



FAI Advisors, Inc.

# Monthly Investment Commentary

## March / April 2009

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Stocks saw their best one-month gain in March in more than six years, but while it was a welcome respite from the battering in January and February, the first quarter still ended with double-digit losses.

Because the environment has been so difficult and scary for many, we

wanted to be sure to communicate our thoughts regarding the array of issues impacting the economy and markets. For some nervous readers, knowing this detail may help with confidence, which we believe is an essential component of investment success in times of turmoil and opportunity.

### Updated Market Data

### “A Year in Review”\*

	March	YTD		4/09/09	04/09/08	% Chg
<b>Large Cap Benchmarks</b>			<b>Consumer Rates</b>			
Vanguard SP 500	8.80%	-11.00%	1 Year CD Yld	1.65%	2.70%	-38.89%
Russell 1000 Growth ishares	8.90%	-4.20%	30 Yr Mortgage	4.73%	5.78%	-18.17%
Russell 1000 Value ishares	8.50%	-16.70%	Prime Rate	3.25%	5.25%	-38.10%
<b>Small Cap Benchmarks</b>			<b>Commodities</b>			
Russell 2000 Growth ishares	9.00%	-9.70%	Gold	878.40	933.80	-5.93%
Russell 2000 Value ishares	8.80%	-19.60%	Crude Oil	52.21	110.86	-52.90%
<b>Other Benchmarks</b>			Gasoline	2.05	3.29	-37.69%
Vanguard REIT Index	3.80%	-32.10%				
Vanguard Total Intl Stock Idx	9.30%	-13.00%				
Vanguard Total Bond Idx	1.50%	0.30%				
Merrill Lynch High Yld bond Idx	3.40%	5.30%				
Citigroup World Govt Bond Idx	2.50%	-4.80%				
DJ-AIGCI (Commodity Futures)	3.60%	-6.30%				

\* Source: JP Morgan Weekly market recap

## Summary of the Current Economic Situation

As we have discussed in previous commentaries, the fact is that over the past several economic cycles U.S. households and the financial sector took on increasing amounts of debt relative to their assets/income in order to fund consumption and investment. This trend was self-reinforcing as purchases with borrowed money drove up asset prices (such as homes) and profits, which supported even more borrowing. Ultimately the upward spiral was unsustainable, causing falling asset prices, lower spending and profits. This cycle can be very difficult to break, and is essentially what happened in the U.S. during the 1930s and Japan in the 1990s. Japan has still not fully recovered from it 20 years later.

Importantly, this is not just a U.S. economic problem, but a severe global slowdown —almost certainly the worst since the 1930s. It is estimated that there has been roughly \$50 trillion of global wealth destruction over the last 18 months. In such a situation, most experts agree, the government needs to help mitigate the extent of the damage. The fiscal stimulus packages you have all been hearing about by the Federal Reserve and the Treasury are the result so far. But, there is significant disagreement as to whether and to what extent the current crop of economic programs will stop the economic slide. No one really knows. Economics is an inexact science, to put it mildly. Fundamental questions about the role of government in our capitalist system—questions that were previously never taken seriously have exacerbated the high levels of uncertainty among investors. And as the saying goes: **the market hates uncertainty.**

## Government Actions

Larry Summers, the head of the White House's National Economic Council, has talked of the need to "contain what is a very damaging and potentially deflationary spiral." Federal Reserve chairman, Ben Bernanke, and President Obama's

chief economic advisor, Christina Romer, had previously written papers on the causes of and lessons from the Great Depression. The Federal Reserve has cut interest rates to pretty much zero, as well as taking unprecedented steps to inject more liquidity into the economy, by announcing that it would buy up to \$ 1.5 trillion of longer-term Treasury bonds and agency mortgage-backed securities. Finally the Treasury announced the details of its plan for a public-private fund to purchase up to \$1 trillion of "toxic mortgage assets" from bank balance sheets. How much is this \$2.5 trillion? The Louisiana Purchase, the New Deal, The Korean War, The race to the moon, The Vietnam War, the Savings and Loan crisis, The Gulf War, and the War on Terror, ALL TOGETHER cost about \$2.5 trillion. How's that for some perspective?

The policies/programs recently announced are likely to help move the economy towards recovery, but they will not solve the serious problems we are facing and we expect more government actions in the months ahead. No matter what policies are introduced, the impact of consumer and financial system slowing will certainly be a drag on economic growth over the next several years. Saving and paying down debt will likely replace borrowing and spending. We also believe that no matter what the short-term outcome, there will be a price to pay down the road for the current policy actions—potentially in the form of a weaker dollar, higher inflation, higher interest rates and tax rates and, consequently, subpar growth and corporate profits. So while we agree that preventing a meltdown in the economy should be the immediate "job one" of the government, it is likely to be at the cost of lower growth and/or higher inflation down the road. There is also no guarantee that policymakers will be able to prevent significant additional economic damage from being done in the near term, despite their best intentions.

So how do we make investment decisions in this environment? We use the same framework and

process that we have always used: assessing the potential risks and longer-term return opportunities in various types of assets.

## A Mid Term Outlook for Stocks

Whether or not to own a “normal” amount of stocks in our portfolio models has been important so far in this bear market; furthermore, making sound decisions now is even more important. As we listen to the financial media bring on guests to talk about the “bull market” they say we are now experiencing due to the recent stock rally, we need to grasp the realistic potential return ranges for stocks (the S&P 500) in the next 5 years before thinking we are in a bull market!

