FOURTH QUARTER PERSPECTIVE
October 7, 2009

A Year To Remember

It's been just over a year since the problems with subprime mortgages came to a head in the form of the failure and near failure of major financial institutions. Those events were quickly followed by severely falling stock and bond prices -- occurring in the midst of a nationwide, major decline in house values, and what has turned out to be a longer- and deeper-than-average recession. It's a natural time to reflect on what happened, is still happening, and the lessons learned so far.

Financial Crisis. Last September brought a shocking barrage of institutional failure. In the span of four weeks, a number of major financial institutions either failed (Lehman Brothers, Washington Mutual), were forced into shotgun marriages to avert failure (Merrill Lynch, Wachovia), or were saved from bankruptcy only through massive federal intervention (Fannie Mae, Freddie Mac, AIG).

These events resulted in a severe contraction of credit (nobody would lend to anybody else, not being able to tell who would fail next), and the threat of a pandemic failure in our financial system. In a Frontline documentary titled "Inside the Meltdown", Christopher Dodd, senator from Connecticut, reports on a meeting held September 18, 2008 between Henry Paulson, Secretary of the Treasury, Ben Bernanke, Chairman of the Federal Reserve, and the congressional leadership. Dodd reports that Paulson said:

> *"Unless you act, the financial system of this country and the world will melt down in a matter of days."*

If you want to understand the seriousness of the events last September, we recommend the Frontline film, which can be viewed on the www.pbs.org website, as well as the article by James B. Stewart in the September 21, 2009 issue of The New Yorker titled "Eight Days: The Battle to Save the American Financial System".

Stock market. The uncertainty brought on by the financial crisis prompted stock and bond prices to plummet. Below is a chart of the Dow Jones Industrial Average, a proxy for the US stock market, from October 2007 through September 2009. The graphic tells the story: stock prices plunged, losing more than 50% of their value over this time period at the March 2009 low. We've seen a tremendous gain in stock prices since then, but prices are obviously still far below the previous high:

Dow Jones Industrial Average Oct 2007 – Sept 2009

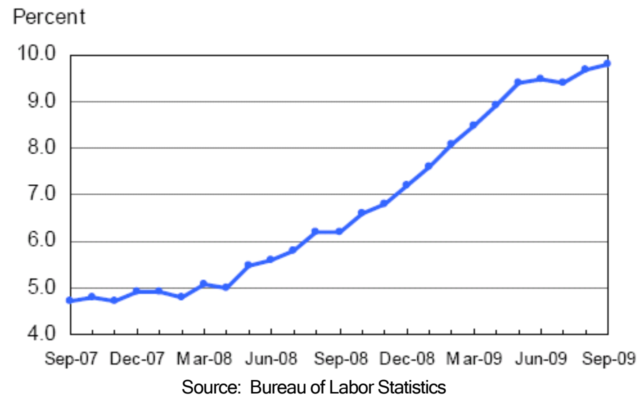
Housing Prices. The nationwide drop in housing prices is both cause and effect of the financial crisis. It's now seen as a classic asset bubble that burst (an unsustainable run-up in prices that inevitably leads to a crash). In the US, home prices have dropped 30% from their peak; in Seattle, the average is 22% (data from S&P/Case-Shiller Home Price Indices).

The fall in stock prices and in housing prices has been a one-two punch for our personal finances, as they generally constitute a person's net worth: the securities they hold, and the equity they have in their home.

The Recession. And finally, the above events occurred in what we now know was a recession, which officially started in December 2007. Below is a chart of US Gross Domestic Product (GDP), a measure of economic activity in this country. It's quite easy to see the dramatic drop in activity in the last quarter of 2008 and first quarter of this year.

With recessions come unemployment, which has been a particularly grim element of this recession.

Unemployment now stands at 9.8%, the highest it's been since 1983, and long term unemployment (people out of work for more than six months) is even more grim, clocking in at the highest rate since 1948.



Source: Bureau of Labor Statistics

Who Is Impacted? These events have impacted all of us on a psychological level, and will have far-ranging consequences for all of us as US citizens. That being said, who hasn't been personally financially hurt by these events? It's a short list:

- people who didn't own real estate,
- investors who had very little of their nest egg in the stock market (or other risky assets),
- and younger people who have kept their jobs, and who have many more years to go until they need to draw on their portfolio.

Who has been impacted?

- investors who had material exposure to the stock market or real estate,
- investors taking distributions from their portfolio for living expenses,
- and investors whose reduced portfolio values mean they may have to cut their spending, save more, or work longer to strengthen their financial security.

A Whack Upside the Head. This bear market has been a sharp reminder. Stocks carry risk; that's why they've provided higher returns than less risky assets over time. The risk you run with stocks is that you won't get the rate of return you expect, or the average rate of return stocks have historically provided.

That's not just a short term risk. While holding stocks for the long run has been a good strategy for most time periods, it hasn't been for all (nor is there any guarantee that the future will be like the past). If you start counting from 1926, there are 74 overlapping 10-year time periods through the end of 2008 (1926-1935, 1927-1936, 1928-1937, and so on). In three of those overlapping time periods, US large company stocks posted negative returns -- including the 10-year time period ending in 2008.

