



FIRST WESTERN



*You're out of the woods.
You're out of the dark.
You're out of the night.
Step into the sun, step into the light.*

“OPTIMISTIC VOICES”

THE WIZARD OF OZ

LYRICS BY ETT HARBURG AND MUSIC BY HAROLD ARLEN

“It's the End of the World as We Know It (and I Feel Fine)”

R.E.M.

After a long, tough fall and winter (at least in the financial markets), spring is finally here. Baseball is in full swing and steroid-free, I hope. Tiger is back after recovering from knee surgery, and golf is so much more exciting with him in the mix, as evidenced by the Masters Tournament in April. Although he and Phil Mickelson came up short and faltered after mounting pretty good charges, it made for great theater.

Our new president has now been in office for awhile, and his administration is generally perceived as being off to a strong start. Despite some early missteps with nominees who couldn't get their taxes right (sometimes I wonder if that says more about our complex, convoluted tax code than about those individuals, but that's another story) and a Treasury secretary who initially looked like a frightened high school teacher in his first day of class in front of unruly freshmen (not a bad analogy, except that the average high school freshman is probably better prepared and behaved than the average U.S. Congressman), the president is getting pretty good marks and continuing to engender confidence.

After continuing horrible performance in the equities markets in January and February, where we've seen equity values essentially cut in half over the last 12 months, the U.S. equity market has bounced strongly, and the S&P 500 is up about 36% since its bottom on March 9. The question is still whether “it's the end of the world (as we know it)” or “[we're] out of the woods.”

Although much has been written about our current economic situation being caused by a “housing” or “subprime lending” crisis, I think the cause is much more basic than that. Throughout economic history, there have been “credit bubbles,” and what we saw come to a head last fall was an old-fashioned credit bubble. In the United States, this was evidenced on the corporate side by financial institutions like Lehman Brothers leveraging their balance sheets 40 to 1, and on the personal side by individuals generally having a negative savings rate. This leverage and availability of loose credit led to increasing asset values (which initially played out primarily in the housing market), which made borrowers feel good about the amount of debt they were taking on, which led to continuing increased asset values and increased debt until we hit a tipping point, which happened in the fall.

There are three things that do appear to be different about this credit bubble. First, we saw a disconnect between the originators of credit and the ultimate owners of the credit. In retrospect, it's not surprising to see underwriting standards get sloppy, when the institution underwriting the credit knows it's not going to own that credit long, if at all. Second, the use of derivatives has never been as widespread during a credit bubble as we saw in the current environment. Derivatives, which are a big and complex topic unto themselves, are not bad per se, but the use of these sometimes very complex instruments



makes it extremely difficult to understand who really owns the economics and risk of a transaction. In an environment where things are going south quickly, this uncertainty makes lenders very reluctant to extend credit to anyone but the safest borrowers (as we saw in the fall, the “safest borrower” was deemed to be the U.S. government almost exclusively) which further exacerbates an already deteriorating situation. Finally, if anyone had any lingering doubts that the financial (especially the credit) markets are interconnected on a global basis, the events of last fall should dispel those doubts.

The bursting of the credit bubble in the fall coupled with these three conditions did make the financial markets feel like it was the end of the world as we know it (and we didn’t feel fine). Credit markets were completely gridlocked initially from fear, which became panic as providers of credit couldn’t ascertain which users of credit could be trusted to pay money back. This proved to be especially problematic for financial institutions, such as investment banks, insurance companies, monoline specialty finance companies and major money center banks, who are both users and suppliers of credit. (At their core, most of these institutions make their money by arbitraging the difference between the cost of capital they receive and the cost they charge or hope to earn). Money rushed away from these institutions to the perceived safest haven of U.S. Treasuries, which at one point were actually producing a negative yield!

