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A Special Report

January 15, 2009

2008: The Year Nothing Worked

Once again, as the calendar turns to a new year, we take the opportunity to reflect and review the past year, the economy, and the markets. 2008 was remarkable in *many* respects, but I suspect that for investors (and their advisors), the year will be remembered for decades as "*the year nothing worked*". Domestic equities recorded the third worst performance in history, with calendar year losses exceeded only in 1931 and 1937. Other than cash and Treasury bonds, virtually every asset class was decimated by the mother of all bear markets, with equity market declines compressed into a single year rivaling those seen in the two and a half year bear we suffered through in 2000 – 2002.

Here are the very, very ugly numbers:

Market Returns for 2008 (without dividends)

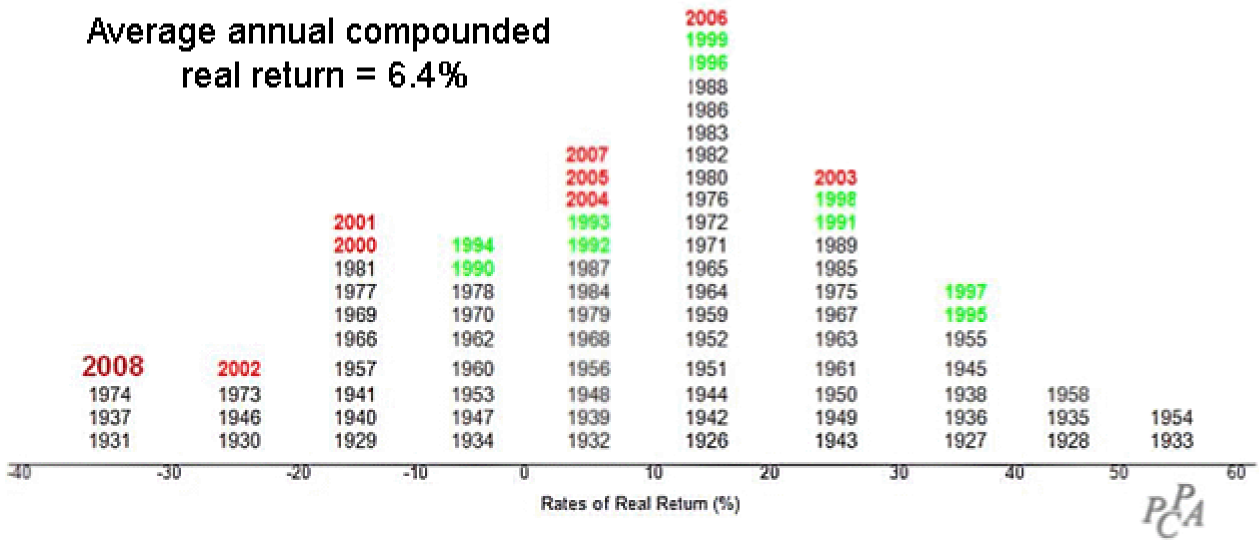
Index	Value 12/31/07	Value 12/31/08	Percentage Change
Dow Jones Industrial Average	13,264.82	8,776.39	(-33.84%)
Standard & Poors 500 Index	1,468.36	903.25	(-38.49%)
Russell 2000 Index	766.03	499.45	(-34.80%)
Nasdaq Composite Index	2,652.28	1,577.03	(-40.54%)
MSCI E.A.F.E. Index	2,253.36	1,237.42	(-45.09%)
MSCI Emerging Mkts. Equity Index	1,245.59	576.04	(-54.48%)
Barclays Aggregate Bond Index	Percentage Change As Reported		5.24%
NAREIT Index	3,394.71	2,127.27	(-37.34%)

Sources: Marketwatch.com, MSCI, Standard & Poors

The markets were cruel to say the least, with a bad year by any standards already booked by mid-September, only to be ravaged by another massive leg down in the fall, with about half the years' equity market losses occurring in October and November, finding (hopefully) a bottom on November 20th. Investors are shell-shocked, and many stopped opening their statements months ago.

This truly was one of the worst years on record for domestic stocks, even when going back eighty-three years. Adjusted for inflation, the S&P 500 has delivered an average 6.4% per year. Whether you are looking at nominal returns, or inflation-adjusted returns, last year's market loss was indeed a "black swan" event.

