Market Review and Outlook—October 9, 2008

Mallard is finishing its twelfth year; my family portfolio had its second worst month in September (only August 1998 with the Asian flu was worse), and the past quarter was the fourth worst quarter (one during the Asian flu and two during the dot com meltdown). This was the worst quarter in 12 years for the Salomon bond index, which fell 8.54%.

The table below shows broad-base losses. In July, the table showed a 13.4% annual gain for foreign stocks in the past three years. Now that figure is down to 1.4%, due to a 20.7% decline during the quarter. Natural Resource (energy) funds saw a similar fall to earth, due to their 32.6% decline during the quarter.

The world changed over the past three months. Oil, which had been steadily rising upward, cratered over one-third, due both to reduced consumer demand (through conservation), a modest hurricane season, and a much lower global economic forecast. Large banks have failed or have been acquired to avoid failing. GSE (Government Sponsored Entities) Fannie Mae and Freddie Mac have both been financially supported (bailed out) by the federal government, along with insurance giant AIG. A hastily-arranged shotgun wedding was created to save Merrill Lynch. In September we learned that we were on the brink of economic paralysis. The Administration and Congress worked on a bailout/rescue bill to resuscitate the country's financial institutions, with taxpayers picking up an unknown tab which could approach $1 trillion. We have just learned that foreign economies are suffering from problems quite similar to our own, and may need to undertake the same type of 'heroic measures' as the Fed, Congress, and the Administration have taken earlier this year. Consumer confidence is lower than it has been for the past thirty years, 60% of Americans surveyed expect that the country is entering a Depression, and screaming TV personality Jim Cramer is ranting that investors (who need money in under five years) should sell their stocks now, all of their stocks.

The table below shows that stocks have lost 19 to 30% in the past year. Traditional investments used to diversify a stock portfolio (real estate funds, natural resource funds) have fallen almost as much. Adding insult to painful injury, even bonds have lost money. The only safe havens in the past year have been inflation-linked and other government bond funds.

Investors should try to maintain their sharply injured allocations to stocks—as crazy and foolish as it feels. This is the exact time when it pays investors the most to stick to their plan—when it is the hardest to do. And it's hard, very hard.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Intermediate Term Bond	-3.65%	-2.45%	+1.48%	+2.15%	+4.09%
Intermediate Muni Bond	-2.48%	-1.34%	+1.52%	+1.97%	+3.37%
Large-Cap Blend Stock	-10.21%	-22.45%	-0.45%	+4.84%	+3.61%
Mid-Cap Blend	-11.51%	-21.78%	-0.33%	+6.81%	+7.94%
Small-Cap Blend	-5.55%	-18.87%	-0.13%	+7.76%	+9.01%
International Stock	-20.73%	-30.24%	+1.36%	+9.24%	+4.84%
Real Estate	+2.25%	-14.46%	+3.41%	+11.62%	+12.11%
Natural Resources	-32.56%	-16.70%	+4.76%	+19.44%	+14.53%
Science/Technology	-15.24%	-27.89%	-1.74%	+2.76%	+2.49%
Morningstar US Growth	-15.89%	-22.91%	-0.75%	+3.11%	-0.93%
Morningstar US Value	-4.67%	-25.08%	-0.45%	+7.27%	+5.33%
Balanced—Conservative Allocation	-6.41%	-10.32%	+0.84%	+2.97%	+3.49%

The data in this table comes from Morningstar Advisor Workstation™.

“It’s déjà vu all over again.” I looked at the Market Review from October 2002. In the three years through September 2002, the S&P 500 was down 34% and foreign stocks were down 38% (does this sound familiar?). **Yet investors who did not sell their stocks at that troubled time were well rewarded.** In the five years through September 2007, US stocks more than doubled and foreign stocks rose over 170%.

What is the right reason to sell stocks? You sell them when they are overpriced, after they have risen sharply. Some of this process occurs simply with periodic rebalancing. The rest of this process comes from examining the overall market and observing when markets (large US stocks, foreign stocks, etc) appear to be overpriced.

What is the wrong reason to sell stocks? It is wrong to sell stocks when they are underpriced, after they have fallen sharply. It was smart to sell stocks in early 2000, and wrong to sell them in late 2002. Just as it was wrong to sell stocks in late 2002 (due to the current worries of the day), it is wrong to sell stocks now, in late 2008. The damage has been done, or at least most of it. Stocks went from reasonably priced a year ago to exceptionally underpriced now. This is the worst time to sell stocks.

Stocks do not start to fall after investors are pessimistic; they start to fall when bad news surprises investors who thought that all was going well. Stocks do not start to rebound after investors are optimistic; they start to rise when good news surprises pessimistic investors, those who had felt that all was going poorly, like today. There is a lot of bad news on the horizon; investors are fearing the worst. In the past, this coincides with being near the bottom of a stock market decline.

The US economy is expected to stall later this year and the first half of 2009. That, however, is already reflected in the prices of US stocks. The Vanguard Index 500 fund is down 35% in the past year. Yet the US economy, as measured by the GDP, is not down 35%—it isn’t even down 3.5%—it is actually up 4% in the past year. Stock markets reflect the underlying economy, but **stock markets move first**—they rise and fall **before** the economy does, usually by six to twelve months. The 2008 market decline ‘predicts’ the economic slowdown that has just begun. Thus US stock prices should rebound late this year or early in 2009, if we still expect the economy to begin to recover by late next year. At least this would be the case if investor fear was less rampant. Emotions (greed and fear—fear in this case) have trumped economics this year, and until investors make more decisions with their heads than their hearts, we won’t be able to rely heavily on ‘rules’, such as those that tie the direction of the economy tomorrow to the direction of stock values today.

There is a fire sale on stock investments at this time. While there is significant bad economic news in the US and abroad, there has been overwhelming declines in stock prices, well in excess of any economic justification. Today’s stock investors, whether holding US and foreign stocks bought in the past or purchasing stocks today, are owning stocks that are strong bargains. We haven’t seen this level of low stock prices since the depths of the dot com meltdown six years ago. Investors then were well rewarded for their faith, for disregarding the fear and pessimism which was widespread in 2002, and is widespread now.

Stocks are cheap. Really cheap. Unlike earlier in the decade, this time stocks did not begin their fall from an overpriced starting point—**this was not the bursting of a bubble**. This time stocks fell 35% from near-normal values. That would make sense if the economy was mortally wounded, if 35% of the country disappeared (everything west of the Rockies slid into the Pacific), or if Microsoft, Walmart, and every technology and retail company in the country went bankrupt. That did not happen. The magnitude of our economic weakness does not justify the magnitude of the stock market losses—this was driven more by emotions, by investors’ panic. There are lots of reasons to be concerned, but there are also reasons to be hopeful.

There are several positive factors on the horizon. In less than a month, investors will know who will be the next President, and will be able to plan for the likely direction in public spending (which industries will benefit and which will not) and in the direction of income taxes. The Fed, the US Treasury, Congress, and foreign central banks and governments have taken significant steps to help the global financial industry recover from the crippling impact of the housing industry meltdown and subprime crisis. These steps take time to produce visible progress, but progress will come. IBM yesterday announced that its sales and profits rose in the past quarter.

Stock investors have a tough enough time having markets rise and fall with the economy. At times this takes a back seat to the impact of investor’s emotions, which are very low now, and which have turbo-charged the stock market declines. This will turn, and when it does, **stubborn stock investors will be rewarded**. Are you stubborn enough?