



FAI Advisors, Inc.

# Monthly Investment Commentary

## MAY / JUNE 2009

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Stocks continued to rally sharply in April and May, with the large-cap S&P 500 (Vanguard 500 Index) gaining almost 10% for the month of April and staying in the same range for May. Smaller-cap stocks did even better, with iShares Russell 2000 ETF gaining 15.4%, trimming the year-to-date loss to 1.8%. Developed-market foreign

equities generally were in line with the U.S., while emerging-market equities outperformed. On the fixed-income side, Vanguard Total Bond Market Index Fund gained about 0.4% in April, and is up about 1.60% for the year. Munis continued their tear in April, and the Vanguard Intermediate-Term Tax Exempt is now up almost 5%

### Updated Market Data

### “A Year in Review”\*

	May	YTD		06/15/09	06/15/08	% Chg
<b>Large Cap Benchmarks</b>			<b>Consumer Rates</b>			
Vanguard SP 500	5.60%	3.00%	6 Month CD	0.65%	1.70%	-61.76%
Russell 1000 Growth ishares	5.50%	4.10%	30 Yr Mortgage	5.25%	6.24%	-15.87%
Russell 1000 Value ishares	6.20%	-2.10%	Prime Rate	3.25%	5.00%	-35.00%
<b>Small Cap Benchmarks</b>			<b>Commodities</b>			
Russell 2000 Growth ishares	3.00%	1.20%	Gold	937.90	867.90	8.07%
Russell 2000 Value ishares	2.20%	-4.80%	Crude Oil	72.12	136.88	-47.31%
<b>Other Benchmarks</b>			Gasoline	2.62	3.98	-34.17%
Vanguard REIT Index	2.40%	-8.70%				
Vanguard Total Intl Stock Idx	14.40%	12.20%				
Vanguard Total Bond Idx	0.80%	1.60%				
Merrill Lynch High Yld bond Idx	7.00%	25.30%				
Citigroup World Govt Bond Idx	3.30%	-1.60%				
DJ-AIGCI (Commodity Futures)	13.00%	6.60%				

\* Source: JP Morgan Weekly market recap

for the year. The positions in High-yield bonds, held their own, bringing its year-to-date gain to 25.30%.

So we find ourselves in the position of being unsure of the short term stock market direction, and also quite concerned about the potential lasting impact of this recession and the multitude of government actions. When looking for information on these issues, we find it is best to avoid an abundance of the following information sources:

- **The news media** – their priorities don't line up with ours, they are interested in ratings
- **Industry magazines** – much of this information is “industry speak” which is almost always in the rear-view mirror
- **Mutual Fund managers** – these are very bright people, but asking a stock mutual fund manager if it is a good time to buy stocks is like asking a real estate agent looking for a sale: “Is this a good time to buy real estate?”. If they are honest, they will do their best to make the case, but it wouldn't be wise to rely too much on that perspective right now.

Having said that, the focus of this commentary will be exploring some information obtained from an April 13th stock fund manager interview conducted by our main research partner, Advisors Intelligence. John Osterweis of the Osterweis Funds has been managing money for a long time, and since 1993 in the current Osterweis Fund (OSTFX). Unlike many industry “experts”, they are willing to discuss whether or not it is a good time to buy stocks. Here are some highlights of the comments taken from the interview:

- Deleveraging will play a major role in the future of financial institutions, businesses, and consumers. As a result, profitability will be under pressure.
- Consumer spending will be held down by the

“paradox of thrift.” Rising unemployment will affect consumers' willingness to spend, which leads to an increased savings rate. As consumers save more, businesses will further contract, leading to higher unemployment, which leads to even lower consumer spending, etc.

