



## Quarterly Commentary Winter 2008

Coming fresh off my tardy Fall report I bring you an early Winter report so that, on average, I am right on schedule. Let's review the state of the markets by playing a fantasy version of the game known as:

### DEAL OR NO DEAL

Many, if not all of you, may be familiar with this popular NBC game show if for no other reason than to check out the models holding the briefcases ... but I digress. My fantasy version has a few different rules and is only played once per year. Each year our host, Howie, tells our player (who we'll just call Cramer for the heck of it) two or three things that will take place over the course of the next year and then asks if Cramer would like to accept market returns (whatever they might be) or some fixed guaranteed return offered up by the Banker.

Let's look back a few years ago and see how the episode filmed in January 2000 went. A brief recap is that Howie told Cramer there would be many corporate accounting scandals mid-year and that the Internet Bubble would burst. Howie offered Cramer a 5% guaranteed return or he could take whatever the market offered. Now Cramer, being no investment slouch, knew that it was a New Era in the economy. That This Time It Was Different. Stocks were going up 30% per year with no end in sight. Who cared if the Internet Bubble burst, a moron can make 15% in this market. And so, Cramer passed on the 5% guarantee and went on to lose over half of his portfolio which was over-weighted in New Era Technology stocks.

Fast forward to 2003 when our host tells Cramer that during 2003 we would go to war with Iraq but we would also get a substantial tax cut. Cramer's choice was between market returns or a guaranteed 10% return. Now Cramer, still smarting from his 2000 mistake, knew a good deal when he saw one. War was never a good thing and there was no way a tax cut with our already-too-big deficits could help things out, so he went with the 10% return. And, once again, chose the wrong option as a well diversified portfolio with international exposure rocketed up 45% in 2003 as the tax cut fueled the stock market not only in 2003 but for several years to follow.

Now as we get ready to film this year's episode, let's look back at January 2007. Howie provided Cramer with some distressing tips of the year to come. By year end, oil prices would

surge to \$100 per barrel, roughly twice what they were in January 2007 and that Citigroup, one of the largest, if not the largest, financial services company, would see its stock price drop in half by the end of the year. Howie offered Cramer the choice of Market Return or a Guaranteed Loss of no more than 10%. Cramer, our sharp contestant, knew that markets did not go up each and every year. He knew that historically they are down once every four or five years. 2003 through 2006 had been great years. Even if he did miss out on 2003, he rode the market in 2004, 2005 and 2006 and now was playing with a lot of house money. Howie's description of the year 2007 seemed as close to Financial Armageddon as Cramer could imagine. He could only guess the devastation to the economy that must have taken place with oil going to record highs. He was surprised only that Citigroup managed to salvage half of its value. 2000 all over again for sure. While Cramer didn't want to give up 10% he also didn't want to lose everything. After all, 90% of what he had was better than 100% of a bunch of worthless stock certificates. And so Cramer took the painful, but bearable loss, to escape whatever returns there would be.

Alas, Cramer chose wrong again. But can you blame him? What would you have chosen? Even armed with foresight like Howie's (which sadly none of us, not even Cramer, has) it's nearly impossible to guess what the market will do in a short time span of one year. 2007 being a great example. Even though certain segments of the market dropped, others had a profitable year. On average, it was a year where a diversified portfolio experienced a little gain or a little loss. In spite of \$100 per barrel oil and a sell-off of the financial services sector, the economy remained surprisingly strong.

The year 2007 consisted of great swings in the markets on a daily basis. Up 2% one day and down 3% the next. A great first quarter, interrupted only briefly with what looked like an implosion of the Chinese market that turned out to be a mild case of indigestion, set the stage for what looked to be another great year. [Editors Note – I know I covered some of this in my last report, but hang in there with me. It bears repeating.] The second quarter went straight up extending the gains into July where the markets brushed up against record highs. And then the Housing Bubble burst. We knew it was coming. It had been predicted for two if not three years. But it came in a way that nobody expected. It didn't occur because buyers decided home prices in the most expensive markets were too high. It came from the bottom up as our financial lexicon gained a new word – Subprime. So it wasn't the high price of homes that necessarily burst. It was the fact that too many people had gotten too much money at too little interest and the tail wind that was driving housing prices from the bottom up shifted to a gale force headwind. It didn't just affect California and Florida. It is taking its toll everywhere including the Cedar Valley. (But this too shall pass. This is a short-term, not a long-term, problem.)

And the market dropped precipitously throughout August. It looked like there would be no bottom. But there was. And thanks to intervention by the Federal Reserve the markets rose in September and October with the Dow Jones Industrial Average and Standard & Poors 500 both reaching all time highs and NASDAQ hitting levels not seen for seven years. And then right when it looked like it was safe to go back in the water, the steepest and deepest drop in five years hit. Disaster right? Seemed like it at the time. Markets were dropping daily, percentage point after percentage point.

