

**Our Portfolios and Lives in This Time of Crisis**

By Meir Statman, Glenn Klimek Professor of Finance, Santa Clara University



Courtesy: Santa Clara University

We are living in a time where each economic shock is rapidly followed by a bigger shock and each fear by bigger fear. At the end of 2008, we were reeling from the shock of decimated portfolios, and now, just a few months in to 2009, many portfolios have been decimated even further. At the end of 2008, we feared global depression, and now we also fear a greater intrusion of the government into our lives and businesses, perhaps even the nationalization of some companies. We fear for our dreams of comfortable retirements and opportunities to pay for the education of our grandchildren. We worry about our jobs and the jobs of our children.

The media inflame our fears and magnify our confusion. Forceful commentators offer magical solutions or doomsday predictions. Some say that the government should get out of the way and let the free market sort out the economy, even if unemployment soars to the levels of the Great Depression. Some say that all existing banks should be jettisoned and replaced with new banks, even if it brings a halt to the meager lending of our existing banks. We have even heard a Russian economist predict that the United States will soon disintegrate, just as the Soviet Union disintegrated two decades ago.

This is a time when knowledge, clear thinking, and emotional control are most needed, yet it is a time when ignorance, ideology and destructive emotions seem to predominate. I want to share with you my perspective, the perspective of an economist. I believe that my perspective is informed by knowledge, clear thinking and emotional balance.

I do not know your political party, nor do I know whether you voted for John McCain or Barack Obama. But I know well the work of some of the economists who are helping President Obama chart his economic and financial course. They include Larry Summers, head of the National Economic Council, Christina Romer, chair of the Council of Economic Advisors, Paul Volker, chair of the Economic Recovery Advisory Board (and former chair of the Federal Reserve Bank in the Reagan administration) and Ben Bernanke, the current chair of the Federal Reserve Bank. Each is a superb economist with extensive knowledge of economics and crisis economics. I trust them to get us out of this crisis and bring us back into prosperity through stimulus spending, a rebuilt banking system and a restructured regulatory system.

Going from crisis to prosperity will take years, not months. But I believe that we are on our way. Our economy is in the worst fall since 1982, but we weathered the 1982 recession, and we will weather the 2009 recession.


I want our country to work, with a vibrant economy and financial markets. I am confident that it will.

You might object, noting that the stock market plunged at the beginning of 2009 during the first few months of Obama's presidency. You might add that the stock market plunge was

especially deep on the day Timothy Geitner, Obama's Secretary of the Treasury, presented his economic plan. You might say that the stock market seems to decline every time the President or anyone of his staff is speaking. But you should also note that not everything that is good for us as stock market investors is good for us as taxpayers. Geitner's plan was not as generous toward banks as we, in our roles as investors, might have hoped. So bank shares declined. But Geitner's plan was more prudent toward us as taxpayers...by being less generous toward us as investors. Moreover, we should have learned long ago not to read much into day-to-day ups and downs in the stock market.

Moreover, our recent experience with banks and automobile companies suggests that while the government is not always wise, free markets are not always populated by geniuses. The checks-and-balances system in government is good for markets, and sometimes regulation serves us well. For example, Canada stands further along the line toward socialism than the U.S. After all, Canada has nationalized health care. Yet Canadian banks are some of the strongest in the world, offering profits rather than seeking government bailouts. This is because, operating under a stricter regulatory environment, Canadian banks acted more conservatively than U.S. banks. They examined their borrowers' ability to pay before extending loans to them and held the mortgages they issued, rather than bundling them into exotic securities.

Financial advisors in the U.S. are prohibited by regulation from recommending unsuitable investments to their clients, such as a volatile stock for a very conservative client. This regulation may be paternalistic. However, suitability regulations do not apply to mortgages. A mortgage broker violates no regulation when he offers a homebuyer a mortgage with zero down-payment, even if the homeowner has no income and no assets. The mortgage industry continues to resist extending suitability regulations to mortgages. But it is hard to see how we would not have been in a better place today if suitability regulations had been in place and prevented the issuance of so many of the subprime mortgages which served as the match which ignited our current economic crisis.

We all know the terrible injuries this gigantic global economic and financial crisis has inflicted on our portfolios and the economy so far, and we fear that more harm awaits us and our families. This is a time when knowledge, clear thinking, and emotional control are most needed. I trust the knowledge, clear thinking and emotional control of the economists who advise President Obama. I am fairly certain that this year and possibly even 2010 will not be easy, but I believe that in a few years we will see not only that our crisis is over, but also that we have used this crisis to improve both government and markets so they do their work better, fostering prosperity and banishing fear. 

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## In Search of a Silver Lining

By Joni L. Clark, CFA, CFP®, Chief Investment Strategist, Loring Ward

With the seemingly endless flow of bad news about continued market declines, a struggling economy, corporate and government missteps, and fraud, investors understandably feel fearful. These are undoubtedly trying times for all investors and for all Americans — almost no one is immune from these issues. As difficult as it is, we must accept what has happened and turn our attention to our collective future. Our country's resilience through other difficult periods gives us hope and optimism that today's issues will also pass.