10 years is the long run by any measure, although far shorter than the holding period most of us will have for stocks. The risk of long term underperformance is real, and bear markets like this bring that risk to the forefront.

What Have We Changed? We are not abandoning the fundamentals of portfolio management that we and many other institutional investors use. We continue to believe that combining multiple asset classes reduces risk, that markets are efficient, and that investing is a good way to preserve and grow wealth.

The importance of discipline in investing has been reinforced for us. We continued to rebalance client portfolios throughout this see-saw of a year, buying stocks last fall and this spring when prices were low and our clients' high risk holdings underweight to their targets, and now, in some portfolios, trimming back on stocks as the dramatic run-up in stock prices exceeds our clients' target allocation to high risk assets. This rebalancing discipline is probably our highest value proposition. We've just heard too many anecdotal stories of people who sold stocks at or near the bottom, and are paralyzed at this point -- fearful of missing the recovery but reluctant to buy back at prices higher than their exit. Behavior like that gets you subpar returns over time -- it's the reason individual investors, as measured by mutual fund contributions and redemptions, consistently underperform the funds they're in.

That being said, we've made some changes in response to the events of the last year:

- We are more fixated on safety and preservation of principal in the cash/fixed income part of our portfolios, favoring insured CDs over bonds, and favoring bond funds over individual bonds to mitigate company and sector risk.
- We are adding TIPs (Treasury Inflation-Protected Securities) positions as a hedge against unexpected inflation.
- We are increasing our allocation to overseas developed and emerging markets in recognition of their growing proportion of the world's market capitalization.
- We're increasing our use of index funds to lower the cost of mutual fund expense ratios in client portfolios.
- We're paying close attention to trading mechanics, minimizing time out of the market when tax loss harvesting or rebalancing, in order to mitigate the effects of intra- and inter-day volatility.
- We are front loading our five-year bond/CD ladders in the expectation that the Federal Reserve will have to raise interest rates as the economy recovers.
- And, we're encouraging clients to hold large cash positions outside Schwab in insured accounts to increase their yield.

Outlook for the Future. We continue to believe that stocks are likely to provide higher returns than less risky assets over the long term, and are an important part of most of our clients' portfolios. That's resting on the belief that the US economy, despite the shock of booms and busts, will provide for growth in stock prices over time.

However, we have to acknowledge that we're in the middle of these economic events, and for our clients approaching retirement, or those already spending from their portfolio, the depth and duration of this recession and bear market is going to matter. Whether the economy recovers weakly or strongly is going to matter. A protracted bear market is likely to have a long term impact on our older clients; a quick bounce back may mean that plans don't need to change much, if at all. If a Plan B is necessary, we're here to help determine that, and outline it.

Finally, an important issue for all of us is gaining some understanding of why these events happened in order to form an opinion on what measures should be taken going forward to prevent a repeat crisis in our financial system. We're all for free enterprise, but also believe unchecked capitalism poses systemic risk. We're all potential beneficiaries or casualties of our economic and regulatory system, and have a big stake in how that looks going forward.

As always, we are deeply gratified to serve as your financial advisors. -- Karen, Joe, and Therese

Shorts

- **Treasury guarantee of money market funds ends.** As you may remember, the US Treasury guaranteed the balances all investors had in money market mutual funds as of Sept. 19th, 2008 -- one of the many unprecedented measures taken by the federal government in response to the financial crisis. This program was instituted after a prominent money market fund "broke the buck" -- dropping in value below $1 per share -- due to its holding of Lehman Brothers debt. The Treasury guarantee was meant to head off a mass exodus of investor funds from the commercial paper market, which serves an important role in short term corporate funding.

  The Treasury let the guarantee program expire last month -- declaring the need for it over. In its coverage of this event, the Wall Street Journal reports that program didn't have to make good on its guarantee, as no money funds failed, and the program in fact netted the Treasury $1.2 billion dollars in fees paid by participating money market funds. Score one for the taxpayer!

- **Light rail comes to downtown.** Sound Transit's light rail system, which runs from Westlake Mall to SeaTac airport, is now running. We're just one block from the transit tunnel under Third Avenue; the closest tunnel entrance is on the corner of University and Third, and the Westlake entrances are just a few blocks north of us.

  While the light rail route is limited, the tunnel hosts a huge array of Metro and Sound Transit buses, many of which offer very quick express bus service to downtown from transit centers like Bellevue and Northgate.

- **Roth IRAs and 2010.** As we have reported before, 2010 brings new opportunities for Roth IRA conversions as the $100,000 income limit is lifted (only taxpayers with Adjusted Gross Incomes below that amount could convert through 2009). However, income limitations on annual Roth IRA contributions still stand. In 2009, Roth contributions phase out at $166,000-$176,000 of Adjusted Gross Income for married filing joint taxpayers, and $105,000-$120,000 single taxpayers; we expect similar figures for 2010.

- **Staff news.** Therese spoke to a group of about 50 residents and prospective residents at Horizon House (a continuing-care retirement community in downtown Seattle) on correcting course after the financial crisis; she also served as a veteran planner for Money Quotient's August "Fundamentals of Life Planning" training.

- **Cash flow management software.** Many of our clients are looking for a simple, somewhat automated way to budget; we're currently testing a new product that could be a great option. We're planning to test it for at least a few months, and will keep you posted.