83 Year Inflation-Adjusted Return History of the S&P 500 Index (1926- 2008)



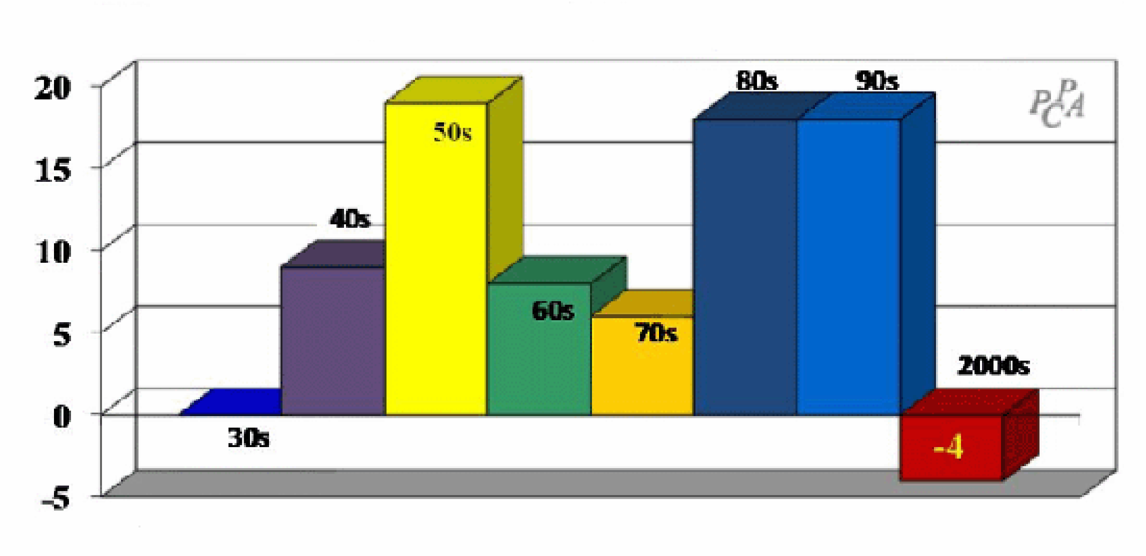
Source: PPCA, Ronald J Surz, CIMA

Looking specifically at the "megacap" benchmark Dow Jones Industrial Average, a surprising 50% (126 of 252) of the year's trading days were actually "up", or advancing days, but obviously, the half that were "down" days were much more severe, point-wise. The blue-chip industrials also experienced unprecedented volatility throughout the year, lurching up and down (mostly down), and often exhibited *daily* movements that were nothing short of breathtaking. There were actually 18 trading days during the year with price movements of 5% or more. To put that statistic in better historical context, during the 52 year period from 1956 through 2007 (inclusive), there were *only a total of 17 days with movements of that magnitude*. The average daily "range" for the entire year was an incredible 280.80 points, and from September 1st through December 31st, the average daily range reached an astounding 421.01 points! All but 2 of the Dow Industrials posted losses for the year, with Wal-Mart and McDonalds the only two to survive the year unscathed.

While the equity market declines in 2008 were nominally comparable to the losses seen in the most recent bear market that ravaged all or parts of three years (2000 – 2002), portfolios as a whole suffered much more this time around, as "traditional" methods of diversification failed to limit losses as they had in the past. Asset class "cross-correlation", the historically risk-reducing *counter-cyclicality* that has existed between and among various asset classes, *virtually disappeared*, with stocks of all countries and in all capitalization ranges *declining together as* *one*, and were joined by (non-Treasury) bonds, real estate, and commodities, rendering attempts at diversification of little to no value.

The year's dramatic decline also put the entire *decade*, with just one year remaining, at risk to experience a *net loss* for the first time since, well…ever.

Annualized S&P 500 Return by Calendar Decade



Source: PPCA, Ronald J. Surz, CIMA

The economy, officially in recession since December 2007, worsened steadily throughout the year, and projections for Gross Domestic Production (GDP) during the fourth calendar quarter of 2008 range from a sharp (-4%) decline, to an even more dramatic (-7%) decline. Few economists are projecting GDP expansion until the second half of 2009, and some believe the recession will continue throughout the entire year. Against this upheaval, investors are questioning long-held fundamental beliefs about portfolio construction. Long revered philosophies like "buy and hold" have come under scrutiny. Nothing less than the presumptive role equities play in portfolio return is in question.

As we've pointed out repeatedly in these missives, every correction, every bear market is different in some respects. No two market declines are exactly alike, and predicting the near-term direction of the equity markets is dicey, even in the best of times. There is little doubt that 2008 was a difficult year for fundamental, long-term investors, who suffered as high-quality businesses were punished right along with the lower-quality ones.

So, with all the carnage in the markets, and the economy struggling to regain its footing, what can investors expect from 2009? What can they count on to be true? How do investors adjust to the current conditions? Does sitting on the sidelines make sense at this point?

There are several tactical adjustments we are recommending in the near term, as we await rationality to return to market pricing.

- **Got dividends?** Dividend paying companies, particularly those that are "self-financing", are attractive during times of economic peril. With equity returns in question, getting "paid to wait" makes sense, especially since a lot of dividend paying companies offer yields that are competitive with bonds.

- **Market Neutral Strategy**. This is a strategy that involves shorting stocks as well as owning them "long" within a portfolio. The strategy emphasizes "stock-picking" skills, and over time, will tend to perform similarly to a "long-only" portfolio, but with a much smoother ride.