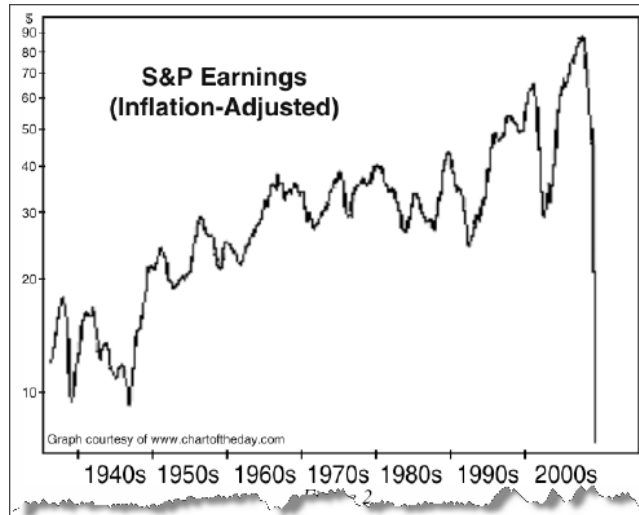
- **INFLATION:** In the near-term, the recession, combined with deleveraging and a rising savings rate, will have a deflationary impact on the economy. Looking ahead, the government's attempt to stimulate the economy, “should stop the bleeding, or even get something going.” But he questions what the ultimate cost of the government's borrowing will be to the economy. Eventually, the vast amount of liquidity that the Fed has pumped into the economy could cause inflation—most likely asset inflation as opposed to general price-level inflation. This scenario is a few years out yet.
- The economy will remain in a recession for the remainder of the year, and any recovery in corporate profits will be anemic for the next two to three years.
- The stock market's recent run up is a reflection of investors' perception that the economy is no longer in a freefall. But, at current levels, the team's assessment is that valuations are not compelling.
- The fund's portfolio currently has about 40% in non-equity exposure because he believes that bonds, especially those without refinancing exposure, “are unambiguously more attractive than stocks as an asset class currently.
- To increase equity exposure, there would have to be a real sense that we've moved past . . . the danger point, and believe that stocks are still cheap. They focus on identifying specific stocks where there's a high probability of actual improvement in earnings. It's not just trying to guess how bad things are going to be on the downside, but to see if there might actually be some real upside.

Staying underweighted to stocks is a function of where else would the money be put to use in the shorter term to expose portfolio assets to less risk and potentially greater returns. The chart below is one example of something we can watch to help determine when we should be feeling bullish and positive about stocks.

As the creator of the chart below, Chart of the Day says: "In fact, real earnings have dropped to a record low and if current estimates hold, Q3 2009 will see the first 12-month period in which S&P 500 earnings are negative". Yet, another reason to watch the data and not the news!

**Economist vs. Analyst**

If we look at historical charts of our economy, we can see that the economy is normally in expansion mode, with regular, and mostly, brief contractions. Most economists stay bullish on the economy long term, and 80% of the time they will be right. But let's compare this with someone that we would call a "market analyst" who is more in the forecasting mode, focusing on long AND short term trends. If the analyst sees signs of a market and economic downturn, they may advise protection of assets



rather than riding it out. What if the analyst doesn't have as good a record as the economist, in that they are only right 50% of the time? So over the long term, which one is best to follow? It normally would make sense to follow the course of action that has the best statistical record, right? *Maybe not.*

Assume for a moment, you like to frequent a coffee shop in your town that has an outdoor seating area. It

happens that every 100 days, a group of criminals drive by and shoots every customer. Since the economist doesn't really have the ability to predict these incidents, he will just do as he always does.....stay bullish. In fact, he will be right 99% of the time, and only wrong 1% of the time. Statistically, it is a great record. Problem is, you are dead.

The analyst on the other hand, using market tools, has some ability using probability analysis, to make some determination when the shootings could occur. This method though has a higher chance of error, but the result is that you avoid 10-15% of the days at the coffee shop that you would normally go. The analysis is sometimes wrong, but you never get killed.

- Economist:** *Always bullish* —————→ **Correct 80% of the time**
- Analyst:** *Sometimes bullish, sometimes bearish* —————→ **Correct 50% of the time**

Starting Value		\$ 100,000
Year	Rate of Return	End of Year Value
1	20%	\$ 120,000
2	20%	\$ 144,000
3	20%	\$ 172,800
4	20%	\$ 207,360
5	20%	\$ 248,832
6	20%	\$ 298,598
7	20%	\$ 358,318
8	20%	\$ 429,982
9	20%	\$ 515,978
10	-85%	\$ 77,397
<b>Average Return</b>		<b>9.50%</b>
<b>Actual Return</b>		<b>-2.53%</b>

The same goes for portfolio management. In the example below, a \$100,000 portfolio experiences 9 years in a row where the return is 20% every year, then a loss of -85% in the last year. The average rate of return (average all the years together) is 9.50%. Not bad. However, the ACTUAL rate of return in terms of what can be SPENT is a paltry -2.53% (taking \$100,000 and turning it into \$77,397). Therefore, avoiding the 10th year loss is much more important.

Using average rates of return to make investment decisions can be misleading when volatility is introduced. Since nobody can spend an average rate of return, controlling volatility is critical.

We believe that the key to getting through this difficult time is making sure we understand the direction things are most likely to go based on economic data, technical data, fundamental indicators, and historical references. Not surprisingly, the media, general public opinion, and even our own financial industry are not the best sources of guidance for us.

Those we serve, our clients and other advisors, surely deserve better.

FAI Advisors, Inc.

Investment Policy Committee May / June 2009

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