This panic led to the failure of “banks,” such as IndyMac, which had essentially transformed itself into a monoline specialty finance company by betting its franchise in the pursuit of increased profits by financing subprime mortgages and investment banks, like Lehman Brothers, whose overleveraged balance sheet could no longer be supported as credit dried up. Other organizations, such as Bear Stearns, Merrill Lynch and Washington Mutual, were fire sold, often at the direction of the U.S. government. Finally, most probably after seeing the fallout of Lehman’s failure on the financial markets, the Bush administration created a class of financial institutions whose failure was deemed to be a systemic risk to the financial markets and who needed to be bailed out by the federal government. Put more succinctly, these institutions were “too big to fail.” Notable among these institutions were Citigroup, Bank of America, Morgan Stanley, Goldman Sachs and the mother of all bailouts, AIG.

This was not solely a U.S. condition, either (despite attempts by German and French politicians to characterize it as such), and we saw financial institutions all around the globe suffering similar distress. We even found out that the tiny country of Iceland was running its treasury like an overleveraged hedge fund. Who would have thought?

Meanwhile, back in the “real” economy, we were probably headed for a garden-variety economic recession without this massive credit crisis. We had been several years into an economic expansion cycle and, put simply, nothing goes straight up. Real economic expansion has to be fueled by productivity, and productivity sometimes needs to take a breather. Business organizations, which are simply people organized around a business mission, get tired. People who are doing well often will trade money for time. When businesses are very profitable, it’s easier to make less-profitable decisions on that last marginal dollar. Most economists and other prognosticators (I guess I’m included) were, therefore, calling for a reasonably mild recession (not too deep or long).

Once the credit bust happened, however, all bets were off, as credit dried up for companies in the “real” economy. Consumers (remember, we’re a consumer-led economy with about 70% of GDP consumer-related) became very scared as they watched the value of their houses fall, their 401(k)s cut in half and their jobs put at risk. Even those people who weren’t worried about losing their jobs



began to worry that their earning power was going to be diminished by reduced or foregone raises, or even salary cuts. Add all this to the notion that the “average” consumer was overleveraged, and we saw consumer spending fall off a cliff, especially in the area of bigger-ticket items, like car purchases (which are generally credit-dependent).

Interestingly, we saw consumer savings rates move back into positive territory, which at reasonable levels, should be and are a positive for a long-term healthy economy. Unfortunately, in the short-term, this leads to something economists call the “paradox of thrift,” in which all these millions of prudent individual decisions of saving for a rainy day cause the economy to slow even more in the short-term and cause even more short-term pains as less money flows through the economy.

We then saw our garden-variety recession turn into something much more significant, with GDP falling very sharply in the final quarter of 2008 and the first quarter of 2009. Unemployment has accelerated, and may hit 10% or slightly higher by the time we’re done. Corporate and high-yield bond markets began trading at incredibly high spreads, and the equity markets halved. Commentators started comparing the current environment to the Great Depression and the market crash of 1929. Every time you picked up the paper or turned on the TV, the economic and financial news was grim. If you had a dollar for every time some financial commentator used the word “unprecedented,” your stock portfolio might actually be back to even. The financial world did, indeed, feel like it was at the end.

Across the financial services industry, people heard talk of investors throwing in the towel and going all to cash. Portfolio managers questioned the wisdom of their strategic asset allocation (indeed, does asset allocation itself work?) and there was plenty of talk as to whether investors should be invested in equities at all. Interestingly, but not surprisingly, when this talk seemed to be at its loudest, the equity market started to go up.

So what gives, are we out of the woods and into the light? Are our economic problems over, and can we breathe easily? The bad news is that I don’t think so. The good news, however, is that it isn’t the end of the world (as we know it), and this simple fact seems to be driving the equity market.

As investors, we need to remember that financial markets, especially equity markets, are anticipatory mechanisms and, as I’ve written before, in the short-term, markets react to “perception of speed of rate of change at the margin.” Put more simply, if things are bad and we think things are getting less bad, markets go up. Conversely, when things are good, but the perception is that things are going to get slightly less good, financial markets go down.

