

# Walden Capital Newsletter

Walden Capital Advisors

Second Quarter 2010

The first six months of 2010 have been a bit of a roller coaster—domestic stocks were up early in the year, then down 5% by early February, then up almost 10% for the year by late April, then down nearly 7% for the year by the end of June.

Our commentary examines the economic “tug of war” being reflected in the stock market, with improving economic and company fundamentals on the one side, and concerns about debt-related stress points and the longer-term strength of the economic recovery on the other.

Our view of the big-picture environment we face in the next few years remains unchanged. The recovery continues but it is not inspiring, and we see above-average risk in spite of being early in a recovery cycle.

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## Quarterly Investment Commentary

Stocks continued their slide in June, ending the first half of 2010 with losses in every segment of the equity market. The large-cap S & P 500 Index lost 11.4% for the quarter, and is down 6.7% year to date. The small-cap Russell 2000 and Russell Midcap both lost 10% in the second quarter, though thanks to a strong first quarter, both benchmarks are down just 2% year to date. Turning abroad, the story was similarly painful. The MSCI EAFE International Index dropped 14% in the second quarter, bringing its year-to-date loss to 13%. The MSCI Emerging Markets Index lost over 8% for the quarter and 6% year to date.

Most of the positive news for the first six months of the year was in fixed income. The Barcap Aggregate Bond Index, a proxy for high-quality, intermediate-term bonds, gained 3.5% over the second quarter, and is up 5.3% for the year through June. Foreign bonds were mixed. The Citigroup World Government Bond index was flat in the second quarter, but still down 1% year to date, and although the JPMorgan Government Bond Index – Emerging Markets Global Diversified Index lost 2% for the quarter, it returned a positive 3.4% for the year through June.

## Investment Outlook

As noted in the performance review above, the first six months of 2010 have been a bit of a roller coaster—domestic stocks were up early in the year, then down 5% by early February, then up almost 10% for the year by late April, then down nearly 7% for the year by the end of June. This reflects what we see as an economic “tug of war” in the stock market, with improving economic and company fundamentals on the one side, and concerns about debt-related stress points and the longer-term strength of the economic recovery on the other. The tension between these opposing forces has left investors uncertain and the stock markets stuck in a trading range (i.e., bouncing around within a range with no clear trend). We think that unusually high uncertainty could be with us for awhile because the economic challenges we face are serious and will not be resolved quickly.

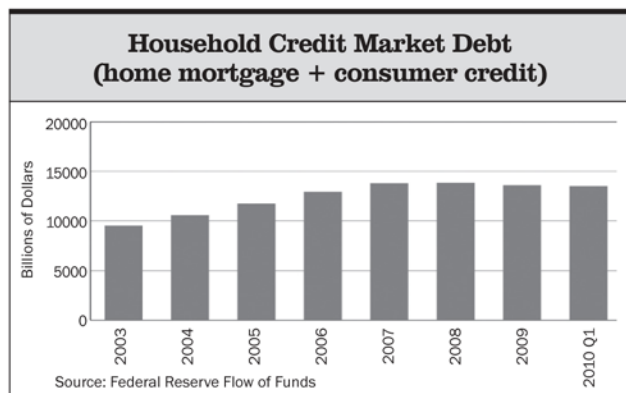
Though we won't forget the market freefall of 2008, now that there has been a strong stock market rebound from the bottom, it's interesting to compare market levels today to three years ago. Despite the rebound they continue to reflect a level of economic stress.

Investment	Time Period (6/30/07 – 6/30/10)		Comments
	Total Return		
S&P 500 (Vanguard 500 Index Fund)	-26.7%	Earnings hit/investor fear	
MSCI Emerging Markets Index (iShares MSCI Emerging Markets ETF)	-8.1%	Damage from global bear mitigated by stronger economies	
MSCI US REIT Index (Vanguard REIT Index Fund)	-23.2%	Real estate mega-bear	
Gold	91.2%	Currency debasement fear	
Yield Change			
10-Year U.S. Treasury yield	-2.1%	Flight to safety	
3-Month U.S. Treasury yield	-4.6%	Monetary stimulus	

## The Challenges We Face

It's no secret that there is too much debt in most of the developed world—the United States, Europe, and Japan. We've written about it ad nauseam. That the problem is identified doesn't lessen the challenge. In the coming years, the developed world must walk a tightrope as it deals with the pressing need to slow and ultimately reverse debt growth without also seriously harming economic growth rates.