- **Broad Market ETFs**. Exchange Traded Funds (ETF's) are increasing in their usage and market share. Lower costs, and tax-efficiency are their two primary advantages over their mutual fund counterparts, and in the broadest, most efficient of capital markets (large-cap domestic equity and developed foreign equity markets in particular), cost savings and tax-efficiency can be meaningful advantages.

- **Sector ETF's.** Tactically overweighting investments within economic sectors likely to benefit from an infusion of economic stimulus makes sense as well. There are any number of ETF's that will give you direct exposure to the most attractive sectors. Infrastructure, Natural Resources, and "Clean Energy" development come quickly to mind.

Despite the irrationality of the markets, and their seeming reluctance to recover anytime soon, there are several reasons for near-term hope.

First, the unprecedented global cooperation by governments and central banks will help to thaw the banking system and increase the availability of credit. Should this continue, we believe credit spreads will improve, which should ultimately lead to improved equity markets.

Secondly, as I've repeatedly pointed out in recent reports, equity valuations across many markets have reached what are undeniably attractive levels. Stocks don't remain "cheap" for long.

Finally, there is significant cash on the sidelines, awaiting re-investment into the equity markets. Alternatives (i.e. Money Markets, Certificates of Deposit, Government Bonds, etc., have fairly limited upside, and hold little long term attraction. Capital naturally seeks its highest and best use. When equity markets begin their inevitable recovery, capital will flow back from whence they came, and the increased demand for equities will bring prices higher.

In addition to these near-term factors, there are a couple of historically consistent facts around bear market declines that give us hope that the recent malfunctions are not permanent changes to the hierarchy of capital market returns.

<u>Bear markets are historically short, and "nasty", while bull markets are historically long, and strong. The coming bull will likely be no different</u>.

Since 1942, we've experienced twelve "bull-bear market cycles", those cycles being defined as a rally (advance) of at least 20%, followed by a decline of at least 20%. The average of those twelve advances lasted 1,625 days, and yielded an average gain of 149.53%. Conversely, the "average" of the twelve bear markets lasted just 393 days, and generated losses averaging (-30.57%).

Admittedly, this bear market is one of the worst during that period, exceeded only by the (-48.20%) decline experienced from 01/11/73 – 10/03/74. However, in ten of those twelve cycles (83%), the following bull market rally not only recouped all the losses of the previous bear, but went on to set higher (all-time) "highs". I like those odds.

<u>There have been only thirteen "rolling" 10 year periods in (recorded) history where the S&P 500 earned less than 6% annualized (including the one we are in now). Most of the 10 year, and all of the 20 year periods that followed these delivered returns which were well above average.</u>

10-Year Period	Average Annual Return of S&P 500	Next 10-Year Average Return	Next 20-Year Average Return
1926-1935	5.86%	8.42%	12.48%
1928-1937	0.02%	9.62%	12.98%
1929-1938	-0.89%	7.26%	13.48%
1930-1939	-0.05%	9.17%	14.15%
1931-1940	1.80%	13.38%	14.76%
1937-1946	4.41%	18.43%	13.72%
1965-1974	1.24%	14.76%	14.58%
1966-1975	3.27%	14.33%	14.59%
1968-1977	3.59%	15.26%	16.65%
1969-1978	3.16%	16.33%	17.75%
1970-1979	5.86%	17.55%	17.87%
1998-2007	5.91%	????	????
1999-2008	-1.38%	????	????
Average		13.14%	14.82%

Source: Axia Advisory Services & MJM401(k)

If history is any indication, things might be looking up!

In closing, it's important for investors, especially American investors to take the time to remember who we are, who we ***still*** are as a nation. We are the largest and most technologically powerful economy in the world. Despite the outsourcing of jobs overseas in recent years, we remain the worlds leading industrial power. We are the oldest continuing democracy, and our election of an African-American president is a testimony to its development and maturity.

As former Secretary of State Colin Powell reminded us when he formally endorsed Barack Obama's candidacy, we don't *make* refugees, we *admit* them. Every morning, at hundreds of US Embassies around the globe, people line up outside their gates, seeking permission to immigrate to our country. They seek that privilege because of the opportunity our system provides people to reach their true potential. Our educational and medical facilities are the best available, and the freedoms we ensure our inhabitants are the envy of the world.

We are indeed a great country, founded on the principals of political and economic freedom, and that economic freedom in particular has allowed us to develop a capital market that has withstood shocks much greater than the current difficulties. We are blessed with human talent and resources sufficient to overcome adversities time and time again. We are Americans, and Americans, as a rule, value the future more than the past, because we are optimistic by nature. To be other than such would be to deny the very history we cherish and fervently teach our children. We will overcome this economic trial as we have each time before. We will persevere, and we will rise again. Believe it, remain committed to a long-term view, and be rewarded for doing so.

- JRP