

FOUR SEASONS



INVESTMENT ADVISORS

Market Update for Clients

March 2009

We continue to be faced with an extraordinarily difficult market environment, one that is probably testing your patience and confidence. I wanted to share with you some current thinking about the overall environment and our investment positioning.

I understand that the powerlessness of watching the value of your wealth decline creates a strong desire to “do something” about it – to take control and end the pain. Going to cash may lock in losses, but at least it creates a certainty amidst a great deal of fear and uncertainty. These are the conflicting forces that every investor faces right now: the certainty of locking in a set (albeit painfully lower) level of wealth, versus the uncertainty of possibly more near-term losses and the hope of better longer-term returns.

One of today’s biggest concerns is whether we’ve fully factored in the extent of economic damage that has become apparent and is being reflected in major market declines. I expect that it is not just possible, but likely, that we will experience several years of economic growth below the historical trend as consumers adjust to a new reality in which they will finally have to pay down debt and increase savings (and thus spend less than in the past). Economists and financial analysts have watched the trend of increased household debt accelerate from the late 1980s, wondering when this growth would have to slow or reverse. It has taken 20 years, but it is clear that the time has come. While the change away from spending and accumulating debt may be healthy on an individual level, happening suddenly and sharply across our economy, even globally, creates a shock which is extremely difficult to absorb. It brings an entirely new set of challenges looking forward. We must understand the range of possible outcomes so that we can sensibly balance risk and return.

It is important to understand that there is a great deal of economic uncertainty and that could take a further toll on stocks in the near term. It also makes it more difficult to forecast the longer-term value of stocks. We can use assumptions so negative that we believe we have a good margin of error on the downside, and a high degree of confidence the conservative end of longer-term forecasted returns. While it is very difficult to have confidence in what the shorter term will bring, I am confident that we can take into account the possibility of a lengthy and extremely poor economic environment. Based on that analysis, the stock market can still earn good returns from current levels over a five-year horizon. It may also help to note that even some of the most pessimistic investment professionals, among the few who saw this crisis coming, now forecast positive multi-year returns for stocks. Importantly, however, capturing these positive returns will require maintaining longer-term focus through what may continue to be a very trying period.

As we look forward into this continued, very scary economic decline we must remember that markets do their best to see into the future and reflect that future in their prices. So, the next question is what is priced into stocks today?

Historical comparisons are sometimes helpful. While there have been many bear markets, the two extreme economic environments in the last 80 years are the 1930s and the late 1970s/early 1980s. By the late 1930s the economy was still in a seriously weakened state, and unemployment well above 10%. Hitler’s Germany was threatening, annexing Austria in March of 1938. In the early 1980s, inflation was sky high, interest rates were in the

teens, and we suffered from back-to-back recessions with unemployment again exceeding 10%. In both periods, investor confidence was crushed after lengthy periods of dismal returns and continuous negative economic headlines. As it turns out, both periods presented a great opportunity for long-term investors to buy stocks. This may be a similar time. These experiences reflect the tension investors face, when risk seems greatest it is usually a good time to invest, and when risk seems only an afterthought, investors are likely to be disappointed with returns going forward. For perspective, it is likely that we are in the midst of a long-term bear market that started in 2000. That year the S&P 500 peaked on March 24 at 1527. After declining for several months, it rebounded to almost the same level in September. After a devastating bear market which declined nearly 50% over three years, stocks began climbing back to reach a new high on October 9, 2007. That high did not last and the S&P 500 broke through the lows of the last bear market, falling to levels in recent weeks not seen since 1996. Whether or not we have seen the bottom in this bear market is uncertain, but the magnitude and speed of the decline is among the worst of the last century. It is also arguable, based on a historical framework, that stocks (and similarly beaten-down asset classes) must now be discounting a great deal of economic damage to come.

There is a mountain of cash sitting on the sidelines today. Since the advent of money market funds 30 years ago, the ratio of money market funds to stock market value has never been higher. Historically ranging between 10 and 20%, it is now approaching 50%. Some of that cash will begin to find its way back into stocks and bonds as investors become willing to take on more risk in order to earn higher returns than they can get from holding cash. This can ultimately be viewed as a positive factor.

But are stocks cheap today? Bear markets often end at extreme levels of undervaluation. Stock prices fall far beyond reasonable valuations. While most measures indicate stocks are attractively priced now, economic risk remains high. Policy makers have made it clear that they will do whatever it takes to support the economy, yet credit markets remain largely dysfunctional and the housing market is severely stressed. While it appears a financial system collapse has been avoided, a newly realistic consumer, attempting to reduce debt and increase savings could mean an economic retrenchment that lasts longer than consensus expects. This could even lead to a period of deflation, which is probably not fully priced into today's stock market. In the near term, it is possible that the recession will be with us at least through the first half of 2009, and possibly into early 2010. Home prices continue to be a problem for consumers, and credit markets are still difficult for corporations, municipalities, and individuals. I believe that the credit markets will improve by the end of 2009, and it should be a good year for bonds, with the exception of Treasuries. I also believe that while we may see the market move lower at some point, the most volatile swings are behind us. I expect we will continue to see strong rallies and subsequent sell-offs, typical of later stages of bear markets as they run their course. We can take advantage of this period by being opportunistic in areas where we find value, such as corporate bonds, including high-yield bonds. These assets appear to have bottomed out, with the potential to provide a defensive position in the event of further stock market declines, and upside opportunity that will be competitive with stocks into the early stages of a recovery.

It may seem impossible to imagine a market rally from here. It can happen, and it will at some point. By definition, investors are most pessimistic at a market bottom. When everyone is hugely pessimistic there are few investors left to sell. Then, as bargain hunters start to step in, a powerful rally can develop.

So while I am confident that from current levels stocks offer good longer-term return potential, I don't know what might happen in the shorter term. This uncertainty creates a dilemma that is very important to understand. Stocks could drop further, perhaps substantially, or they could rebound sharply. If I try to predict this and invest accordingly, I have to consider the consequences of being wrong. If we go to cash the market could rebound sharply before we can get back in. It is possible we could see a rally of 20%-30% before concrete signs of sustained

economic improvement begin to show up. This is because the market is forward-looking and nearly always reaches a bottom well before the economy reaches a bottom. If that happens, we could see a material portion of the good multi-year return potential that I believe exists realized in a short time. At that point I would have to decide whether the market's turn was going to be sustained, and move back in, or continue to wait and risk losing further upside. If we did get back in, we could be whipsawed if the upswing proved to be temporary, as commonly happens during severe bear markets.

On the other hand, if we remain invested, current valuations indicate we will earn a good return over a five-year investment time horizon, independent of what the short term brings. I know that we will continue to see tactical opportunities amidst the near-term weakness, and that our active mutual fund managers will have opportunities to add value by buying stocks that have been oversold due to fear rather than fundamentals. Longer time horizons have the highest value when short-term fear is greatest, because that is when the greatest opportunities are created, but those are also the times when a long time horizon is the most difficult to sustain.

Like you, I find this environment literally gut wrenching. I believe that at some point in the future, I will be able to look back and see that commitment to doing what I believe is right for you during this time period led to good long-term decisions. The investment business is stimulating, fascinating, and humbling. It is challenging on multiple levels. I continue to try to focus on decisions that are informed and rational rather than emotional, and believe that over the longer term, that will pay off in the form of good returns on your behalf.

As always, I greatly value the trust and confidence you place in me to manage your investments.

Craig Wolverton
President, Four Seasons Investment Advisors, Inc.