The United States and other countries with excessive household sector debt are in the early stages of what is likely to be a long process of deleveraging. Though it is dropping, household



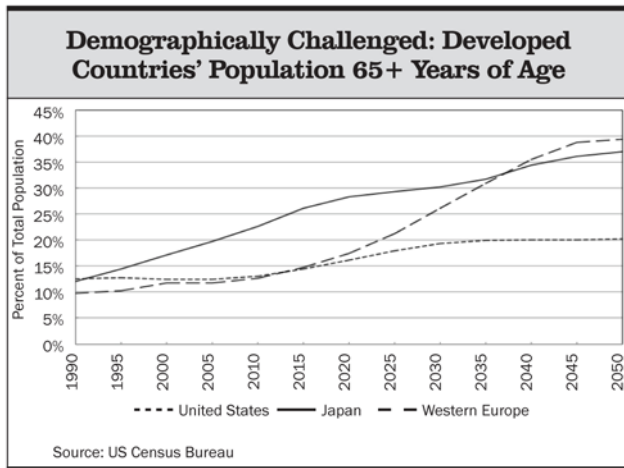
*Credit is contracting but it's been a drop in the bucket in terms of total debt outstanding (shown here) and also relative to household income (not shown).*

debt relative to income remains excessively high. Most of these countries must also dramatically reduce public sector (government) debt growth and in some cases they will need to reduce the absolute amount of debt. This huge challenge has not yet begun.

The timing and aggressiveness with which public sector debt and deficits are attacked will be extremely tricky to get right given current economic headwinds. On the one hand, too much austerity coming from very tight fiscal policy can be counterproductive because it risks smothering already weak growth, which reduces tax revenues, increases social safety net spending, and could weaken the political will that is needed to follow through on spending discipline.

But waiting too long to tackle rising debt levels digs a deeper hole and risks a lenders' strike, which could result in government borrowers (and all others too) being forced to pay a much higher interest rate to finance their debt. At the extreme, as we are seeing with Greece, debt levels become unmanageable as borrowing costs become untenable, resulting in a crippling crisis for the country and a ripple effect that in a global economy has reached far beyond Greece's borders. A critical unknown is whether enough countries, including the United States, can thread the economic needle so that the recovery has time to gain steam while maintaining lender confidence that the deficit/debt problems will be addressed over time. Slowing and ultimately reversing the growth of debt is further complicated by aging populations—a reality that most of the developing world faces to different degrees.

An aging population presents several challenges. It means that savings rates will face downward pressure as more of the population moves from working and saving to retiring and depleting savings, and paying fewer taxes given lower income. More retirees also mean more government retirement and health care expenses (Social Security and Medicare in the United States). This is fine if pensions and health care are fully funded. But that is not the case.



*A large portion of Japan's population is over 65 and the percentage will move sharply higher in coming decades. Europe's demographics are not too bad at present but are set to get sharply worse over the next 30 years. The U.S. population is also aging and though the 65+ age group will be a much large percentage of the total population in 25 years, we will be much better off than Japan.*

While the private sector gradually de-levers, and we wait for the public sector to later do the same, at least the United States is experiencing an economic recovery, albeit a tepid one. There has been clear improvement from the depths of the recession. The economic cycle is, for now, a plus, but the big problems have not been resolved.