We do this by looking at a few economic scenarios that could play out. Our main research source, Litman Gregory Analytics, recently conducted an analysis using four possible economic scenarios that we could experience over this next 5 year time period, we have decided to summarize them here as a way to explain to you what we are thinking. The background calculations are fairly involved, but they are summarized as follows:

### Scenario 1: “Muddle Through”

An economic recovery in late 2009/early 2010 with subpar recovery for several years makes the assumption that inflation is gradual. This is what happens in most historical market correction/recovery cycles.

### Scenario 2: “Stagflation”

An economic recovery in late 2009/early 2010 with subpar recovery, but strong inflation (mid single digits) near the end of the five-year period.

### Scenario 3: “Severe Recession/Deflation”

Extended/deep recession and potential deflation through 2010, due to severe deleveraging and negative wealth effects. Recession does end but

recovery is anemic.

### Scenario 4: “Goldilocks”

Government policies are effective and economy starts growing in the latter half of 2009. An average recovery with moderate inflation.

Among the spectrum of scenarios, #4 (*Goldilocks*) is the most optimistic, and probably the most unlikely in the near term. It assumes there isn't much inflationary affect of the stimulus, which is unlikely.


The most pessimistic scenario, #3 (*Severe Recession/Deflation*), assumes that corporate earnings are impacted somewhat similar to the post Great Depression/World War II era period. This reflects concern about the high amount of leverage in the system and the potentially long-lasting effects of its unwinding. In the near term, consumers may be reluctant to take on debt, and bank lending (which will also likely be more-heavily regulated) could be cautious, contributing to a subdued earnings recovery. In this scenario, stocks have low returns, low single digits to slightly negative.

The final couple of options, #1 (*Muddle Through*) and #2 (*Stagflation*), are similar in assumptions, but #2 (*Stagflation*) assumes inflation becomes a bigger problem. #1 (*Muddling Through*) assumes that the market follows historical trends of recovery, but this situation has been far from normal. Relying on market history too heavily here can be misleading, at least in the short term. For our discussions here, we will review the chart on the next page using five-year return assumptions for the S&P 500 (the market).

### “Fair Value”

With the S&P 500 at its current level of 850 as of this writing, the chart shows potential rates of return for the market under each of the 4 scenarios and their corresponding assumptions. As mentioned above, (*Goldilocks*) is not likely. In

looking at the other 3 scenarios, we see potential average 5 year expected returns between 6.6% and -2.2% as shown under a (Deflation) scenario.

Scenario	Muddle Through	Stagflation	Deflation	Goldilocks
Earnings Assumption	Average	Below Ave	Low	Above Average
P/E Ratios	Average	Below Ave	Low	Above Average
<b>Starting S&amp;P 500 level</b>				
550	17.7%	14.9%	7.9%	27.0%
600	15.3	12.6	5.8	24.5
650	13.2	10.5	3.8	22.3
700	11.3	8.7	2.1	20.3
750	9.6	7.0	0.5	18.5
800	8.0	5.5	-0.9	16.9
 850	6.6	4.0	-2.2	15.3
900	5.2	2.7	-3.5	13.9
1000	2.8	0.4	-5.7	11.3
1100	0.7	-1.7	-7.7	9.1
1200	-1.2	-3.6	-9.4	7.1

*The question is this:* At the current level in the S&P of 850 as of this writing, are there other places to place portfolio dollars that can expose us to less risk and potentially greater returns? That is the big question. Our current allocations in High Yield bonds are an expression of this opinion.

If the S&P 500 experiences a substantial drop from here, to 700 for example, we can see in the chart that expected returns of the index rise (11.3%, 8.7%, 2.1% respectively) because we would be purchasing at lower prices. Timing the market is not the point here, and going back into a more normal weighting to stocks is an eventuality in all our portfolios. However, doing it prematurely is what should be avoided. To be clear: we are not predicting the market will drop 25%, and the prior low could prove to be the bottom. But we think it is within the realm of reasonable worst-case outcomes, given the severity of the current economic crisis and the potential for market

psychology (fear) to overshoot on the downside. That is, irrational pessimism can take hold and push the stock market to ridiculously low levels just as irrational exuberance pumped up stock prices to unsustainable heights during the tech bubble or other similar manias.

## Extending the Time Horizon

As we extend our investment time horizon out to 10 years, our expectations for equity returns move toward the more optimistic end of our range, in the upper-single-digit to lower-double-digit return range. This is because earnings are more likely to revert to their long-term averages as time goes on and the global economy heals itself. However, we also believe earnings may be in the process of re-setting at a lower sustainable trend line as a result of what has happened. The excessive use of leverage over the past decade led to unsustainably high profit margins, and such leverage probably won't be repeated any time soon. Even when we do ultimately see a reversion to the mean, there is a good chance it will be lower than what we have seen historically.

Although we think a tough road is likely in the months ahead, we have some level of confidence that the economy in general will emerge from this deep and painful period, possibly on a more subdued growth path than in past recoveries. We hope we are positively surprised and a recovery is sooner than we expect. But we are not managing portfolios based on HOPE. Instead, as always, we must analyze the situation carefully to make the best investment decisions we can on your behalf. No matter whether investor psychology has created a market bubble or a bust or something in between, sticking to those principles helps us make sound decisions.

FAI Advisors, Inc.

Investment Policy Committee March / April 2009

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