Finding a silver lining in your investment portfolio may be difficult if you experienced significant declines last year. You may even be questioning some of the academics, research, and disciplined approach that are employed in managing your portfolio. That's completely normal, considering what we've gone through in recent months. However, you should also recognize how the *Structured Investing* approach may have helped to mitigate, or even avoid, many of the issues that other investors have experienced.

### Diversified Portfolios are Down but Not Out

Some pundits have argued that the traditional benefits of diversification evaporated during 2008's steep market declines. We believe, to the contrary, that this downturn provided a powerful example of the real benefits of diversification. While there were considerable declines in the equity markets and even some fixed-income markets, these declines were not all of the same magnitude, and high-quality bonds actually performed quite well. All fixed income investments involve some degree of risk of price declines and fluctuations in value because of changes in interest rates, but some are subject to greater credit risk, or risk of default. Some investors took excessive credit risk in search of higher yields in their fixed income portfolios. This subsequently led to substantial losses during the credit crisis as lower quality bonds experienced severe illiquidity and price declines.

The role of fixed income in *Structured Investing* portfolios is to help reduce the portfolio's overall risk to a level appropriate for each investor's situation. Our goal is not to enhance portfolio returns using fixed income — it's a risk we don't believe is worth taking. High-quality, short-term, diversified fixed income funds did exactly what was intended — they helped to protect portfolios from equity market declines when they needed it most. These benefits are illustrated in the *Asset Class Index Performance* chart on the preceding page. However, it is important to note that diversification cannot guarantee a profit or protect against a loss. The performance of an asset class or the return of a portfolio will vary over time and past performance is not indicative of future results.

*Structured Investing* portfolios are broadly diversified across thousands of global securities, reducing the impact of individual company failures. Investors who held concentrated stock portfolios with large positions in stocks like Fannie Mae, Freddie Mac, AIG, Lehman (GM) may have suffered more substantial, or even total, losses during the financial crisis. Just a few months ago, these same stocks were considered by many "experts" to be relatively safe and conservative.

The way in which your assets are held (at your custodian) is also important. Like holes in the roof when it rains, economic crises tend to reveal investment frauds and deceptions. The prototypical example of this is Bernie Madoff's elaborate Ponzi scheme, which came to light when the downward pressures of the market made his particular deception (which relied on constantly bringing in new money) unsustainable.

Lack of transparency and regulatory oversight is one of the biggest risks of investing in private investment vehicles. It is often difficult to know exactly how or even where your money is invested (rule of thumb: avoid any money manager who can't or won't tell you their investment methodology).

As we saw with Madoff, this can result in massive and permanent investor losses — money that's not likely to be recovered. The use of an independent custodian (such as Schwab, Pershing, State Street or Fidelity) helps to mitigate these risks. And the transparency, multiple layers of monitoring and regulatory oversight built in to *Structured Investing* significantly reduce the chance of fraud and deception.

### Looking Forward

In these times of turmoil and uncertainty, it is easy to become emotional about our investments. We may feel the need to *do something*. When you feel emotional because of stressful market conditions, it may not be a good time to make important investment decisions. Rather than focus on daily or weekly market movements, look at the bigger picture to be sure that you are able to meet your long-term goals. Now is a good time to review your long-term plan with your Advisor.

Any changes to your portfolio should be in line with your long-term goals and with the guidance of your Advisor. Changes should be based on a fundamental analysis of the facts, not fear and panic driven by volatile markets.

### Reasons for Hope and Optimism

Optimism about the future is important because it gives us reason to keep going in the face of difficulties. While it may be a bit early for outright optimism about the markets, there are factors that could benefit investors in the years ahead.

One silver lining in the recent stock market decline is that it has brought stock prices to levels that are actually more promising for long-term investors. Stock prices may continue to decline, but they are now cheaper than they have been in more than a decade. We don't know exactly when we'll hit the bottom, but we are certainly closer to the bottom today than we were a year ago.

Another silver lining is that the recession began over a year ago. Historically, markets have generally turned around before the economy. Global markets are a reflection of expectations about how things will be in the future. For example, the price of a security is based on the projected future earnings of that company. The market anticipates changes faster than economic figures are reported. And remember, economic data is generally backward looking.

The willingness and ability of the U.S. government to act swiftly and provide the necessary stimulus should also give us comfort. Will the *2009 American Recovery and Reinvestment Act* work? Of course we won't actually know for a while, but the stimulus package is targeted to reduce the severity of the recession.

We can also take comfort in the fact that the federal government and central banks have gained insights from the Great Depression and from the painfully slow unwinding of Japan's real estate bubble in the 1990s. Though each of these periods in history has its own unique set of circumstances, we've learned that the actions required to adequately address problems of such magnitude should be swift and substantial. Thus far, the world's central banks indicate that they understand this. The U.S. appears to be instituting a number of coherent strategies aimed at revitalizing bank lending. There are some positive signs of thawing in the interest rates banks charge to lend money to other banks, suggesting the current tight consumer credit markets may be easing.

We've been through market declines before — 14 times in the past 100 years. Just as other market declines were followed by market recoveries, it is let's hope that this "Great Recession" will also have its market recovery sooner rather than later. ☺