

A View on Market Volatility

March 5, 2009

In light of the continuing market volatility we are experiencing, we wanted to offer an updated view of the market and the implications of the recent continued volatility. The following is some analysis from a firm with whom we work and from whom we obtain analytical analysis. We have modified their comments to reflect the specifics of our clients' situations.

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

Perhaps the biggest question we are being asked is whether we've fully factored in the extent of economic damage that is now becoming apparent and being reflected in the form of major declines in the stock market. The short answer is that we are confident we have.

We 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. We want to give you perspective and information about how we've made that judgment, and to make sure you can accept the current risk levels in your portfolio (versus switching to a more conservative posture).

First, while this may not make you feel any better, we want to remind you that after the painful November lows, we've been saying that we would not be surprised if, in the short term, the S&P 500 exceeded those lows (of around 748) and dropped below 700. This has now happened. We make the point solely to make clear that while these declines are both gut wrenching and wearying, they do not represent new information to us or suggest that we've missed something in our analysis.

It is also 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. What we can do about this is make assumptions that are so negative that we believe we have a good margin of error on the downside, and a high degree of confidence at least in the lowest end of our longer-term forecasted return ranges. We have done this work, which includes an intense focus on identifying the most negative scenarios we or other experts we talk to can envision, and factoring those into our analysis. So while we are never confident in what the shorter term will bring, we are confident that our scenarios fully take into account the possibility of a lengthy and extremely poor economic environment (where the earnings decline is comparable to the Great Depression). Based on that analysis, the stock market can still earn good returns from current levels over a five-year time horizon. It may also help to note that we are not alone in this assessment; even some very negative 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 that 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 key question is what is priced into stocks today? We discussed three metrics in our 4th quarter Quarterly Letter; all currently suggest the market is cheaper than it was back in early January (no surprise since stocks have declined since then).



- One metric we discussed, the Shiller P/E, was then at 15X and is now down to 12X normalized earnings (using the S&P 500's recent price of 700). In the past, this valuation level has been a good entry point for *long-term* investors into the stock market.
- The second metric is the 9-year risk premium (which is the comparison of stock returns to a "risk-free" return—we use the S&P 500 and Treasury Bills). Based on this measure, stocks are coming off of their worst nine-year return relative to T-Bills ever—including the Great Depression period (we looked at returns since 1926). This strongly suggests stocks are not expensive and annualized returns over multi-year periods after the lowest risk-premium periods were double-digit.
- Expected annualized S&P 500 returns in *our most pessimistic* five-year scenario are up to 7% (we have adjusted some of our assumptions slightly lower since early January). If equity P/E multiples turn out to be even lower than what we are now using in that scenario, returns could be further reduced by 1% to 3%. That would be quite harsh and would result in unprecedented bad returns based on the other metrics mentioned above. But even in that case, returns are positive and probably in line with what the bond indexes deliver, and better than cash. Five-year annualized returns are higher in other scenarios that are still negative but not as much so.
- Finally, the massive dumping of stocks in the last part of 2008 led to valuation discrepancies which seem to be reversing a bit.

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. There is a huge amount of cash on the sidelines, which is good. 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. Our expectation is that we could see several rallies and declines before we move on to another bull market. We are confident in our longer-term expectations, but as we have been saying for several months now, we are prepared for a very rocky ride.

So while we are confident that from current levels stocks offer good longer-term return potential, we 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 we try to predict this and invest accordingly, we 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 we believe exists realized in a short time. At that point we would need to decide whether the market's turn was going to be sustained, and get 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, our analysis gives us confidence we will earn a good return over our five-year investment time horizon, independent of what the short term brings. 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, we find this environment literally gut wrenching. We believe that if we continue to stay intellectually honest, work extraordinarily hard to make deeply informed and rational rather than emotional investment decisions, over the longer term that work will pay off in the form of good returns on your behalf.



If you are not sure if you can stand more declines, we continue to urge you to discuss any concerns with us here at Tarpley & Underwood Financial Advisors. We can help you make an informed decision in light of the financial planning objectives you had previously established. We develop and manage planning and investment strategies with varying risk levels, and it is important in an environment as volatile and trying as this one that you are in a strategy you can live with both in the short and long term.

As always, we greatly value the trust and confidence you place in us.

~ Tarpley & Underwood Financial Advisors, LLC ~