Three variables critical to improvement in private-sector consumption and a normal recovery—the labor markets, credit growth, and housing—remain weak. We are still down about eight million jobs from the peak and in the private sector job growth is barely positive – though that is an improvement from last year. Credit market debt is contracting as it has been for about two years, which removes an important driver of consumer spending. And the housing outlook, which is critical to household financial strength and the banking sector, remains cloudy and appears to be slipping backward with an expiration of the homebuyer tax credit.

The rest of the developed world looks worse. Europe is experiencing very slow growth, southern Europe is uncompetitive and has many countries in various stages of sovereign debt crisis, and economic policy is a challenge given a single monetary policy in the eurozone, but no political union and differing economic situations.

Fortunately, key parts of the developing world are in much better shape with stronger balance sheets, higher growth rates, younger populations, and slowly emerging consumer sectors. Their strength is an important source of support for the global recovery. And there are other positives that help to mitigate the negatives. The continued impact of massive federal stimulus (though this will wane later this year in the United States), healthy corporate balance sheets and cash flow (after huge cuts to expenses), and a natural rebound in economic activity after a huge decline are also sources of strength in the U.S. and global economy.

Thus, our view of the big-picture environment we face in the next few years remains unchanged. The recovery continues but is not inspiring, and we see above-average risk in spite of being early in a recovery cycle.

### **Capturing Returns and Protecting Capital – Our Investment Posture**

Our scenario analysis approach allows us to be forward-looking so that we can factor in a number of possibilities that impact potential returns over our decision horizon, and it gives us the advantage of considering a range of outcomes when we make investment decisions, rather than requiring us to correctly identify one specific forecast.

**Stocks:** After a huge stock rebound from the market depths of March 2009, it is likely that developed stock markets will offer returns lower than historical averages over the next five years. On the positive side, we continue to have some optimism that the low-return environment may be a good one for highly skilled active managers to add value over their benchmarks.

**Bonds:** Within our bond allocation, while high quality investment-grade bonds may not offer exciting return potential over our five-year horizon, they do offer a defensive investment that could perform well if the economy is very weak or falls

back into recession. Additionally, the fixed-income vehicles we hold are more diversified and potentially more volatile than a typical investment-grade bond portfolio, as we believe these fixed-income positions will capture materially higher returns and provide much better protection against unexpected inflation and in a rising rate environment. As such, our portfolios now include the following bond sectors: foreign, emerging markets local currency, high yield and real return.

**Diversifying Strategies/Real Assets:** As we have discussed in the two previous newsletters, we continue to add funds categorized as long/short, market neutral, asset allocation, pure short, convertibles and focused long as well as funds which invest in commodities, real assets and metals because we believe they can provide some downside cushion through their relatively low correlation to stocks and bonds. In fact, these funds did hold up better than the market during the last six months' downturn.

Though we recognize a positive investment scenario is possible, as is a temporary period of strong market performance that could be driven by improving economic news and impatience with the near zero return offered by the money markets, we are not placing a high probability on a bullish environment just yet. We expect the market to have up and down cycles within a trading range. And while the story is what it is, it is also important to remember it won't last forever—there will be better opportunities at some point. We hope that some of those opportunities will come soon and allow us to perform better than what the broader markets give us. But we're prepared to be patient. In the meantime we are working hard to ensure that when opportunities do present themselves we are in a position to recognize and take advantage of them, while also being highly attuned to the potential risks in this uncertain environment.

## New Cost Basis Reporting Rule

A new rule requires custodians to begin reporting cost basis of securities sold on the Form 1099 you receive annually for tax-reporting purposes. Previously, they were only required to report the proceeds received from the sale so additional work was necessary by you, us and your accountant to determine gains and losses. Because the cost basis must now be in the custodian's system upfront, it will make things easier at tax time. This new rule will be phased in over a three year period beginning in 2011 for equities, 2012 for mutual funds and ETFs and 2013 for fixed income and options.

You may receive information on this initiative directly from your custodians so we wanted to let you know ahead of time what it was all about. We will work directly with your custodians to make sure the cost basis in their systems is accurate.

*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.*

*Our current disclosure statement is set forth on Part II of Form ADV and is available for your review upon request.*