April 9, 2009

2009 First Quarter Review

After a historic decline in 2008, the investment markets took another tumble for more than the first two months of the first quarter. After declining almost 40% last year, major indexes declined a further 25% to hit a 12 year low for the markets on March 9^{th}. On that day the Dow Jones Industrials visited 6550, and the S&P 500 touched 676. That represented a stunning 54% drop for the Dow and a 57% drop for the S&P 500 during just the previous 18 months. Many investors did not survive, even those who had no money with Bernie Madoff.

March 9th, however, has turned out to be the low-point for the quarter, and perhaps for longer. By the time that the gloom was the thickest, the opportunities may have been the greatest, with stocks staging, in recent weeks, one the sharpest rallies since the Great Depression. This was an example of one of those "head snapping rallies" that I mentioned in past quarterly letters that we should expect. The law of negative compounding still holds, however. If you lose 25%, then gain 25%, you are still down. That's why these sharp rallies still left the indices lower for the quarter with the Dow Jones down 13% and the S&P 500 down 12%. Financial stocks sank for the quarter, as did real estate-related companies, but precious metal and technology stocks began a good rebound. As the stimulus measures of the government have taken effect, short-term credit markets have unfrozen. U.S. Government and corporate bonds, as well as many municipal bonds, have rallied while interest rates on short-term investments like money market funds have fallen to near-negligible levels.

It has been the effort to avoid the "negative compounding effect" that has left us in relatively good shape with significant cash reserves to make investments. With perfect hindsight, we should have gone fully invested in stocks on March 9^{th}. However, the practicalities are that a perfectionist does not usually make a good investor and the desire to be "all in" at the bottom often makes for repeated losses, especially in a bear market. Just ask all the investors who bought "the bottom" for the last year and a half.

"The Crash and Burn of Buy and Hold"

I mentioned last quarter that we had done relatively well by being flexible and reacting defensively as the economic situation worsened. We sold off investments and lowered exposure as the severity of the economic problems became apparent. Many investors, however, followed Wall Street's "buy and hold" mantra, which worked well for many years, but which has now produced zero returns for the past 10 years, and disastrous returns more recently. This bear market has been called "the crash and burn of buy and hold" as many investors may never recoup the losses that they suffered by simply holding investments as they plummeted. Imposing some discipline in limiting losses has proven to be an essential ingredient of recent investment survival. Keeping a good amount of dry powder has also put us in the position to avoid the trauma of debilitating losses. Now that we have weathered this part of the storm, we are still faced with difficult decisions. What do we do now? Short-term interest rates no longer provide much in the way of income. This is the environment that I pointed to several quarters ago as a possibility. Investors have now to choose between being safe and getting very little return, or trying for more return and accepting more risk.

"Dazed and Confused"

I have been managing investments for over 30 years and I have never seen a more difficult investment climate, or more divergence in investors' attitudes. Most investors are like the old Led Zeppelin song, "dazed and confused." Even among those who have done well, some are still traumatized by all the bad news and are willing to take only very limited risks. Some have sustained some losses, but are still eager to take advantage of the opportunities for profit on any recovery. This divergence in attitudes toward risk makes for some difficulty in shaping each portfolio to reflect the needs and desires of each person. But risk comes in several flavors. The risk of outright loss is the one most investors are focusing on now. However, anyone who was an investor through the 1970's knows that inflation is a risk as well, with its erosion of purchasing power. With money market yields and CD rates dropping, investors are having to work harder to generate an acceptable level of income. That cannot be done without some increase in risk. Risk, like many other things, exists on a spectrum. Venturing to take a little more does not mean becoming reckless. We don't need to go to any extremes, partly because so many opportunities exist farther down the scale. The trouble is that we must be willing to peek out of the bomb shelter and take a step outside. I always like to move incrementally in volatile markets because the possibility of bad timing is higher, but we need to be able to envision the scenario where things improve and be willing to take some steps to profit from that.

It is the wrong question to ask investors what they are "comfortable" with. We are all comfortable when a market has been rising for a while and appears to be moving ever higher. The real question is what risk level are you willing to tolerate. That is the important question, because investing when the gloom is thick is often better than doing so when optimism is rampant, although most are more "comfortable" with the latter.

Regarding the bailouts, there are huge amounts of money at stake. Government seems intent on erring on the side of overreaction versus inaction. Unintended consequences are inevitable, but unknowable. There will be headwinds for investments and continued volatility. These also present opportunities, but only if we have the courage as well as the cash to take advantage. Common sense dictates that appropriate steps include above-average cash positions, smaller-than usual investment positions, and opportunistic strategies to take advantage of short-term volatility while building longer-term holdings.

Many would say that we are "in the catbird seat." We've done a pretty good job of preserving capital in the downturn, and I believe we can do a good job of taking advantage of the opportunities created by the gloom. What I would like to ask you to do is take stock of your financial and emotional situation. Consider the possibilities for profit from a recovery and the fact that our portfolio discipline is designed to limit losses on investments that don't perform well. Then, please give me a call at your earliest convenience so that we can confer on the strategy that fits your current situation.

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Sincerely,

Claude Carmichael CFA