

# Walden Capital Newsletter

Walden Capital Advisors

Fourth Quarter 2008

2008 was as bad an investment year as most of us will likely experience in our lifetime. Stocks had their worst calendar year since 1931.

Many metrics suggest that stocks should at least provide satisfactory returns going forward and possibly something better. But the near term is much less clear. While it may be probable that we have seen the market bottom, we can't be sure.

We expect the recession to last through 2009 and possibly into 2010, but with a great deal of negativity already priced in, the longer-term return outlook is decent. We believe we will continue to see numerous opportunities created in this highly dislocated environment.

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## Quarterly Investment Commentary

For investors 2008 was arguably the most painful in modern investment history. Almost every asset class was in the red for the year, with many deeply underwater, giving investors almost no place to hide. The S & P 500 finished the year down 37% while small cap stocks, as measured by the Russell 2000, were down 34%. Developed country international equities declined 43% while emerging market stocks plunged 53%. As a result of the credit freeze and lack of liquidity, corporate bonds were down 2 to 6% depending on maturity. Government bonds, up around 7%, were one of the few exceptions as investors flocked to instruments backed by the U.S. government.

Clearly we are now in the midst of a severe recession. Consumers are being forced to adjust to a new reality in which they finally have to pay down debt, increase savings and thus spend less than before. Many have been wondering since the late 1980s when the growth in household debt would slow or reverse. It took 20 years but we believe the time has come. Corporate earnings growth may not get back to its long-term trend for several years after the recession ends, and the recession itself could last through 2009 or even into 2010. But as we look forward from here at beaten-down financial markets and an economy on the ropes we ask the question we always ask: what expectations are currently reflected in asset class prices? We approach this question in many ways and consider the weight of the evidence in the context of how the broader economic environment might play out over coming years. This exercise leaves us with conflicting evidence to digest.

## Encouraging Signs

Historical comparisons are sometimes helpful. There have been two extreme economic and investment environments in the last 80 years—the 1930s, and the 1970s/early 1980s. In both periods investor confidence was crushed after lengthy periods during which returns were dismal and because of a continuation of negative headlines. But as it turned out, both periods presented a great opportunity for long-term investors to buy stocks. This may be a similar time. These experiences reflect the tension that investors face—when risk seems greatest it is usually a good time to invest and when risk is an afterthought investors are likely to be disappointed with their returns going forward.

## Historical Evidence: Trailing Risk Premiums

There are many ways to consider historical stock-market performance. One is to focus on the risk premium. This compares stock market returns to the returns an investor could have achieved if the money had instead been invested in a risk-free asset. Since we date this secular bear market at about nine years old, we looked at the stock market risk premium over the past nine years (using month-end returns). To do this we compared the S&P 500 returns to returns from three-month Treasury Bills. We then compared the returns to other periods going back to the Great Depression.

The takeaway is that by underperforming T- Bills

Worst Nine-Year Risk Premiums Since 1935							
Nine-Year Period Ending	Risk Premium	Cumulative Return		Annualized Returns in Following Years			
		S&P 500	T-bills	Next Five	Next Seven	Next 10	Next 15
Dec-08	-59%	-28%	31%	?	?	?	?
Jul-82	-58%	52%	111%	29.7%	23.1%	19.2%	19.7%
Sep-74	-67%	-5%	62%	16.8%	14.4%	15.6%	17.2%
Mar-38	-56%	-46%	10%	13.0%	13.4%	11.9%	14.1%

\* S&P 500 return less the T-bill return.

by 59% over the last nine years (as of 12/31), the risk premium was one of the worst on record – matching the worst nine years during the Great Depression but not quite as bad as the worst periods that encompassed portions of the inflationary 1970s. On a forward-looking basis, what is very encouraging is that the long-term returns were quite good following similarly horrible nine-year periods for risk premiums. And also, the end of these nine-year periods fell close to the bear market bottom.

## Forward-Looking Evidence: Scenario Analysis

We look at a variety of potential outcomes over the coming five years – ranging from optimistic to pessimistic. Presently our most pessimistic scenario assumes that the economy gets through a very severe recession only to experience an extended period of slow growth as consumers retrench and rebuild savings over several years

(deleverage). Our assumptions are for an earnings environment that is worse than any period other than the Great Depression era (our earnings data goes back to the 1920s). If this is the scenario that plays out and we put a below-average P/E multiple on the earnings in five years, the return on the S&P 500 would be between 4% and 5% (from a starting S&P level of 900). In a somewhat less severe but still challenging climate, returns would be in the high single-digits. In more-optimistic scenarios we could see much higher returns. While the returns we forecast in the very negative environments are not exciting, they are not terrible. That they are not terrible, in what would be one of the worst earnings environments in a century, suggests that quite negative expectations are already priced into stocks. With prices down well over 40% and well below levels of nine years ago, that is not surprising.

## Valuation Evidence: Shiller P/E

There are many ways to assess valuations. Most now suggest that U.S. large cap stocks range from fairly valued to bargain priced. One metric we have added to our valuation tool box is the so-called Shiller P/E, named after Robert Shiller, the Yale professor. Shiller calculates his P/E based on an average of the last 10 years' earnings in order to smooth out short-term earnings volatility and also inflation-adjusts his earnings and stock price levels. The current Shiller P/E is 15x normalized earnings, which is lower than most of the post-WWII period except for the early 1970s through mid-1980s when inflation and interest rates were generally much higher. P/E's could go lower and stay in a low range for a period of years. But this level of P/E has generally been a good long-term entry point into the stock market.

