

Walden Capital Newsletter

Walden Capital Advisors

Fourth Quarter 2007

2007 was a turbulent year that saw the housing market take a dive and the credit markets seize up. Many financial stocks were hit hard, but overall returns on the year were modestly positive.

International equities continued to outperform U.S. equities. On the domestic side, however, we saw a shift in market leadership as large caps outperformed small caps and growth stocks beat value stocks for the first time since 1999.

The housing contraction has a direct impact on employment and spending, but the related credit crunch could cause damage as well.

Presently most asset classes do not appear to be bargain priced despite all the worries but they are not expensive either.

Inside This Edition

- **2007 Review**
- **2008 Outlook**
- **Overview of Speech by Head of Philadelphia Fed**

The Investment Letter is mailed quarterly to our clients and friends to share some of our views. Certain material in this work is proprietary to and copyrighted by Litman/Gregory Analytics and is used by Walden Capital Advisors with permission. Reproduction or distribution of this material is prohibited and all rights are reserved.

Quarterly Investment Commentary

For the most part, fourth quarter returns were consistent with the rest of the year. Commodity prices moved sharply higher, as they did over the full year. Emerging markets continued their advance. Developed country foreign equities declined, a reverse after a strong advance earlier in the year—but they still outperformed the U.S. equity market, which was down across all styles in the fourth quarter. The Dow fell 3.9% in the fourth quarter representing the first fourth quarter drop in 10 years as investors worried about the impact of the turmoil in the housing and credit markets on the economy. Value continued to underperform growth in the fourth quarter, this time on the downside. Small caps continued to lag large caps. As recession fears increased, bonds performed well in the quarter.

2007 Retrospective

Without a doubt, investors will remember 2007 as the year that the housing market collapsed and triggered a credit crunch. The earnings of just about any company that was involved in homebuilding or lending were crushed, and resulting economic worries triggered stock declines for many consumer goods companies. While all this was going on, U.S. exports were booming and reached an all-time high of 12.1% of GDP (as of 9/30/07). Not surprisingly, companies with significant foreign-based earnings did well.

International equities continued their dominance delivering returns of 11.2%, approximately twice that of the S & P 500. Related to the overseas story was the continuation of demand for energy and raw materials commodities from China and other high-growth developing countries—a trend reflected in the strong performance of the energy and materials-related sectors.

On the domestic side, the S & P 500 was up 5.5% for the year. For the first time since 1999, growth stocks outperformed value stocks. Small caps saw an end to their strong run, posting a return of negative 1.6% for the year. As recession fears increased, taxable

bonds performed well in the quarter and ended up with a solid 7% return for the year—ahead of the broad stock market. Municipal bonds returned approximately 4%. Investors first worried about inflation and then recession. At times they worried about both. The 10-year Treasury yield ranged from a high of 5.25% in June to a low of 3.85% in November. But outside of the government bond market, perceived credit risk rose, leading to underperformance.

2008: Big Worries...Any Opportunities?

Our investment decisions are generally made based on a multi-year outlook. This allows us to focus on underlying fundamentals and valuations—the factors that ultimately drive returns—and distance ourselves emotionally from the day-to-day “noise” of the markets and the financial media. Over shorter time periods these relationships—between fundamentals, valuations, and returns—don’t always hold. This is the point made in the legendary Benjamin Graham saying “In the short-term the market is a voting machine but in the long-term it is a weighing machine.”

The question most investors are asking at this point is: will the troubled housing and mortgage industries take down the economy? The underlying key is consumer spending, which makes up 70% of the economy. The contraction in the housing-related industries has a direct impact on employment and spending, but it is the related credit crunch and its impact on spending that could cause the most damage. The impact of hundreds of billions of dollars in loan losses to banks, hedge funds, and other investors means less capital available to lend, and less willingness to lend because of uncertainty about the borrowers (and because of the need to keep cash on their balance sheets to cover their

own potential losses). Moreover, capital has increasingly come from outside the banking system (structured notes are an example), making it tougher for the Fed to restore confidence and liquidity.

The problem is that it is difficult to quantify the losses and impossible to confidently forecast how restrictive credit will be and for how long. There is also fear that credit problems will spread to other areas, with credit cards being one area of concern because of permissive underwriting standards. At this point it seems pretty clear that banks will have more write-offs over the next few months or quarters and that structured investments (pools of debt that have been turned into securities), which are often highly leveraged, will suffer through more ratings downgrades as collateral values decline further. Certain types of hedge funds, which have exposure to these vehicles, are likely to suffer sizable losses in coming months. Moreover, it is very likely that lending practices will be generally more conservative, suggesting slower growth in credit for a sustained time period. A predisposition to conservative lending will make the Fed’s job harder. This suggests that the current trend of less credit and higher costs probably has a way to go. This is true not just in the mortgage market (subprime and prime) but in the consumer and small-business loan market as well.

