

# Walden Capital Newsletter

Walden Capital Advisors

Fourth Quarter 2011

After huge volatility, the S & P 500 Index ended 2011 up 2% while U.S. mid-cap, U.S. small-cap, developed international, emerging markets and real assets all underperformed the S & P 500 significantly.

Returns from bond indices were higher largely due to investors' fear-driven flight to Treasuries despite the fact that yields are unattractive. Shorter-term bond returns were hurt by the Fed's Operation Twist.

Market volatility is likely to continue in both directions for awhile as we await resolution on macro challenges and uncertainties we face, in particular the European debt crisis and the unsustainable high levels of U.S. debt.

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## Quarterly Investment Commentary

Following a significant downturn at the end of the third quarter, the markets rebounded in the fourth quarter, with the majority of the U.S. stock indices up double digits and the international indices up in the low single digits for the quarter. 2011 was a disappointing year for most investors as the markets were driven by fear and uncertainty once again. The S & P 500 Index ended 2011 where it started, with its 2% return coming from dividends. Despite their large fourth quarter gains, small-cap stocks closed the year down 4.2% while mid-cap stocks were down 1.6%. Fear over Europe and slowing growth in China dragged foreign stocks down 12.1% for the year, with China concerns and a flight from risk hitting emerging markets stocks even harder; they fell 18.4%.

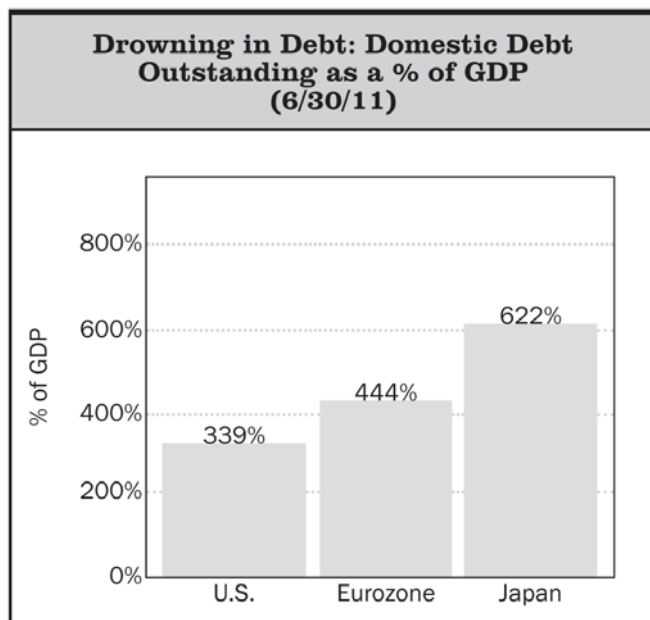
High quality bonds were on the other side of the volatility, with sharp flight-to-safety rallies that helped net the Barcap Aggregate Bond Market Index a 7.8% full-year gain. Most actively managed diversified bond and absolute return oriented funds underperformed the index as most were underweight Treasuries before the flight-to-safety mentality took hold based on the extremely low yields and unattractive fundamentals they offered. You may recall that Bill Gross, the long-time, well-respected manager of the PIMCO Total Return fund, famously sold U.S. Treasuries earlier in the year based on the fundamentals, causing the fund's annual return to suffer. Over the long term, however, Mr. Gross has had a superior track record. The returns of short-term bonds were only in the mid-1% range as the Fed's Operation Twist favored intermediate and long-term bonds over their shorter counterparts.

Over shorter periods in which investors' decisions about getting in and out of sectors are driven by macro headlines (often referred to as "risk-on, risk-off"), there is less consideration for the fundamentals of these sectors. At Walden Capital Advisors, we believe in investing in a diversified portfolio of assets based on longer-term fundamentals. Over shorter, one year periods, the diversification will sometimes help our returns and in others, it will hurt depending on how other sectors perform relative to the S & P 500. For example, in 2010, U.S. small and mid-cap, international developed, emerging markets and real assets equities all outperformed the S & P 500 and added value to the overall performance of our portfolios; however, in 2011, all of these sectors underperformed the S & P 500, some very significantly. The presence of the diversifying strategies funds, which returned a

positive one half of a percent this year, in the portfolios helped mitigate some of the losses from the allocations to the other sectors. Over the long term, a diversified portfolio has proven to have a favorable risk/reward tradeoff and that is why we believe in this method of investing. The market is currently dominated by short-term trading rather than long-term investing. The key right now is for investors to have patience as we wait for the market to perform based on fundamentals rather than fear and let things reverse out.

## Consequences of High Debt Levels

As most of the developed world struggles to dig out from under a mountain of debt, all options involve economic pain that is compounded by political uncertainty. Having hit debt levels that are unsustainable, deleveraging (debt reduction relative to GDP) is necessary. Ideally this comes from economic growth—increasing the denominator in the debt/GDP ratio. But when debt is so high, it becomes a headwind to growth. Governments try to use fiscal stimulus to counterbalance the private sector's retrenchment, but this can only continue for so long, as increased government spending/stimulus adds to the growing burden of public debt. So, that leaves spending reductions and tax increases as solutions at the government level (austerity), or some degree of debt default. Default can happen in two ways: (1) not repaying debt, or (2) creating inflation by "printing" money so that money is devalued. Both of these options create other problems.



