarter, but gained back 11.4% in April. Emerging Market funds actually had a very good first quarter relatively, losing just 1.8%, but still participated in the April rally by gaining 16.2% for the month.

Gold Oriented funds lost 7.2% in the first quarter, but gained 10.7% in April. Real Estate funds exhibited the most extraordinary round trip by losing 29.7% for the first quarter, but gaining 30% in April.

Fixed Income (Bonds)

In comparison to the volatility in the equity markets, bond markets were downright boring. Long–Term Bond funds lost 0.7% for the quarter, but gained 2.6% in April. High Yield funds did quite well in the first quarter, gaining 3.6% and an additional 9.1% in April.

First Quarter 2009 Commentary

The seeds of opportunity grow in the soil of despair.

What Was That?

If you usually skip the review section on the first page, I would suggest that you take a moment to go back and read it. It is truly nothing short of extraordinary. The April monthly returns for many of the asset classes would make for very happy years or incredibly rare quarters. For those returns to be contained in a single month is truly astounding. What is even more incredible is that April returns don't even tell the whole story. The story really begins on March 9th, when the S&P 500 closed at 677, a level not seen since September of 1996. By April 30th the index had recovered to 873, up 29%. By May 8th it was at 929 or up 37%. All of this in 61 days. Remember as well that, as the previous page pointed out, US Large Cap stocks, which the S&P 500 represents, weren't even close to the best performing asset class during this period.

Let's contrast all of this with the period of September 19, 2008 through November 18, 2008 also a period of 61 days. During this period the S&P 500 went from 1255 to 859 or a decline of about 32%.

So here we have two moves of roughly the same magnitude* over the same time frame. As you may recall from reading prior commentaries, short-term performance isn't something I much care about. That hasn't changed and I'll expound on that a little later. There are, however, some lessons to be learned, or at least reinforced, from this exercise.

In the last couple of commentaries I focused on (picked on according to some) the media and how they tend to overemphasize the negative and get the bigger picture completely wrong. I would continue that theme by saying it was very difficult in the beginning of March to find anyone in the media who was brave enough to say things were going to improve. When the gains did occur, they certainly didn't receive anything approaching the media attention that the losses did.

As much as it pains me to say it, it isn't all the media's fault. It's how our brains are hardwired. The nice folks who do behavioral finance research tell us that we feel twice as much pain per unit of loss as we feel pleasure for the same unit of gain. They may never get as good a real life laboratory as the two 61-day time periods noted above.

**Mathematically the loss and gain of the same nominal percentage do not result in the same absolute loss and gain. In other words if you start with $100 and lose 50%, you have $50 left. If you then gain 50% on your remaining $50 you then have $75. In the real example shown above, the 32% loss on $100 would have resulted in a remaining $68 and the subsequent 37% would have resulted in $93 being left. Not a complete comeback, but pretty close.*

Please, Don't Be Too Frank

Obsessing over short-term results is a short cut to the grave by way of the asylum. Time reduces perceived volatility and increases certainty.

To put this in more real (and fun) terms, let's create two characters, Calm Carl and Flustered Frank. Calm Carl enjoys his leisure time immensely, doesn't watch the news or read newspapers and glances at his portfolio once very six months. Flustered Frank has no hobbies and watches CNBC excessively (he especially loves Suze Orman) and checks his portfolio multiple times a day, often while wringing his hands. Let's further assume for the sake of simplicity that they both invest only in the S&P 500.

Now let's say that on May 8th (the end date from our above two period comparison) Calm Carl realizes it's been six months since he checked his portfolio, so he takes a look at it. He notes that his portfolio has been almost perfectly flat since he last checked in on November 8th (actually down 0.2%, but he doesn't sweat that) so he goes back about his business playing bridge or whatever it is he does with all of that leisure time.

Flustered Frank on the other hand has had a terrible time during this six-month period. After all, he's had to suffer through the market plunging 28% during this period only to modestly enjoy a subsequent 37% gain. His hands are raw from all of the wringing. His cardiologist is very unhappy with him. All of this angst was in spite of the fact that from November 8th through May 8th he had the same overall performance as Calm Carl of a virtually flat -0.2%.