And that's when, at the very depths of the drop, things were put back into perspective for me. I was watching the financial news. (Please don't do this at home. Only seasoned, if not delusional professionals, with vast quantities of antacid should watch CNBC.) It was then that the panic-stricken commentator announced that the market had dropped so far that it hadn't been this low

since ... (drum roll please) ... April 21<sup>st</sup>. And I remember thinking “this past April 21<sup>st</sup>? I don’t remember the world at the verge of collapse on April 21, 2007. I wondered if they had gotten the year wrong. But they hadn’t. You mean the worst they can come up with is the market is back to where it was seven months ago? I can live with that. I can move-on-with-my-life with that. I can quit-wasting-my-time-watching-CNBC-and-being-concerned-about-the-market-on-a-daily-basis with that.

And finally, just for good measure, the markets bounced up in December and then dropped again to close out the year.

Here are the results for those keeping track at home: Large stocks did fairly well, all things considered, with the S&P 500 up about 5% for the year. “Growth” stocks did great (it’s about time). The corollary is that “Value” stocks did not (somewhat due to the hits financial stocks took, most of whom were “value” stocks.) International stocks did very well and Emerging Markets continued their torrid pace although with signs of cooling late in the year. Small Cap and Real Estate funds gave up some of their great gains achieved since 2002.

As you may know, we believe in diverse portfolios with emphasis on Value and Small with a dash of Real Estate. That is because long-term historical and expected returns favor those asset classes. But it doesn’t happen every year. For the first time since we started managing money for clients, our clients did not do as well as the Large Growth stocks that dominate most portfolios. And that’s okay. It’s actually expected. It’s actually welcomed. The natural order of things is working just like it is supposed to. And also, now, Value, Small and Real Estate are all on sale. A great time to stock up, but more on that in another Commentary.

So while 2007 may have been disappointing for many, it is only one year. We did not buy stocks in 2002 – 2006 with the intention of selling them in 2007 or even 2008. Their prices today are irrelevant. What is relevant is their prices 10, 20 and 30 years from now. And that’s what we invest for and we won’t be distracted by a short-term and temporary drop in markets along the way.

I don’t want you to think I am making excuses for 2007. No apologies offered here. What I hope to offer is perspective. And for long-term investors 2007 is a non-issue.

And now the part you have all been looking forward to: Howie and Cramer and Deal or No Deal for 2008.

I am not exactly sure what tidbits Howie will pass on to Cramer, but I wouldn’t be surprised if Howie utters the “R” word. That’s right Recession. (Shhh! Shhh! Don’t mention that word out loud in mixed company! You’ll cause a panic! The markets are skittish enough!)

Because what we are most likely seeing now is that enough people have been predicting that we are either headed into a Recession or that we are already in one, that it is becoming a self-fulfilling prophesy. Technically speaking, a recession is defined as two consecutive calendar quarters of Negative Growth (There’s an oxymoron for you. Why don’t they just say Positive Shrinkage?) in the US economy. So far, if you are still playing along with me, you will note that we have had a total of ZERO consecutive quarters with negative growth through the last quarter of 2007. None. Zilch.

But here's the spin on Recessions even our make-believe contestant, Cramer, knows. We have had 12 of them since World War II. That's an average of one every five years. We haven't had one for six or seven years. Ya think we're due? And they tend to last six to twelve months and the stock market tends to drop on average 25%. Well, as far as I can see the market is already halfway there so if we have a Recession coming let's get it over with and move on.

I have no clue whether or not we will have a recession in 2008. I don't say that with regret. I say it with apathy. I DON'T CARE whether or not we have a recession in 2008. The reality of recessions occurring on a regular basis is already planned for in your (and my) portfolios.

I don't care about recessions because there is one other "R" word that our game show host Howie might whisper in Cramer's ear this episode. You haven't heard anybody in the news mention it and I guarantee you won't, not at least for some time. And that "R" word is Recovery.

Because Recovery is the kid brother of Recession. Where the older brother goes the younger one tags along. Inseparable. One leads the other. Always has. Always will.

Recoveries not only recapture the declines of the Recession but almost always launch the markets to new all-time highs.

Funny thing about Recessions and Recoveries; one thing they both share. You don't know you're in 'em until it's too late to do anything about it. It applies to trying to get out of a Recession before much damage is done as well as trying to get back into a Recovery before most the gains are taken. It's easy in hindsight to know what to do or what to have done but try and try again, nobody has figured out how to do it with foresight. Nobody.

Recessions and market drops are nothing to fear. They are a normal part of the markets and are absolutely required in the short-term in order to provide the substantially higher long-term returns that stocks enjoy as compared to "safe" investments such as bonds and CD's.

So here's what I leave you with for 2008. Not a Prediction as much as a Core Belief.

"Where Recession goes, Recovery is close behind."

Be well,

Robert M. Heaton, CPA CFP  
Investment Advisor Representative