

Walden Capital Newsletter

Walden Capital Advisors

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The broad economic environment remains highly stressed, and there is uncertainty as to what the impact of the recently enacted government policies and programs will be.

Broadly speaking, the near-term imperative is to prevent a debt-deflation spiral from taking hold and that is the basis for policy actions. But longer-term these actions are likely to come at the cost of lower growth, higher inflation, and dollar weakness.

We consider four broad economic scenarios that are reasonably possible in assessing potential returns for equities.

Short-term risk remains, and investors should consider now how they would react to another significant decline in the stock market.

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Quarterly Investment Commentary

Stocks saw their best one month gain in March in more than six years, but while it was a welcome respite from the battering in January and February, the first quarter still ended with a double-digit loss for equities. The large-cap S&P 500 surged by almost 9% in March, yet finished the first quarter with an 11% loss. While returns in March did not vary by much across equity styles, that was not the case for the quarter. Value sharply underperformed growth, and smaller-caps generally did worse than larger-caps. The best performing equity style was large growth, which lost “only” 4% for the quarter. At the other extreme was small value, down 15% for the quarter. High-yield bonds, on the other hand, produced a gain of 5% for the opening quarter. Abroad, the results for developed market equities were similar to what we saw at home. The MSCI EAFE Index gained over 6% in March, but its almost 14% loss for the quarter was a bit worse than that of domestic equities. In contrast, emerging market equities had a great March (up over 14%) and finished the first quarter slightly in the black, based on the MSCI Emerging Markets Index. Turning to bonds, Barcap (formerly Lehman) Aggregate Bond Index was up 0.1% for the quarter. Municipal bonds fared slightly better, up 2 – 3% for the quarter depending on maturities.

Recap of the Current Economic Situation

The list of issues affecting today’s investment landscape is dizzying; at the top is the dismal state of the global economy. The fundamental problem is that over the past several economic cycles U.S. households and financial services businesses took on increasing amounts of debt in order to fund consumption and investments. This trend was self-reinforcing as purchases with borrowed money drove up asset prices (such as homes and financial stocks) and profits, which supported even more borrowing. Ultimately this upward spiral was unsustainable, and its unwinding has created an adverse feedback loop of falling asset prices and lower spending and profits. As the economy deteriorates, contributing factors (such as rising unemployment, mortgage defaults, loan write-offs, reduced lending, and overall fear) all fuel one another.

In such a situation, most experts agree that the government needs to step in as a consumer and lender of last resort to try to stop or mitigate the effects of this adverse feedback loop. In effect, the public sector (the government) must take on more leverage and spend more in order to try to plug the gap created by the deleveraging in the private sector. The \$800 billion fiscal stimulus package and the monetary and credit policy actions undertaken by the Federal Reserve and the Treasury to support the financial and credit markets are the result so far.

But there is disagreement as to whether and to what extent the current crop of economic policies and programs will be successful in stopping the economic slide. And as uncomfortable as it is to say it: *no one really knows*. Economics is an inexact science, to put it mildly. There are too many variables that interact in dynamic and unpredictable ways. Moreover, as globalization has led the world's economies to become even more interconnected, this complexity has only increased. When you add politics and introduce the government as a player in markets and industries where they were previously only the referee (or not even that), the implications for and outcomes of economic policy decisions become even more uncertain. Fundamental questions about the role of government in our capitalist system have exacerbated the already high levels of uncertainty among market participants and investors. And as the saying goes: the market hates uncertainty.

Certainty and Uncertainty

While we admit to being uncertain about a lot of things in this environment, we are confident that the current administration and the Federal Reserve are very aware of the severity of the economic challenges we are facing. For example, Larry Summers, the head of the White House's National Economic Council, has talked of the need to "contain what is a very damaging and potentially deflationary spiral." And Federal Reserve chairman, Ben Bernanke, and President Obama's chief economic advisor, Christina Romer, had previously written papers on the causes of and lessons from the Great Depression. We are also confident that they will *try* to do everything they can to break the downward momentum. Last December, for example, the Federal Reserve cut

the Fed Funds interest rate to zero for the first time ever. It subsequently took additional unprecedented steps to inject more liquidity into the economy and loosen up the frozen credit markets, by announcing that it would buy up to \$300 billion of longer-term Treasury bonds and \$1.25 trillion of agency mortgage-backed securities. Most recently, the Treasury announced the details of its plan for a public-private fund to purchase up to \$1 trillion of "toxic mortgage assets" from bank balance sheets with the goal of getting the lending markets to start functioning normally again.