Sources: U.S. Federal Reserve, Bank of Japan, and Eurostat.

Governments can also attempt to force "financial repression," where they use all possible tools to keep interest rates low. This serves several purposes including keeping their borrowing rates low so that the debt-service burden does not explode to impossible levels. For investors, this means low returns from fixed-income investments.

The lesson from economic history is that, without exception, a debt-induced financial and banking crisis results in a lengthy period of subpar economic growth. This is exactly what has been happening throughout the developed world economies since the 2008 financial crisis. Weak economic growth leads to periodic recession fears and unacceptably high unemployment. Moreover, high debt levels mean that we will likely be living with these macro-level risks for at least a few more years. If that is right, it is probable that we will experience: (1) continued high financial market volatility, and (2) reduced investor risk appetites, meaning lower prices for risk assets like stocks and high-yield bonds than would otherwise be the case.

## Risk and Uncertainty Still Exists

There are many debt-related risks in the world today. Europe is an obvious big concern in the near term. What we're seeing in Europe is that investors are afraid that the region lacks the political unity and possibly even the financial capacity required to provide a sufficient financial backstop for the Eurozone. That increases the risk of weaker governments defaulting on their debt, which makes investors demand higher yields for taking on that risk. Those higher yields contribute to an adverse feedback loop that makes a default even more likely, because governments can't sustain interest payments above a certain level, so only some type of unified policy action and intervention can allow governments to roll over all the debt that is coming due.

Most economists now view recession in Europe in 2012 as almost certain. European authorities have so far been ineffective in containing the crisis through incremental steps. The worsening of the crisis actually increases the likelihood that the European Central Bank will finally step in more decisively and provide major support for the sovereign debt market

and the banking system, e.g., by buying Italian and Spanish government debt via “quantitative easing” (much as the Federal Reserve has done with Treasuries) to bring down interest rates, restore confidence, and break the debt-contagion adverse feedback loop. But, this is not certain and the question is whether they will do it in time to avoid a serious economic downturn. The costs of a European Union break-up are high so there should be strong motivation to avoid it, but the political and practical realities are highly complex.

While Europe is the imminent risk, there are other areas of concern. The U.S. economy, though still weak, has performed somewhat better recently and appears to have moved back above stall speed. But, 2012 will be a year of fiscal contraction with the amount still uncertain as we write this. If a European meltdown can be avoided, it is expected that the United States will continue its slow expansion, but our own maddening political dysfunction, severe debt problems, and continued housing weakness makes the United States susceptible to economic shocks and policy errors.

China’s economy is slowing and the authorities are now moving to stimulate growth. The question is whether China will be able to avoid a sizable slowdown in growth (a “hard landing”). Concern exists because of the importance of China’s impact on global growth, which has been disproportionate to their portion of the global economy. (Based on World Bank data, in 2010 China accounted for almost 20% of global growth.) Finally, the possibility exists of rising Middle East tensions (with Iran specifically) driving up the price of oil.

## **Looking forward**

No environment has been more challenging than the recent financial crisis and the aftermath that continues. The weight of the evidence suggests to us that it is right to be cautious, but there are bullish arguments worth examining. By far the strongest bullish argument, in the short run, is that authorities will do whatever it takes to avoid financial catastrophe, and therefore there will be much stronger steps taken in Europe. For example, if the European Central Bank undertakes major quantitative easing as discussed above, global

stock markets could experience a massive rally. If this coincides with continued improvement in the U.S. economy, 2012 could turn out to be a very good year for the stock market. That could happen because a second bullish factor is that companies have piles of cash and are ready to spend it if uncertainty declines or demand increases. So, if policies are pushed forward that reduce some of the biggest risks, we could see companies loosening up their purse strings. This could be a positive double play for the economy and markets—as we’d have both policies that reduce uncertainty and a business sector that is poised to expand.

There are many serious known issues yet to be resolved, and there are always unforeseen events affecting the markets each year. We expect continued volatility this year as investors react to headlines and engage in short-term trading rather than long-term investing based on fundamentals. Eventually we will have more clarity on the resolution of these uncertain issues and then those who invest based on longer-term fundamentals will be appropriately rewarded. For now, we recommend patience as the U.S. muddles through its economic recovery. We are hoping for help from our government leaders so that we can avoid a repeat of the situation we had this summer when their lack of action due to partisan bickering created a crisis of confidence and made things so much worse than they had to be. We are also hoping for a timely and orderly resolution to the European debt crisis that is the biggest risk factor looming out there at the moment. Things will get better eventually. It is just a question of when and at what price. We encourage our clients to have patience in the wake of the volatile times in which we live – we believe it will serve you well.

*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 Form ADV Part 2 and is available for your review upon request.*