



FAI Advisors, Inc.

# Monthly Investment Commentary

## February 2009

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In an unwelcome but fitting encore to the worst calendar year since 1931, stocks posted their worst January ever. The large-cap S&P 500 (as represented by Vanguard 500 Index Fund) was down 8.4%. Smaller caps did even worse, with the iShares Russell 2000 ETF falling 11.1%. On the growth-value spectrum, value trailed growth by a wide margin across all market

caps. Developed market foreign equities (Vanguard Total International) were down 12% in January, more than their U.S. counterparts, while emerging market equities (Vanguard Emerging Market) were down 8.2%, about the same as U.S. stocks. REITs had the worst month of any of the asset classes we track, with a 17.4% plunge, more than offsetting their

### Updated Market Data

### “A Year in Review”\*

	January	YTD		2/06/09	2/07/08	% Chg
<b>Large Cap Benchmarks</b>			<b>Consumer Rates</b>			
Vanguard SP 500	-8.40%	-8.40%	1 Year CD Yld	1.60%	2.96%	-45.95%
Russell 1000 Growth ishares	-4.80%	-4.80%	30 Yr Mortgage	5.28%	5.61%	-5.88%
Russell 1000 Value ishares	-11.50%	-11.50%	Prime Rate	3.25%	6.00%	-45.83%
<b>Small Cap Benchmarks</b>			<b>Commodities</b>			
Russell 2000 Growth ishares	-7.60%	-7.60%	Gold	1.89	2.98	-36.58%
Russell 2000 Value ishares	-14.30%	-14.30%	Crude Oil	910.55	900.40	1.13%
<b>Other Benchmarks</b>			Gasoline			
Vanguard REIT Index	-17.40%	-17.40%		40.21	87.13	-53.85%
Vanguard Total Intl Stock Idx	-12.00%	-12.00%				
Vanguard Total Bond Idx	-0.70%	-0.70%				
Merrill Lynch High Yld bond Idx	5.30%	5.30%				
Citigroup World Govt Bond Idx	-4.30%	-4.30%				
DJ-AIGCI (Commodity Futures)	-5.40%	-5.40%				
Barclays Credit Bond Ishares	5.10%	5.10%				

\* Source: JP Morgan Weekly market recap

17.4% gain in December. High-yield bonds were the best-performing asset class, with a 5.3% gain. The domestic investment-grade Vanguard Total Bond Market Index Fund was down 0.7% in January as Treasuries retreated.

## The Saga Continues

You may be asking yourself, what is happening now? We now have a new administration in Washington, and the uncertainty has remained at very high levels. First, no one knows what is going to happen in the short term. We can have different degrees of confidence about the likelihood that different economic scenarios will play out, but we never have certainty about the outcome. Even the most well established economic veterans are not sure what will happen in the short term. Having said that, our purpose is to bring information to you from a number of diverse sources; placing the emphasis on the more cautious sources. Here is some explanation of where we are now.

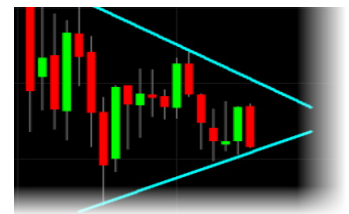
- We do know that the Federal Reserve and Treasury are clearly focused on preventing an economic/banking system meltdown, and they will continue to implement new approaches/programs/policies as long as they perceive the risk is still there. As many people have noted, Bernanke is a student of both the Depression and Japan's deflation period in the 1990s, and he believes the Fed has numerous tools/weapons at its disposal.
- There are no guarantees that the Fed/Treasury/Obama will succeed in preventing a period of significant/sustained deflation. Macroeconomics is not a science but, eventually, the negative feedback loop slows, stops, and starts turning positive for the economy as a whole.
- It is unlikely that the Fed fails in its efforts at stabilization, and over the long-term we would

assign a 0% probability to the likelihood that the US economy never recovers from this. However, we have to keep an eye on the banks as they become the target of potentially full or partial nationalization. Professor Nouriel Roubini, who warned about many of the systemic risks that have come to pass, recently wrote that it will take an additional \$1 to \$1.4 trillion in private and/or public capital to restore the financial health of the US banking. This is a huge amount, but it is not beyond our country's financial resources.