It is easy to dwell on the negatives and this is a common investment mistake that has been made over many years. It is not a foregone conclusion that the negatives will drag the economy into recession—though some slowdown seems quite likely. Although the employment market is showing some signs of slowing (unemployment claims are starting to

rise), it remains healthy. Corporate earnings outside of the financial sector are still growing. Emerging markets continue to thrive and are a positive for the global economy. A weaker dollar has helped support a boom in U.S. exports. The Fed and other central banks are aware of the economic risks and are using interest rate policy and other measures to improve liquidity. They will not stop until they have an impact, though how quickly this will happen and how successful they will be is not yet clear. Overall, global liquidity remains strong with large foreign exchange reserves and huge growth in sovereign wealth funds (government controlled investment funds created to invest foreign exchange reserves), two indicators of liquidity. There are already some tangible examples of available liquidity, including recent investments in major but troubled financial institutions by Chinese, Singaporean, and Middle Eastern investors. As we weigh the information we have, we know we can't confidently predict how the macro picture will play out. However, we believe the odds of a meaningful slowdown or even recession have moved sharply higher from a few months ago, though a recession is still far from certain.

That there is big-picture uncertainty is nothing new—it's always a given. And as always it begs the question: what is priced into the markets? This is important because at times the relationship between the macro climate and security prices disconnects. When fear is high, investors avoid risk, driving up the prices of safe assets and driving down the prices of riskier assets—often to excess. The result is that riskier assets usually are bargain priced when fear is high, and vice versa. Presently most “risky” assets (anything other than cash and investment-grade bonds) do not appear to be bargain priced despite all the worries but mostly they are not expensive.

One quick valuation reality check is to look at trailing returns for riskier asset classes. When trailing returns are very high, especially over a lengthy period, chances are that the asset class is richly priced. But when returns have been low or average for a long period, chances are the asset class is undervalued or fairly priced. Currently, trailing longer-term returns are not so high as to suggest inflated asset class valuation levels.

Conclusion

Looking ahead, the impact of the housing slump and lack of liquidity in the credit markets has increased the level of economic risk, and recession is a clear possibility, though not necessarily a high probability. We are always evaluating our allocations in light of current market and economic conditions and will make any necessary adjustments. However, clients should understand that the possibility of a rough year lies ahead. They should also understand that this is not an outcome that can be predicted with high confidence. We've been surprised by positive market returns many times over the years. Remember that the only way to assure that your portfolio will not decrease in the short term is to hold cash or invest in money market funds. Such a strategy, however, has long term risk as your assets do not keep up with inflation. So we focus on doing our best to maintain adequate risk protection over a one-year time horizon based on the risk tolerance of each investor, while keeping our eye on the more important goal of long-term returns. This common sense approach has served investors well in the past. For long-term investors, market turmoil can create great opportunities. We will continue to evaluate the opportunities the markets present, and will seek to take advantage of them when we believe it is prudent.

News

Overview of Speech by Head of Federal Reserve Bank of Philadelphia

I was fortunate to attend a lecture early this month by Charles Plosser, the head of the Federal Reserve Bank of Philadelphia and a new voting member on the Fed's Open Market Committee. He described that the fall in the market this past August and later into the fall was triggered by the realization that the default rates on subprime mortgages would be greater than expected as well as the subsequent uncertainty as to which firms held these risky assets and to what extent they were exposed. He said that the Fed can not solve this problem of price discovery, the market has to and that the best thing would be for firms to promptly disclose their positions and take writedowns. As with many other issues, it is the uncertainty that the market doesn't like, not always the actual news itself.

He further stated that the Fed's long term monetary policy goals are to promote sustainable economic growth and price stability. When the Fed meets to set Fed funds rate targets, they consider how changes affect these long term goals, and their changes don't ripple through the economy for a few quarters. His general view was that the housing sector and credit markets would be weak through the first half of 2008 and then start to show signs of turning around with more significant improvements coming in 2009. The Fed has a challenge on its hands as concern over inflationary pressures, now with energy but possibly becoming more widespread, make monetary policy more difficult. In order to counteract recessionary pressures, rates need to decrease but that creates issues for inflation. It should prove to be an interesting year.

For the Record

Please contact Walden Capital Advisors promptly if there are any changes in your financial situation or investment objectives, or if you wish to impose, add or modify any reasonable restrictions to the management of your account.