Generally speaking, the policies and programs recently announced are likely to help move the economy towards recovery, but they may not alone solve the problems we are facing and we expect more government action in the months ahead. No matter what policies are introduced, the impact of consumer and financial system deleveraging will likely be a drag on economic growth over the next several years, as saving and paying down debt replaces borrowing and spending. There will also likely be a price to pay down the road for the current policy actions in the form of a weaker U.S. dollar, higher inflation, higher interest rates and tax rates and, consequently, subpar economic growth and corporate profits, with lower-than-normal stock market valuations (P/E multiples). So while preventing a debt-deflationary spiral from taking hold right now should be "job one" of the government, it is likely to be at the cost of lower growth and/or higher inflation down the road. And there is also no guarantee that policymakers will be able to prevent significant additional economic damage from being done in the near term, despite their best intentions.

So there is a huge amount of *uncertainty* as to how this all plays out. But it is important to remember that while uncertainty is uncomfortable, it is always an aspect of investing and it is what creates great long-term opportunities. (If there was perfect certainty about the future, one would never be able to buy an undervalued asset.) So how do we make investment decisions in this environment? We use the same framework that we have always used: assessing the potential risks and longer-term return opportunities in various scenarios across a variety of asset classes.

Outlook for Equities

The analytic framework for equity return ranges—and the resulting asset allocation decisions—starts with four broad economic scenarios that have a reasonable likelihood of playing out over the next five years. Earnings and valuation assumptions are based on an analysis of stock market and economic history going back to the 1920s as well as a qualitative, forward-looking assessment that accounts for differences between this cycle and prior economic and market cycles. Each earnings growth path and P/E multiple implies an ending value for

the S&P 500 five years hence. The approximate rate of return from capital appreciation and dividend yield for each of the scenarios is then calculated.

Four possible broad economic scenarios are as follows:

Scenario 1: "Muddle Through" - Economic recovery in late 2009/early 2010 but sub-par recovery for several years. Inflation gradually rises.

Scenario 2: "Stagflation" - Economic recovery in late 2009/early 2010 but sub-par recovery. Strong inflation (mid single digits) near the end of the five-year period.

Scenario 3: "Severe Recession/Deflation" - Extended/deep recession and potential deflation through 2010 due to severe deleveraging and negative wealth effects. Recession does end but recovery is anemic. Assumes a peak to trough decline in nominal S & P earnings of about 65% compared to a 75% decline during the Great Depression. This is also worse than any other earnings decline since then. Assumes a slow recovery rather than a sharp recovery in earnings that typically occurs after sharp declines. This reflects concern about the high amount of leverage in the system and the potentially long-lasting effects of its unwinding. As we come out of the current contraction, consumers may be reluctant to take on debt, and bank lending (which will also

likely be more heavily regulated) could be cautious, contributing to a subdued earnings recovery. Assumes the multiple during the period after the earnings trough during the Great Depression and another lower multiple to account for the possibility that market psychology may be depressed if this worst-case economic scenario plays out.

Scenario 4: "Goldilocks" - Government policies are effective and economy starts growing in the latter half of 2009. We see an average recovery with moderate inflation. It is assumed that S&P earnings revert to their long-term earnings trend line five years from now (which reflects a 6% long-term average annual growth rate going back to the 1920s.) Assumes a P/E multiple which is consistent with long-term historical average P/Es during periods of moderate inflation and normal economic growth.

The results of this analysis suggest an average annualized return for the S & P 500 over the next five years as follows: 1) For the worst case scenario: -1 %

to 3%; 2) for the best case scenario: 17%; 3) for the two middle scenarios: 5% - 8%. As you can see, these numbers vary widely and no one knows with certainty which scenario is going to actually play out. Because of this, it is important to maintain some level of equity exposure for longer term goals but be careful not to overweight equities due to the further loss potential.

Extending Our Time Horizon

We want to emphasize that there will be a recovery in earnings at some point and we believe investors with a long time horizon (greater than five years) should do at least okay owning equities at current prices and likely better than bonds. And as we extend our investment time horizon out towards 10 years, our expectations for equity returns move toward the more optimistic end of our range, in the upper-single-digit to lower-double-digit return range. This is because earnings and P/E multiples are more likely to normalize (revert to their long-term trend lines or averages) as time goes on and the global economy heals itself. But the path from here to there is likely to be bumpy and there will probably be some big dips along the way.

We have talked a lot about the risks and uncertainty in the economy and the financial markets. At the same time, we want to emphasize that we are focused on meeting these challenges with process and discipline. In addition to analytics and patience, we believe our ability to navigate this environment and make effective long-term decisions requires that we think creatively, expand our knowledge base, continually challenge our analysis and assumptions, seek new data, and discuss our views with other experts in the field. We remain strongly committed to focusing everything we do on rewarding you for your confidence.

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