In the beginning of March, the markets began to recognize two things. First, the financial world wasn’t ending; and second, maybe our economic and financial situation wasn’t as “unprecedented” as previously thought. As to the world not ending, a few things have happened. First and foremost, it hasn’t ended. We’ve had several months since the credit crisis in the fall, and financial markets are still functioning. Although this sounds trite now, there were times last fall that this wasn’t a given. Credit markets may not be fully back to “normal” (whatever that means), but credit markets are functioning. The future and actual ownership of some major financial institutions (in the U.S., most notably Citigroup, Bank of America and AIG) may still be in play, but others, like Goldman Sachs and Morgan Stanley, seem to be coming out of the tunnel, and Goldman is even talking about paying back the bailout money. The government, through both the Treasury department and the Federal Reserve, has demonstrated that it is committed to providing and maintaining liquidity to the financial system, and protecting the markets, to the extent possible, from systemic risk.



Once you remove the risk of the credit markets, and the risk of major financial players in the credit markets collapsing, the economic situation doesn't look quite so "unprecedented." The U.S. has seen tough recessions before (most notably 1973-1974) and we've seen unemployment greater than 10% as recently as the early 1980s. (Note that I'm not even comparing the current environment to the economic environment of the early 1930s. While this comparison makes for interesting reading and may get headlines, I don't think the comparison is that helpful or meaningful. The U.S. economy today is much, much different than it was in the 1930s, as it is much larger, more diverse and richer. We also have the benefit of seeing how destructive tight monetary policies were back then, and can at least avoid that problem).

All of this doesn't mean that we're out of the woods and into the light; it just means that the world isn't ending and that financial markets have seen recessions before and have dealt with them. By itself, removing this from the marketplace probably caused the equity market to go up 25%. How the equity market responds from here in the short-term is anyone's guess. On the negative side, the economy has some continuing tough hurdles in the short-term. Consumers, who are again roughly 70% of the economy, are still not feeling too confident about the economy and their place in it. A 10% unemployment rate, not to mention all those people who are "underemployed" and who have taken substantial hits to their income, reminds all of us that unemployment is a possibility. Employment is also a lagging indicator, so we could see the technical recession end a year or two before employment starts to turn around. This level of unemployment will probably also be exacerbated by the problems in the U.S. auto industry, which are not simply recession-related, but primarily structural in nature.

In addition, I don't believe that housing as an asset class has hit a floor. Although we are seeing some very preliminary signs of potential strengthening in the housing market, and low mortgage rates definitely help, I continue to believe that housing has not hit a bottom, and we may see another 15% to 20% decline in housing prices. (Remember that this statistic is as an asset class and there will be wide dispersion in recoveries across the country).

Also continuing to be problematic is that nominal credit rates for corporate borrowers (both investment-grade and high-yield) remain very high on a relative basis to U.S. Treasuries, and spreads have not yet begun to contract significantly.

Finally, the Obama administration is going to need to overhaul the regulatory scheme governing the financial sector, and this is creating a great deal of uncertainty in the marketplace. How these new regulations play out and how they affect the marketplace remain to be seen.

On the positive side, we may start to see corporate earnings turn around faster than anticipated. Corporate earnings generally recover faster than the overall economy, and I think that because so many companies have been so aggressive about cutting employees and inventory (including some companies who have probably used the current environment as a "cover" to reduce headcount, where in a normal environment it would not have been palatable to do so), we could see some very strong earnings recovery with very modest revenue growth.

I don't think anyone has a good handle on the timing of how all this will play out, and in the short-term the market's going to move around based on its perception of how things are doing against what is then currently anticipated. My guess is that we're nine to 12 months away from the recession ending, but that's just a guess.



So What Does All This Mean for My Investments?