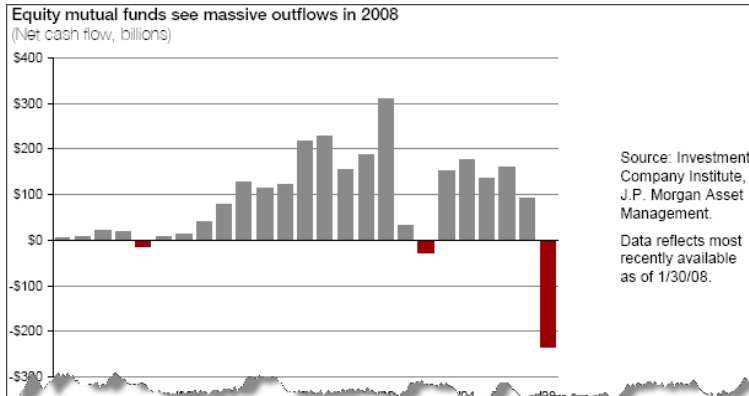
## What will we do next?

Our experience in 2008 reinforced some important lessons. One is that there is a risk to relying too heavily on history to show how different assets behave. Fortunately we were willing to deviate from the "ride it out" mentality somewhat, because there were things happening that haven't happened before. David Kelly, Chief Market Strategist for JP Morgan Funds refers to this current period as *Investing without Precedent*.

Another key is that taking a common sense, forward looking portfolio construction can help to see what may lie ahead, allowing us to plan accordingly. Also, we will continue to rely on charting (called technical analysis) to see what the market may be "telling" us. This could be very useful during the recovery process.



The graph on the next page illustrates the levels of 2008 stock mutual fund outflows, substantially dwarfing the numbers we saw after the tech bubble burst in 2002.



Actually, this leads us to point out some encouraging signs:

- The selloff in 2002 was followed by a substantial run up in the markets. While we don't anticipate a large up-tick in the markets in 2009, we do know that this state of flux will return to some sense of normalcy. Someday.
- Volatility is easing: The VIX index, a measure of stock market volatility soared to an unprecedented level of 81 in the fourth quarter. Since then, it has fallen to 43 – still above normal but clearly moving in the right direction.
- Bank lending is improving: One analyst estimates that bank lending in the 4th quarter among the nation's 12 leading lenders increased by nearly 5% over the 3rd quarter. While credit markets are still in significant stress, this improvement in bank lending can help lay the foundation for an economic rebound.

- Positively sloped yield curve: A traditional way banks make money is by accepting deposits at low short-term interest rates and lending at higher long-term rates. In just the last month, 10-year Treasury yields have risen from 2.25% to 2.84%, indicating a steeper yield curve which should boost bank margins.

- Housing is more affordable: Average new home prices are down 25% from their peak and 30-year fixed rate mortgage rates are hovering at near 5%, leaving housing at its most affordable level in decades. Inventories of unsold homes are also down sharply, hinting at a bottom in the price declines, which have wrecked havoc on financial assets.

- Money on the sidelines has surged: the money supply (M2), which includes cash, small CDs, money market funds and savings accounts, now stands at over \$8.2 trillion, earning close to a zero interest rate. This number is larger than aggregate value of 500 companies that make up the S&P 500. That much money will not stay where it is for long.

Andy Grove's saying, "Only the paranoid survive" is appropriate for a period this difficult, and we aren't willing to leave any argument unchallenged or any view unconsidered. We are pushing ourselves hard to make sure we are getting access to useful information through a rigorous, thorough, open-minded, and intellectually honest process.

FAI Advisors, Inc.

Investment Policy Committee February 2009

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