



Fourth Quarter 2008

As I sit here today writing this letter, Barack Obama is being sworn in as our nation's 44th president and the first African American president. Watching and reading the news coverage of the inauguration, one is moved by the sheer emotion of this historic event, the pride Americans feel in our country and how far we have come as a nation. For a little while, we were allowed to forget the financial crisis, sagging economy and battered stock market. But, of course, life moves on. After all of the inaugural balls are over, President Obama will get to work quickly on facing the economic challenges that lie before us.

I don't think anyone would disagree that we are happy to bid 2008 farewell. The equity markets experienced steep declines in all asset classes, posting the worst performance since 1931. Corporate bonds also took a beating as the fixed income markets dried up. The only safe haven was Treasuries. Market volatility climbed to twice that of its previous high, which occurred at the start of the Iraqi war. We saw 3% daily changes in U.S. stock prices on nearly 17% of the days compared to a previous high of 7% in 2003. If you look at the 15 best and worst trading days since 1928, two of the best days and four of the worst days occurred in the fall of 2008. We witnessed well established, blue chip companies fail or merge, massive government intervention, continued troubles in the housing market, rising unemployment and decreased consumer spending.

How did all this happen with such speed and magnitude? I recently heard Gus Sauter, the Chief Investment Officer of Vanguard, speak and he explained it as follows. The root cause of the recession was a domino effect starting with easy monetary policy, willing borrowers, low lending standards and lax mortgage documentation, all of which led to a boom in subprime mortgage lending from 2003 – 2006. Instead of the banks holding the loans on their books, they now sold them so they were less concerned about credit quality. Once sold, the financial engineers securitized the mortgages into investment vehicles which were then distributed through Wall Street brokerage firms. This market boomed due to the greed of both brokers and investors. Once default rates started to increase, it all came crumbling down. Banks and brokerage firms have written off over a trillion dollars of subprime loans, thereby decreasing their capital, which then reduced their capital ratios to minimal levels and made it difficult for them to lend. When banks couldn't lend, brokerage firms did not have enough capital to buy the inventories of securities they normally hold to sell to market participants. Ultimately, the capital markets dried up as buyers and sellers became fearful. Corporate financing costs soared which then led to bottom line pressure for companies. This, in turn, contributed to layoffs and then consumers, who account for two-thirds of the GDP, cut back on spending.

In order to have a healthy financial system, we need strong banks and brokerage firms. If banks can start lending again, liquidity in the bond markets will increase and we will get a tightening in credit spreads, thereby reducing the cost of corporate borrowing. This improves companies' ability to finance operations and ultimately reduces unemployment which will then circle back to increase consumer spending.

So where does this all leave us? 2008 was the perfect storm with almost no place to hide. Never before had the market experienced declines in so many asset classes at once and at such speed and magnitude. With only cash and Treasuries performing positively for the year, it is natural to question the strategy of portfolio diversification. It also lead many to question whether investing will be different going forward. In response to these questions, let me say that the alternative to diversification, investing in one safe asset class, has its risks too as it has generally underperformed and not always kept up with inflation over longer time periods. Also, at this point, investors should be careful to assume that this very unusual three month period will be the norm going forward. Yes, this is a very atypical time; however, we have had other crises that seemed horrible when in the midst of them but with the benefit of hindsight appear to be the normal ups and downs of the market. Having said that, we will continue to learn from these events and adjust our models accordingly.

When reading the various economic and market forecasts for 2009, it is once again clear that nobody knows what will really happen and how fast things will improve. You have many very bright people predicting doom and gloom past even 2009 and, as always, there are an equal number believing that things will improve toward the end of this year. Clearly, in order for things to get better, the housing market needs to bottom and the credit markets need to thaw. The government appears ready to use both monetary and fiscal policy to help turn the economy and markets around.

We are not out of the woods yet, and there will almost certainly be more bumps in the road. The economy will be weak for awhile longer and the markets will be volatile. The bad headlines need to go away before things can really improve. Remember that the markets usually lead the economy out of recessions by about six months or so.

At Walden, we have not yet moved our portfolios back to their original equity allocations. When we do so, it will most likely occur a little bit at a time. During our discussions with clients this year, it is important to focus on your individual goals, time horizons and levels of risk tolerance. Shorter term goals should be achieved through more conservative investments while you can take more risk with money that you do not need for longer periods of time. History has rewarded investors over time, and there is no reason yet to assume that paradigm has changed.

Here's to a 2009 filled with hope, peace and prosperity!

A handwritten signature in cursive script, appearing to read "jill".