This is a bit of an unusual example given the level of volatility in such a short period, but it is representative in form if not degree. The same ideas of lower volatility and greater predictability hold truer over much longer time periods. Short-term, myopic investing can be hazardous to your health and wealth.

"How I Learned to Stop Worrying about the Economy and Love the Stock Market"

At the other end of the time horizon perspective is a recent paper by Ben Inker of GMO wonderfully titled "*Valuing Equities in an Economic Crisis or How I Learned to Stop Worrying about the Economy and Love the Stock Market*." The paper expands on the most basic principle of finance which is that the value of stocks (or any asset) is the value today of money that is expected to be received from the asset in the future. This number is modified to take into account the fact that we'd rather have money now than later. He goes on to examine exactly how those future payments are reflected in the current price. More specifically, what is the relative importance of payments received sooner rather than later?

In examining the case of stocks, he looks at dividends and the growth of those dividends over time. The objective is to determine which time periods most affect the price of stocks. He concluded that 25% of a stock's value is a result of dividends expected in the next 11 years, 25% is attributable to dividends in years 11-25, another 25% is due to years 25 through 50 with the last 25% of a stock's value being attributed to dividends more than 50 years out. This is a pretty profound revelation in a culture where people check stock prices multiple times per day and obsess over weekly economic data.

The conclusion of all of this is that 75% of a stock's value is a function of the dividends that are more than 10 years into the future. What's more is that since 1871, dividends and dividend growth have remained surprisingly stable. Even more consistent has been the growth of the economy as measured by Gross Domestic Product since 1889. In other words, the value of stocks remains quite stable; it's the price that is volatile.

The ultimate purpose of this analysis is to try to give us some sense of what stocks are really worth. Given the nearly 150 years of data and the fact that actual intrinsic value of stocks appears so stable over time, we are left with the question of what causes the sometimes dramatic short-term volatility of stock prices. The answer would seem to be the emotions of market participants based on ultimately unimportant short-term economic events. As the author of the study noted, "it is the myopia of investors that causes market prices to vary so wildly." Maybe Calm Carl's twice yearly portfolio check is even much too frequent.

Death by Cash

Our story of Calm Carl and Flustered Frank left out what, for the Franks of the world, is a very common end to the story, one in which Frank (after his closely monitored 27% loss) simply can't take it anymore, sells everything and decides the life of cash is for him. No more of this market up and down mumbo jumbo. The world of risk is for others. The world of 1% CD rates is for him.

Comforting as the siren song of cash seemed to Frank, it will end badly for him for at least a few reasons. Firstly, at current returns on cash (CDs, money market funds, treasury bills, etc.) it would take Frank well over 25 years to realize the 37% gain that Carl enjoyed in just a few weeks. There is also the possibility, or likelihood, that Frank would then jump back into the market again after it had gone back up again. In short, Frank would have sold low and bought high, or at least higher.

As mentioned in last quarter's commentary, the biggest problem currently with cash is that it practically guarantees losses through the erosion of spending power.

At a long-term inflation rate of 3%, you lose 2% annually in spending power. It's as real a loss as any other; you just never receive a statement for it.

Cash can be very useful as part of a portfolio, but not as an entire portfolio. Massive moves to cash when it feels best can be the financial equivalent of suicide; a long-term solution to a short-term problem.

Deafening Silence

The question everyone seems to ask these days is "have we hit the bottom?" I don't know, and I think it's not the right question. As I've noted before, they don't ring bells at market bottoms and tops, so that sound you don't hear is the bell not being rung. A much more useful question is "am I able to buy assets at valuations that are lower than their long-term value?" By the analysis of the paper cited above and others, equities are at least fairly valued and probably undervalued and so the answer would certainly seem to be yes.

At these levels there isn't much long-term risk. In the shorter term, irrationality could certainly make one last decisive stand and pull equity values to new lows. Should this scenario play out, I would suspect it would be quick, both in coming and going. Calm Carl will be just fine with it, but it may well do in Flustered Frank.

Sour*ces:*

Indices cited above are as reported in The Wall Street Journal, both print and online, April 3 and May 3, 2009. Fund averages cited are the respective Lipper Mutual Fund Indices.

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