

## TURBULENT TIMES

As our old friend George Leylegian reminded us in his most recent letter to clients “Since 2000 cash has outperformed equities both in cumulative and absolute results.” Actually, the S&P 500 has returned 1.66% per year from January 2000 -December 2007 and 3-month T-bills have averaged 3.40% per year. Ten dollars (\$10.00) invested on January 1, 2000 in the S&P 500 turned into \$11.41 by the end of 2007 and \$10.00 invested in 3-month T-bills turned into \$13.07. George’s firm has never had a negative return for any calendar year in its 27 year history and I am sure no other large cap growth manager can say that. As his current market prognostication goes he quotes Margo Channing “Fasten your seatbelts! It’s gonna be a bumpy night!” Or, as his dad says, “Save your money kid!” George’s father founded the firm many years ago and counts among his closest friends Sir John Templeton.

Our clients, or most of you, lowered your equity allocation in the Spring of 2000 and increased the allocation in 2004, and added energy, real estate, emerging market debt and commodities to your portfolio. These tactical allocation moves in the equity portion of your portfolio resulted in much better returns than the S&P 500. In addition, where it was appropriate you moved your bond allocation to money market in 2006 when the yield curve inverted as a result of the Fed raising the Fed Funds rate to 5.25%. After the Fed started reducing the rate late last year we recommended moving back into bonds and this has paid off as the Fed continues to lower the Fed Funds rate.

Looking forward, the question now is what, if anything, should you do now that we have this sub-prime mess created by greedy Wall Street investment firms and irresponsible mortgage lenders.

Van Hoisington and Lacy Hunt, Ph.D., two really smart guys at Hoisington Investment Management in Austin, Texas, believe we are in for a recession. They say, “Present circumstances suggest that a quick resolution by monetary and fiscal authorities to overcome these economic conditions is overrated.” They say that even with 90% of the population with jobs, that there will be downward pressure on corporate profits and inflation creating an environment of increased risk of recession, not inflation. If commodity costs manage to rise in this environment, they increase the risk of recession, not inflation. Finally, the intersection of supply and demand for credit will be lower, suggesting a period of sustained low interest rates.

James W. Paulsen, Ph.D., Chief Investment Strategist at Wells Capital Management, another smart guy, makes the following points:

Throughout this decade, calls for imminent consumer death have been prevalent and persistent. Four major concerns swirl about the household sector:

- 1) Will falling home prices cause consumers to slow spending? If housing prices declined 20% from peak levels, they would return to levels first reached in the summer of 2004 and would still be almost 55% above their level at the start of the decade.
- 2) Will higher energy prices finally take a bite out of spending? Overall energy cost as a percent of household disposable income is still only about 6%, only a little different that it has been since 2005 and still far below peak levels of the early 1980’s.
- 3) Will job creation grind to a halt? Ultimately the outcome of the housing crisis will be

determined by jobs. Annual job growth has slowed to about 1%, down from a peak growth rate of about 2% in mid-2006. The unemployment rate, even at 5%, is not high. Household incomes are being bolstered by healthy wage gains and by solid workweek and overtime hours.

- 4) Have the lack of savings and high debt loads finally caught up to the consumer? Even though debt loads are high and savings are low, the financial situation surrounding the consumer is not disastrous. Interest rates remain near four-decade lows, most still have a job and enjoy solid real income growth, core inflation remains low, stock markets remain near highs and household liquidity remains surprisingly healthy.

Barring an outright recession which would cause earnings to plummet, the stock market is poised for a fairly good year. At about 16X this year's estimated earnings per share, the S&P 500 sells at an attractive valuation.

Barron's, dated January 14, 2008, conducted its annual Roundtable survey. The Roundtable includes some of the brightest and most experienced people in the investment industry, like Bill Gross of PIMCO, and Abby Joseph Cohen of Goldman Sachs. Bill Gross agrees with Hoisington that we will have anemic growth or a mild recession in the economy, job creation

and wealth creation. Abby Joseph Cohen says we will avoid a recession and things will start looking better toward the end of 2008. She forecast the S&P 500 will be at 1675 at the end of 2008 and the Dow at 14,750. Now that would be something.

The question was what, if anything, should our clients do about all this? Should they run and hide in bonds or money market because the "sky is falling" or increase equity exposure because of a great buying opportunity? Our position at Monroe Vos, at this point, is stay the course. We will be revisiting each client's current allocation in the first quarter meetings to make sure your allocation is appropriate for the type of funds you are investing and your risk tolerance. Pension plans, profit sharing plans, endowments and foundations are long-term investments and the allocation should reflect this. We will revisit allocations to see if you are comfortable. 401(k)/403(b) plans should do nothing. Remember that a falling stock market allows participants to buy stocks on sale with their monthly deferrals. This is a good thing because "bear" markets historically do not last very long. The allocation for high-net-worth individuals varies case by case. Our high-net-worth clients have been positioned in the right sectors for the last four years.

We look forward to seeing you at our next meeting.

Jamison Monroe, CIMA  
Chairman & CEO