## Dry Powder

There is a mountain of cash sitting on the sidelines. In fact, since the advent of money market funds more than 30 years ago, money market assets relative to total stock market capitalization has never been higher. Some of that cash is likely to find its way into stocks and bonds

at some point, especially with returns on cash so low.

## Cautionary Signs

All of this evidence as it relates to the long-term potential in stocks is encouraging, but the near term is much less clear.

### Secular Bear Markets Usually End at Extreme Levels of Undervaluation

Most valuation measures suggest stocks are attractively priced now, but only one that we follow (price to free cash flow) puts stocks at the screaming buy levels seen in the 1930s or 1970s and early 1980s. The counter argument is that the 1930s economic collapse was much more severe than the current one is likely to be and that in the 1970s and early 1980s inflation and interest rates were much higher than they are now.

### Economic Risk Remains High

Policy makers have made it clear that they will do whatever it takes to support the economy, yet credit markets, though slightly improving, remain dysfunctional and the housing market remains highly stressed. And while a financial system collapse has been avoided, a newly realistic consumer, attempting to reduce debt and increase savings, could mean an economic retrenchment that lasts longer than the consensus expects. This could lead to an extended period of deflation, something that we are already getting a whiff of. In the near term, a significant deflation scare is not fully priced into the stock market.

## Weighing the Evidence

Overall the evidence does not clearly suggest that stocks are at highly compelling valuation levels. It also doesn't make an iron-clad case that the stock market bottomed in late November after the S&P 500 hit its lowest level since 1997. While it is quite possible, maybe even probable, that we have seen the bottom, we can't be sure. Forced selling by hedge funds and others may not be quite done and more individual investors could simply give

up if the market heads back down towards its prior low. Despite the near-term caution, we think the weight of the evidence overwhelmingly suggests that investors are very unlikely to get hurt owning equities over the next five to 10 years and are likely to reap at least satisfactory returns. That is a justification for owning stocks with capital that is not needed in the near term. Moreover, periods of extreme dislocation usually create opportunities for significant value-added from active management. The entire market does not have to be a screaming buy if some portion of the market is. Based on our read of history as well as data that indicates extensive valuation discrepancies in the market currently, we believe that the next few years are likely to be good ones for active managers relative to their benchmarks. We believe the same holds generally true for foreign stocks. Because valuations there are not materially different from those of U.S. equities, we are maintaining our current weight to foreign stocks at this time. We think it is likely at some point in the coming years that foreign stocks will see a currency tailwind to domestic investors as U.S. monetary and fiscal policy begins to take a toll on the dollar.

Thus far this discussion has focused on stocks but they are not the only game in town. There are also now opportunities in investment grade and high yield corporate bonds which took a beating relative to Treasuries last year but now have historically high spreads. Having rebounded by over 25% since a low in November, we now put emerging markets stocks in the cheaper end of fair value with decent to very good returns likely in all but our most pessimistic scenario.

## What the Future Might Look Like for Investors

We are prepared for volatile markets (though less volatile than this past fall) and the possibility that many equity-type asset classes will experience wide performance swings with occasional strong rallies and subsequent sell-offs. Rallies could last for months with sizable returns, followed by sharp pullbacks. We have already seen a stock market

rally of 18%, followed by a 25% decline, and a 21% rebound within the last few months. Sizable ups and downs in equity markets could play out over a period of a few years even as some equity markets stay within an overall trading range or move only marginally higher before beginning a new bull market. We don't know if this is what the next few years will look like but we believe this to be a possible scenario because this is how other secular bear markets have petered out over time. This grinding process is one way to get at more bargain-priced markets as earnings start to recover faster than prices (this could happen even if earnings growth is sub-par). An environment like this could present us with opportunities along the way which we will continually evaluate. Those possible opportunities, along with potentially solid returns from fixed-income investments, could translate into an attractive investment environment as we wait for a new bull market. We know that 2009 and beyond will remain challenging but we believe we are well equipped to navigate treacherous waters. We also believe that financial assets have priced in enough damage so that sustained losses (as opposed to temporary down market blips) over multi-year periods are now very unlikely.

We remain strongly committed to focusing everything we do on rewarding you for your confidence.



## Tax Changes for 2009

Listed below are some tax items you should be aware of this year:

- The annual gift tax exclusion increased from \$12,000 to \$13,000.
- Required minimum distributions from IRAs and qualified retirement accounts are suspended for 2009.

- The federal estate tax exemption amount increased to \$3.5 million from \$2 million in 2008. The top federal estate tax rate remains unchanged at 45%. The future of the estate tax, both exemption levels and rates, will likely be addressed this year as, under current law, the estate tax is scheduled to disappear entirely for one year only in 2010.
- Taxpayers who are at least 70 ½ years old may still transfer up to \$100,000 in 2009 from an IRA directly to a charity. Such a distribution is not treated as taxable income and can not be treated as a charitable deduction.

## 2009 Retirement Plan Contribution Limits

- IRA and Roth IRA contribution limits remain unchanged from 2008 at \$5,000. Those age 50 or older can contribute an additional \$1,000 for a total of \$6,000.
- Contribution limits to 401k and Roth 401k accounts increased from \$15,500 to \$16,500. Those age 50 or older can contribute an additional \$5,500 this year, for a total of \$22,000, up from \$20,500 in 2008.
- The maximum allowable contribution to a defined contribution plan such as a profit sharing plan increased to \$49,000 from \$46,000.

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