



January 4, 2009

It's been three months since the Lehman Brothers bankruptcy panicked the stock and bond markets. On October 10th, the British government announced that it would directly invest in its teetering financial institutions. The United States eventually followed suit. Since then, the market has been extremely volatile, but it seems to be finding its footing. Since late November, the S&P 500 is up more than 20%. Technically speaking, this is the beginning of a new bull market.

Although it may seem like all stocks suffered equally, there is a clear divide in the market. Companies with the highest degree of predictability have held up much better than those with greater uncertainty. This has been the case across all asset classes. Treasury bonds have substantially outperformed high quality corporate bonds. Stocks with stable earnings and low debt have outperformed companies that achieved more rapid earnings growth.

During a panic, the need for certainty overwhelms any desire for risk taking. Consequently, interest rates on government securities today are as low as they have been since the creation of the Federal Reserve. The "safest" investments are as expensive as they have ever been, while less predictable investments are extraordinarily cheap.

In a normal market environment, investors benefit from owning a diversified portfolio. Typical investment distinctions like large stocks vs. small stocks or growth stocks vs. value stocks, and even international vs. U.S. stocks are not particularly relevant today. The most relevant distinction today is certainty vs. uncertainty.

As the panic subsides, less predictable investments will outperform more predictable investments. Since the peak of the bond market crisis in early October, the safest stocks and bonds have barely budged while most of the gains have occurred in the less predictable investments. Corporate bonds are gaining while government bonds decline; many volatile stocks are up 100% while the stocks that suffered the least during 2008 are flat or even down.

This is evidence that we are in the early stages of a new bull market. Once the investment climate stops getting worse, the traditional market behavior is to look towards the future recovery. Unfortunately we won't know for another twelve to eighteen months whether this is a temporary reprieve or the dawn of a new bull market. The longest post WWII recessions in 1972-73 and 1981-82 lasted 16 months. The current recession started in December of 2007. Fourteen months is very mature by historic standards.

For now, we are maintaining what institutional portfolio managers describe as a "barbell" portfolio. Predictability is hard to define, but it can be measured in a number of different

ways. In general when the market is down, these companies should be down less than the market. Companies in economic sectors like health care, and utilities tend to be less volatile than the overall market. Also, large, low-leverage, dividend paying companies will tend to hold up better during bear markets. Roughly two-thirds of the stocks in our client portfolios are more “predictable” than the average stock. Our concentration in these kinds of stocks allowed us to modestly outperform the market last year.

A smaller portion of the portfolio is invested in companies that will outperform over the course of an economic recovery. You can easily recognize the companies in this category as they generally went down more than the S&P 500 last year, but have rallied substantially in the last three months. As the economic recovery continues to assert itself we will likely increase the portfolio’s weighting in these companies. These stocks will likely double or triple the market’s return in the first 12 months of the next bull market.

Perhaps the most perplexing aspect of investing is that the best performance years have often occurred during the worst economic environments. The Dow Jones went up 67% in 1933 and 38% in 1935. Stocks are priced as if investors expect a depression. They seem to discount the impact of unprecedented government spending and interest rate cuts. Evidence that these actions are having a positive effect on the economy is elusive, but fiscal and monetary actions take a while to show up in the numbers. Eventually, the impact will be substantial.

Businesses rapidly depleted inventories during the last quarter of 2008. If consumer demand holds up better than the current worst case scenarios, we could see an explosive turn around in the economy. It certainly won’t take much to surprise investors on the upside as expectations are as pessimistic as I have ever seen.

Most likely, the economy will stay weak for a while. The new consensus is three more quarters of negative growth and unemployment pushing 8% from 6.5% today. Sentiment and valuations seem to be discounting a much worse slowdown than that.

These are terrifying times, but I’m very hopeful that we have survived the most traumatic phase of the economic cycle. Thank you for your continued confidence. I look forward to writing the letter that warns investors that the recent great performance we’ve experienced is not sustainable.

A handwritten signature in black ink, appearing to read "Eric Barden". The signature is fluid and cursive, with a long horizontal stroke at the end.

Eric Barden, CFA
Chief Investment Strategist