January 7, 2009

2008 Year End Review

When I thought of how I might characterize the investment climate of 2008, I could only think of a variation of the old Johnny Carson set-up line, “How bad was it?” (Picture Rodney Dangerfield grabbing his tie and saying “My 401-K is now a 201-K……No, seriously folks…) As has often been mentioned recently, it was the worst year since the Great Depression. For the Dow Jones Industrials it was the worst year since 1931 (down 34%). For the S&P 500 it was the worst year since 1937 (down 37.5%), and for the Nasdaq composite it was the worst year since its inception in 1971 (down 40.5%). Just in case you might think investing overseas might have been a better idea, consider these: China down 65%, Russia down 67%, Brazil down 41%, India down 52%, Japan down 42%. Commodities ramped up during the first half of the year, then plummeted in the second half, led by a stunning $100 per barrel drop in the price of oil. That is the largest drop on record, ever. The Commodity Research Board Index representing a wide range of industrial and agricultural commodities fell 35%. Municipal bonds and corporate bonds fell. Investors in mortgage derivatives and in many Wall Street institutions were wiped out. Virtually every asset class dropped and there was pretty much nowhere to hide. The few places of safety were treasury bonds, certificates of deposit and the money market funds that didn’t “break the buck.” Fortunately for us, we had a good portion of our assets in these instruments and have survived to invest another day.

It was a difficult enough year for investors. Then came Bernie Madoff. In last quarter’s letter, we addressed the safety of our cash reserves as fear of money market problems arose. At the end of the year, we need to address the fear of being “Madoffed.” Bernie Madoff is alleged to have bilked investors out of as much as $50 Billion in a classic “Ponzi” scheme. Charles Ponzi created a fund in 1920 to take advantage of differences in various international postal rates. He proved more adept at getting money from investors than from investments. He started claiming outsized profits and paying off older investors with newer ones’ money. Madoff seems to have done the same thing. However, he was able to hide it for so long because he not only “managed” the investments, his firm *held* all the assets, *executed* all the transactions, and was audited by a CPA who had *only one client*, Bernie Madoff. You, on the other hand, have a manager watching your broker (e.g. Schwab), the broker watching your manager, and statements from both for you to compare. We think it makes good sense to follow Ronald Reagan’s Cold War advice to “Trust, but verify.” Unfortunately for Madoff’s investors, they didn’t.

Last quarter we described the tug of war between deflation and inflation, and promised more on that later. Decades of increasing leverage and financial complexity is now being reversed in what some people call “The Great Unwind.” That will involve tighter credit, de-leveraging, debt repudiation (default and bankruptcy) and retrenchment in spending. All of these are deflationary forces that tend to reduce the amount of money in circulation in the economy and to push prices down. Once the crisis became obvious, the U.S. government sprang into action with a series of bail-out plans that boggle the mind. No politician or bureaucrat wants to be called the new “Herbert Hoover” or to repeat the mistakes of the Japanese in their “lost decade” of the 1990’s after their “Japanese Miracle” economic bubble burst. The government’s massive bail-out plans involve borrowing still more in order to spend our way out of our problems by stimulating demand and creating the money to be spent. Initially, the deflationary forces are more powerful as credit tightens and spending slows. It is more than likely that the government will want to err on the side of creating too much liquidity (money) rather than too little. Inflation, though not a problem right now, may be a very big one at the point that we begin to emerge from this mess. Just as we anticipated the possibility of some of our recent problems, and protected ourselves accordingly, we can anticipate a future phase of the Grand Recession and perhaps benefit from that as well.

Most investors are traumatized by the news and happy to be out of harms way to the extent that they have held cash. But the greatest opportunities come from times like these and I wouldn't be doing my job if I let fear (yours or mine) paralyze us in the process. People will only feel *comfortable* investing again after the market has recovered, i.e. gone back up. Unfortunately, I have found that the comfortable investment can be the most dangerous one, when everything looks great. The best investments are made when things don't look good, because the storm eventually passes, the gloom lifts, and those bargains disappear in the sunshine. I used to say that the market swings between fear and greed. Now I realize that greed is another kind of fear, the fear of being left behind in a market advance. That is why you will see such dramatic rallies in declining markets. People are then fearful of missing the profits that are to be made. I have never preached the "stay the course" mantra that echoes from institutions on Wall Street. Staying the course crushed investors after the 2000 tech bubble and again in the 2008 "Great Unwind." Flexibility is important, if not essential, in investing. We have to remember that the economy will pull out of this eventually and we need to be prepared to position ourselves to benefit. You need at least three c's to be a good investor; cash, caution, and courage. We have quite a bit of cash. We have been employing caution by staying defensive. If we now add a little courage we can profit from the opportunities created in disaster.

We don't know if the markets will recover quickly or take a long time. Therefore, the new investments we are taking emphasize high dividend and income yields so that we get paid while we wait. Money market rates are dropping and alternative yields have risen, providing some opportunities we will want to take advantage of in increments.

2009 may bring a few developments that we might do well to consider. At the beginning of each year, the eminent market strategist Byron Wien publishes a list of possible surprises that he thinks might catch investors off guard during the coming 12 months. This year's list includes a target of 1,200 in both the S&P 500 and an ounce of gold (up 32% and 42% respectively), a dollar slide and Treasury interest rate climb, recoveries in China and the housing markets sooner than anticipated, trouble for municipalities, and a recovery in retail for a record Christmas of 2009. These may not happen, but if we consider the possibilities and remain flexible we will be in a better position to profit from whatever surprises that 2009 is sure to bring.

Enclosed you will find your quarterly statements and year-end performance and tax reports. Please review them at your convenience and give me a call with any questions, comments, or suggestions you might have. And thank you again for the opportunity to work together.

Sincerely,

Claude Carmichael CFA