

# Walden Capital Newsletter

Walden Capital Advisors

Third Quarter 2007

## Quarterly Investment Commentary

The subprime-fueled liquidity crunch in the third quarter cascaded into broader risk avoidance by investors and other financial market players. With the Fed's rate cut, things have settled down but they have not returned to normal.

The other major problem is the housing market, where excess supply, declining prices, and tighter credit are feeding each other. This could trigger a material slowdown in consumer spending—a key driver of economic growth.

It is difficult to predict how the economy will play out. Stocks appear to be in a fair-value to undervalued range, but there is an increased possibility of recession and earnings growth is likely to decline from historically high levels.

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The market volatility, credit crunch, housing market collapse, and hedge fund debacles make it hard to believe the overall stock market was in the black during the third quarter. It was, however, with the S&P 500 gaining 2%. Moreover, through September the index is up 9.1% on the year. While the broad market managed nice gains, there was a wide degree of variation across asset classes. Many of the value benchmarks were in the red for the quarter, with smaller-caps doing worst. Growth benchmarks did quite a bit better, with larger-cap growth stocks generally delivering strong returns during the quarter. For the year growth is ahead of value by a wide margin after seven consecutive years of underperformance. International stocks gained over 2% in the quarter, extending their run of impressive returns. With the exception of high-yield bonds, most other fixed-income asset classes had a solid quarter, with investment-grade bonds climbing almost 3%.

### “Prediction is Very Difficult, Especially of the Future”

The above quote, credited to physicist Neils Bohr, comes to mind in assessing the developments of the turbulent third quarter and what they may mean for investors.

**The Economy**—It is easy to find plenty of intelligent-sounding predictions about the economy. Investors are drawn to such forecasts because they make investment decisions much easier. Unfortunately, accurately predicting the future is another story. The real key is to accept that some things are inherently uncertain and instead focus on the knowable. The trick is then to balance the two in assessing a range of possible outcomes.

When it comes to assessing possible scenarios, it would be immensely helpful to accurately predict the health of the economy. One thing we know is that credit is the lifeblood of the economy, and it has become less available than it was. The ease with which homebuyers could access capital will go down as one of the defining characteristics of the last few years, as it contributed to an unprecedented surge in housing prices in many parts of the country. At the same time, in the leveraged buyout market, loans

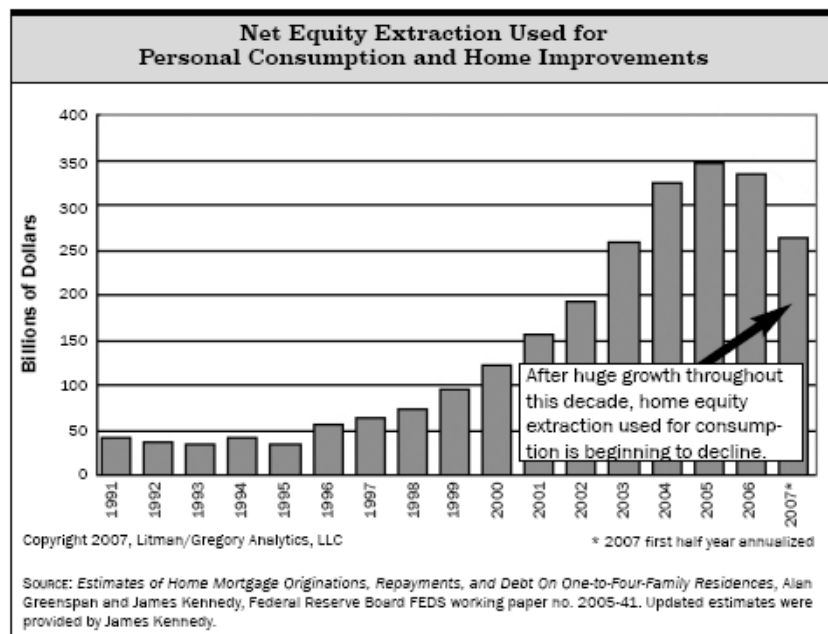
were written on remarkably generous terms, which spurred acquisitions at ever increasing cash flow multiples and boosted stock prices.

Unfortunately, when excesses end, things don't just return to "normal." Often they go to excess in the other direction. This type of snapback triggered much of the volatility during the third quarter as there was an extreme lack of interest in holding consumer-backed debt, and an inclination on the part of most institutions not to lend to each other. This cascaded into broader risk avoidance on the part of investors, hedge funds, and other financial market players who had played an important role in expanding the amount of available credit. This was greatly exacerbated by large amounts of leverage (debt) held by many of the non-bank credit providers (e.g., hedge funds). The result was that credit, which as noted is crucial to the economy, was sharply restricted for a few weeks. With the Fed's decisive action in September to cut the federal funds rate by 50 basis points things have settled down, but they have not returned to normal. Capital will no longer be available to certain groups of borrowers and it will be costlier to other groups. This we can count on and it's not a bad thing, because excess liquidity was leading many investors to make imprudent investment decisions. What is bad is a seizing up of the credit markets in a credit-dependent economy. It seems highly probable that the economy will, at the very least, experience slower growth.

The question now is how long it will take to fully return to a normal credit environment, which is necessary to mitigate recession risk. If there are other events that shock the markets and cause another retrenching, recession risk will rise further. Because there is a lot of credit extended through hedge

funds (which lend their capital) and structured products (e.g., collateralized debt obligations which slice and dice loan portfolios to create different risk tranches that are then repackaged and sold to investors), it is difficult to know the magnitude of some of the more questionable debts, who holds them, and whether they are in strong or weak hands. This in turn makes it hard to know if there may be blow-ups yet to come.