This has been the most difficult time for investing that I have seen in my 25-year career, and I hope that when I look back in another 25 years, that statement remains true. We have had a terrible 10-year period in the equity markets, and many investors are frightened, and appropriately so, as they have watched their net worths plummet. It is a natural tendency to become very defensive, not from any rational strategy or thought, but because the pressure and fear are too great.

We are where we are, however, and stating the obvious, we can't change the past. We can learn from it, though, and use it to plan for the future. So for what it's worth, this is what I think investors should be doing in this environment:

1) Ensure Your Liquidity

Make sure you have enough liquidity (essentially cash or the ability to get your hands immediately on cash) for two to three years. This is not an allocation toward cash or a strategic call that cash is going to provide decent returns, but having enough cash on hand means that you can stick to your allocation.

2) Prepare (or Redo) Your Financial Plan

This is an important time to know where you stand financially, and having a current budget and long-term plan helps remove some of the emotional knee-jerk reactions to the current environment. Many, if not most, individuals operate without a long-term financial plan, and understanding some realistic scenarios is especially important today.

3) Revisit Your Strategic Asset Allocation

All investors should have a strategic allocation of assets that is explicit, and if you don't have one, now is the time to work with an advisor to get one. If you are in this category, make sure you explicitly understand how your assets are allocated and what your potential return and risk parameters look like.

For investors who already have a strategic asset allocation plan in place, this is the time to revisit your strategic allocation to make sure it still fits with your goals and objectives. This doesn't necessarily mean changing your strategy (in fact, if it was well-constructed initially and your circumstances have not changed, it should not change). A good asset allocation strategy should fit with your short-, medium- and long-term financial needs, not just one of those three time periods.

4) Rebalance to Your Strategic Asset Allocation

With the recent sharp moves downward in the equity market, it is easy for an investment allocation to get out of balance and be underweight in equities. This can result in significant underperformance when equities start to recover. This recovery can be as drastic to the upside as to the downside (as we recently saw in the 25% upside move in March), and investors who fail to rebalance run the risk of significantly underperforming in a recovery. This is especially difficult to do because it essentially means buying more of an asset class that has gone down in the short-term (and often selling something that has gone up). This discipline may be the single greatest factor leading to good long-term performance.



5) *Don't Lose Faith in Equities*

During the period 1926–2008, the average annual return in the stock market was 9.6%. This even encompasses the crash of 1929, when the market was down 8% in 1929, 25% in 1930, 43% in 1931 and 8% in 1932 (it was up 54% in 1933, just as everyone was despairing of it ever going up again). Although we have just experienced a horrific period (and we may not be done), reversion to the mean is the most powerful force in investing, and there are no credible arguments that long-term equity returns have changed permanently and irreparably.

6) *Do Take Advantage of Market Irrationality (or: Don't Succumb to It)*

We have just experienced maybe the largest popping of a credit bubble in the history of financial markets (not unprecedented, but huge in scope). This has caused the fixed-income markets to go from providing very little value for taking on extra risk to providing great value for taking on some additional risk. This must be done prudently and cautiously, but we find ourselves at a time when certain fixed-income instruments may be historically cheap.

7) *Pay Attention to Counter-Party Risk*

This is a fancy way to say that times of stress expose weaknesses in the various suppliers of financial services (or to paraphrase Warren Buffet, “You don't know who's swimming naked until the tide goes out”). It is especially important in this environment to know who is advising you on your money, who is the transacting brokerage for you and who is custodial and safekeeping your assets.

“These are the times that try men's souls.”

THOMAS PAINE

Economies (and ultimately markets) recover due to two basic ingredients: confidence and productivity. The United States, throughout its history and despite many stumbles, has always been, and I believe continues to be, the most productive and confident economy and country in the history of the world. The economic situation we find ourselves in, although difficult, is by no means unprecedented, and the economy will sort itself out. As investors, we need to remember that even before that happens, capital markets (which anticipate events) will rally, and investors need to be positioned to participate in the rally when it comes.

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