

Walden Capital Newsletter

Walden Capital Advisors

Second Quarter 2008

Stocks were sharply lower in June amid renewed concerns that fallout from the housing crisis and credit crunch will drag down the economy.

Meanwhile, inflationary pressures from higher gas and food prices make it more difficult for the Fed to balance the goals of boosting the economy while keeping inflation in check.

Final first quarter GDP numbers showed a rise of 1% indicating that the economy is technically not in a recession (defined as two consecutive quarters with negative GDP growth.)

Inside this Edition

- **Quarterly Investment Commentary**
- **What is Driving Stocks Lower Again?**
- **What Does the Future Hold?**
- **Mary Received Her Registered Paraplanner Certification**

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Quarterly Investment Commentary

The first half of 2008 dramatically reinforced the idea that over the short term the stock market is *predictably unpredictable*. A sharply negative first quarter was followed by two months of positive returns, but the selloff resumed with a vengeance in June, with the S&P 500 Index dropping 8.4% for the month and almost 3% in the second quarter. The phrase "June gloom" could be used to describe investors' moods as the quarter came to an end. The S&P is now down 12% for the first half of this year and about 18% below its October 2007 high. The market offered few places to hide. Mid and smaller cap stocks fared better than large in the second quarter, but still got slammed in June and now have high single-digit losses for the first half of 2008. International stocks also had a rough month, losing 8% in June and 2% in the second quarter and are now down 11% through the first half.

Domestic high-quality bonds were flat in June and down just over 1% for the second quarter. Though not a good return in a normal environment, bonds nevertheless provided balanced investors with a margin of protection from stock market losses, which is part of their role. The Lehman Brothers Aggregate Bond Index, a proxy for the bond market, is up 1.1% through the first half of the year.

What is Driving Stocks Lower Again?

As always happens in an environment of fear, we are being asked (and asking ourselves) a lot of questions. What is going on, and how bad could it get? Is there anything we should be doing about it in our portfolios? This environment is in many ways unique and presents its own set of challenges, which we'll address more specifically in a moment. But more generally, in all of the market crises over the past decades, one thing that is common is that a sense of accelerating bad news, escalating risk, fear, and panic were almost always present.

The Federal Reserve's unprecedented actions to shore up credit markets a few months back led many to hope that we were past the worst of the financial crisis and that the stock market had hit bottom. But while the Fed's actions may have significantly reduced the risk of a full-scale financial meltdown, the losses from bad loans are continuing to be worse than expected. Meanwhile, the positive feedback loop of soaring home prices and easy credit is now gone, and with it has gone a major source of consumer spending (which of course is a major driver of the economy.) Add in the impacts of high levels of household debt (which suggests the need to retrench rather than spend), higher gas and food prices, a weakening labor market and low consumer confidence, and it seems increasingly likely that consumer spending will continue to decline.

Consumers feel anxious for several reasons as home and stock prices have fallen; household net worth has decreased; credit conditions have tightened and, as a result of high energy prices and weak labor markets, real incomes have declined. The fiscal stimulus package has helped support consumption in the short term but this effect will likely fade while the concerns above will remain. Once there is evidence that the housing market is near bottom, individuals' perceptions of the economy and its outlook should improve. Many have suggested we may reach a trough in early 2009 as the data indicates that we are likely not too far from the bottom.

The damaging combination of a slowing economy and higher inflation (the widely feared "stagflation") has also led to questions about the ability of the Fed to support economic growth and employment without stoking fears that it has gone soft on inflation. What it all means is that risks to the economy

remain high, and the financial markets are now more fully discounting this risk, which is an unemotional way of describing the battering taken by stocks in recent weeks.

As always, there are positives as well. Outside the financial sector, corporate balance sheets remain generally healthy and earnings have been okay. One source of strength has been exports, which so far have managed to offset much of the impact of the housing decline on GDP. But this could diminish if our slowing economy means we also export economic weakness to the rest of the globe.

Making Decisions in an Uncertain Environment

"History is merely a list of surprises. It can only prepare us to be surprised yet again."

Kurt Vonnegut

Though we have experienced a multitude of market crises, we also recognize that history never repeats itself exactly, so almost anything can happen from here. One possibility is that things will get worse before they get better in the stock market. Even without a bad recession, fear and pessimism can take hold of investor psychology and send the market down further than what would be justified by long-term economic fundamentals. In this type of environment, a sense of perspective and a reliance on our investment discipline helps us avoid becoming panicked by short-term concerns and paralyzed by longer-term uncertainty. Like it or not, we are always faced with making decisions in an uncertain world and this will not change.

At this time we do not believe it is time to get more defensive and reduce our equity exposure. It is easy to put too much weight on

negative scenarios when bad news dominates the daily headlines, but we view stocks as priced to outperform bonds over most five-year scenarios.

Big market downturns invariably present opportunities. Bubbles lead investors to make errors in judgment and misprice assets on the way up. On the way down, riskier assets often fall to bargain prices when investors are in the grip of fear. Our investment discipline can help us identify those asset classes where investor panic has led to excessive under-valuation.

Setting Return Expectations

The annualized return for the S&P 500 over the past 10 years is just under 3% – more than 70 basis points below that of risk-free Treasury bills! In the decade prior, stocks returned a whopping 18.6%. It would be nice if this history meant that, having come through a decade of above-average returns and a decade of below-average returns, we could now start from scratch and simply expect “average” returns of 10% to 12% a year on equities. Unfortunately, though, the market is forward looking and doesn’t care where it’s been. As we look forward to the next five years, the general expectation is for a lower than average return environment overall—for both stocks and bonds. We note, however, that the market’s selloff in June has brought equity prices down far enough to make the potential return range on equities higher than it was just a few weeks earlier.

Despite our expectations for a challenging, lower-return environment, we believe we can add value from both asset allocation and manager selection decisions. We added in a commodities real return fund as both an inflation hedge and a diversifier due to this sector’s low correlation to the U.S. stock

market. Over the past six months, we have also shifted some assets from value to growth, small cap to large cap, and U.S. to international. We have also added some pure emerging markets exposure to the international allocation. We believe that in aggregate, our actively managed funds will beat their benchmarks over the long term. Many of the fund managers we respect most tell us they are buying shares of high-quality companies at bargain-basement prices. Consequently, even though the overall market does not look compelling to us from a top-down valuation perspective, the current economic and market turmoil appears to be creating significant return opportunities at the bottom-up individual stock level. Indeed, it is often when the overall trend is negative that disciplined investors can build a portfolio for long-term outperformance by carefully taking advantage of the opportunities created by these dislocations. It requires patience and the ability to weight long-term analysis above short-term fear, but it is what distinguishes successful investors.

News

Please join me in congratulating Mary on earning her Registered Paraplanner designation. She recently completed the six month course of study and passed the College for Financial Planning examination. The curriculum included coverage of the financial planning process, time value of money, risk management and insurance, investments, tax planning and estate planning. Mary is excited about gaining this additional knowledge and is looking forward to helping Walden’s clients with any issues that may arise.