With the housing ATM machine largely shut down and home sales severely slumping, the economy is faced with the possibility of a material cutback in consumer spending—the



primary driver of economic growth. Consumers have less cash available, there are fewer homebuyers buying things for their new home, and the homebuilding and mortgage industries are retrenching. All this has a negative multiplier effect on the economy. A key going forward will be the labor market, which, while still pretty healthy, has begun to exhibit a few signs of weakness over the past few months, starting even before the summer meltdown.

The problems seem bleak, but as always there are additional factors to consider.

The global economy has been quite strong and is less dependent on the U.S. than it used to be. For example, according to Goldman Sachs, the four largest emerging market economies—Brazil, Russia, India, and China—are responsible for a sizable portion of the growth in global demand and significantly more than the U.S. In general, due to much improved economic fundamentals, the emerging markets are playing a much more important role in the global economy. On the other hand, the credit crunch is being felt around the world, not just in the U.S. Europe, in particular, is sharing the U.S.'s experience and in several countries there are similar problems in the housing market.

The weakness in the dollar, as long as it doesn't turn into a rout, is like an interest rate cut. It will help U.S. export growth, which has already been very healthy, and contribute to the bottom line of U.S. firms that do business globally. Meanwhile, a dollar collapse is unlikely because this outcome would be very harmful to the global economy. For this reason central banks around the world would take extreme measures to avoid it.

The Fed does have influence and room to maneuver. If the economy continues to weaken, the Fed can be expected to continue to lower short-term interest rates to make more capital available at a lower cost, which should spur the economy. The financial markets are expecting additional rate cuts, so if the Fed doesn't lower rates this year, market participants are likely to react negatively. Also, additional Fed rate cuts (along with a declining dollar) may spur increasing inflation expectations, which

would not be a positive for the economy or longer duration interest rates.

The bottom line is that the economic outlook is murky. Due to the credit crunch and continued deterioration in the housing market, recession is more likely than it was earlier in the year; however, it is not a foregone conclusion. Many prominent firms continue to believe that a recession is not the most likely outcome, but most are less confident than they were a few months ago.

**What This All Means**—As we frequently note, we are constantly making decisions in an uncertain world. Economic predictions are not accurate enough to serve as a basis for investment decisions. We are more confident in our valuation work as a basis for decisions, but this can not be done in a vacuum.

Looking at the current environment, we know the economy could fall into recession. It could also avoid recession and surprise on the upside with the aid of Fed easing, a weaker dollar that stimulates exports, and global growth driven by emerging markets. Getting defensive in our portfolio allocations could result in missing out on returns that could be captured during, potentially, a few more years of economic growth. (It's worth noting that many of the "experts" arguing for a defensive posture now have been bearish on equities for many years and missed the strong global equity market rebound since 2003.) On the other hand stocks could drop 10% to 20% in a cyclical bear market.

So what do we do? In setting our portfolio allocations, first we draw upon our basic building blocks of diversification, such as using investment-grade bonds to protect against recession and investing in a variety of equity sectors. Our historical framework helps us understand how asset classes

perform in different environments and over short and long term periods. Spreading risk among many sectors rather than concentrating risk in a few sectors has historically worked to enhance returns and lower risk.

Second, we factor in valuation analysis for each asset class. Currently, the major asset classes are in neutral territory—meaning they are neither very attractive nor very unattractive on a long-term valuation basis. Third, we consider that we are willing to accept a certain amount of near-term risk (less than one year) in exchange for some flexibility to capture long-term return (three years or more).

This disciplined approach allows us to capture long-term returns that are driven by factors in which we have confidence (valuations), while still keeping risk in line with each portfolio's profile. Today, this process leads us to leave our portfolio allocations right where we have been. For quite some time we've believed most equity asset classes to be in a fairly priced range—suggesting that over the long run we will make more money in equities than we would in more defensive asset classes (e.g., bonds). We've been rewarded for taking that view. We have also recognized that, as always, there are troubling risks, and equity asset classes have not been priced at levels that were low enough to ignore these risks. There still exists concern about the likelihood that corporate earnings growth will slow from its historically high recent levels.

## **Final Thoughts**

With three-quarters of the year on the books, returns have been decent, though we admit it doesn't feel that way given the turbulent summer and high level of uncertainty. We continue to have a high level of confidence in the funds we own (and, as always, we continue to research other funds as well).

## **News**

### **Using IRAs to Make Charitable Contributions**

IRA owners aged 70½ or older are permitted to use their IRAs to make gifts to qualified charitable organizations without claiming the amounts taken from the IRAs as taxable income (remember that regular distributions from an IRA count as taxable income). The amount of the gift, however, may not then be used as a charitable contribution deduction on the federal income tax return. The maximum gift amount allowed for 2007 is \$100,000. These contributions need to be transferred directly to the eligible organization. If you are interested in doing this, please be aware that unless Congress extends this provision of the Pension Protection Act, it will expire on December 31, 2007.

### **New Walden Capital Emails and Web Address**

Please note that we shortened our email and web addresses. Going forward please use [www.waldenadv.com](http://www.waldenadv.com) to access your accounts online. Jill's email is now [jill@waldenadv.com](mailto:jill@waldenadv.com) and Mary's email is [mary@waldenadv.com](mailto:mary@waldenadv.com).