



## Tarpley & Underwood

Financial Advisors, LLC

January 21, 2009

Mr. & Mrs. John Doe  
123 Peachtree Street  
Atlanta, GA 30033

Dear John and Kelly,

Please find enclosed your reports for the fourth quarter of 2008. We trust this commentary will provide you with some perspective for the economic environment in which we are currently planning and investing.

### **Quarterly Commentary**

Solid returns for stocks and bonds in December provided little relief in a year that will go in the books as the worst in decades for financial assets. While equity returns varied widely in the month, fourth-quarter and full-year returns were comparably dismal for most equity asset classes. The Vanguard 500 Index Fund, a proxy for large-cap U.S. stocks, gained 1.1% in December, but lost about 22% and 37% for the fourth quarter and calendar year, respectively. Smaller-caps closed the year with a strong 5.9% December gain for the iShares Russell 2000, but losses for the quarter were 26% and for the full year the index was down 33.7%. Aided by dollar weakness, foreign stocks saw very strong gains in December, with Vanguard Total International Stock Index Fund gaining 8.2%. The 21% fourth-quarter loss was not as bad as U.S. stocks, but for the full year the Vanguard fund was down 44%, about seven percentage points worse than domestic equities.

Domestic bonds had a good showing in December, with the Vanguard Total Bond Market Index Fund gaining 3.3%, which was enough for a very solid 4.4% gain in the fourth quarter and a 5.1% gain for the year. Among other asset classes, returns varied widely. The Merrill Lynch High Yield Master Index rebounded strongly in December after reaching record-level yields, with a 7.6% gain, and REITs, which have also been plagued by concerns about access to credit, shot up 17.4% for the month. However, both finished the year with big losses: high yield lost 26% and REITs fell 37% in 2008. The commodity futures asset class was the only loser among those we follow, with a 4.5% loss in December. This asset class, which in many environments behaves quite differently from equities and is therefore valued as a diversifier, saw a full-year loss of 35.6%, almost the same as that of stocks. But in a grim year where almost nothing unfolded according to expectations, and there was no place to hide short of stuffing cash in a mattress, that is of little surprise.

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## **Investment Review and Outlook**

For investors, 2008 was a once-in-a-lifetime train wreck. The year was arguably the most painful in modern investment history (it was the worst year for the stock market since 1931). Almost every asset class was in the red, with many deeply underwater (see the table on the last page). Government bonds were one of the few exceptions.

Clearly we are in the midst of a severe recession. Beyond that we also now believe it is not just possible, but likely, that we will experience several years of economic growth that is below the historical trend as consumers adjust to a new reality in which they finally have to pay down debt and increase savings (and thus spend less than in the past). Since the late 1980s, some have wondered when the growth in household debt would have to slow or reverse. It has taken another 20 years since, but it is now clear that the time has come.

If the environment plays out as well, it could take a number of years after the recession ends for corporate earnings growth to return to its long-term trend, and the recession itself could last through 2009 or even into 2010. This has implications for stock market returns and investment decisions.

As we look forward from here at beaten-down financial markets and an economy on the ropes we ask the question we always ask: what expectations are currently reflected in asset class prices? We approach this question in many ways and consider the weight of the evidence in the context of how the broader economic environment might play out over coming years. This exercise leaves us with conflicting evidence to digest. Some of the key factors are described in the following paragraphs.

### **Encouraging Signs**

Historical comparisons are sometimes helpful. There have been two extreme economic and investment environments in the last 80 years—the 1930s, and the 1970s/early 1980s. By the late 1930s the economy was still in a weakened state with unemployment well above 10%. Moreover, Hitler's Germany was ominously flexing its muscles, 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 exceeding 10%. In both periods investor confidence was crushed after lengthy periods during which returns were dismal and because of a continuation of negative headlines. But as it turned 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 that investors face—when risk seems greatest it is usually a good time to invest and when risk is an afterthought investors are likely to be disappointed with their returns going forward.

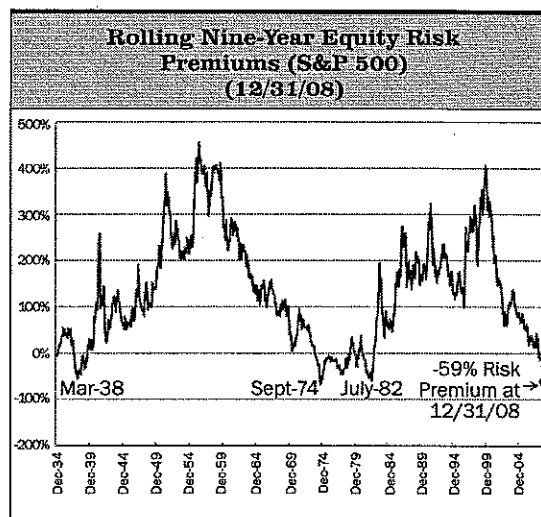
We argue that we are in the midst of a secular or long-term bear market that started in 2000. That year the S&P 500 peaked on March 24 at 1527. After declining for several months it rebounded to almost the same level on September 1. After a devastating bear



market in which the market declined by nearly 50% over almost three years, stocks ultimately clawed back to the year-2000 high and briefly and slightly exceeded it seven years later on October 9, 2007. But that high did not last, and in November of 2008 it broke through the low of the last bear market, falling to 752, a level first reached in 1997. Whether or not we have seen the bottom in this bear market is uncertain, but there is no arguing that the magnitude of the decline is among the worst of the last century. It is also arguable, based on a historical framework that stocks (and similarly pummeled asset classes) must now be discounting a great deal of economic damage to come. Are stocks cheap? Many metrics suggest that stocks should at least provide satisfactory returns going forward and possibly something better:

**Historical Evidence: Trailing Risk Premiums**

There are many ways to consider historical stock-market performance. One is to focus on the risk premium. This compares stock market returns to the returns an investor could have achieved if the money had instead been invested in a risk-free asset. Since we date this secular bear market at about nine years old, we looked at the stock market risk premium over the past nine years (using month-end returns). To do this we compared the S&P 500 returns to returns from three-month Treasury Bills. We then compared the returns to other periods going back to the Great Depression.



The risk premium is the difference between the stock market return and the "risk-free" return available from the average three-month T-bill yield over the period.

The takeaway is that by underperforming T-Bills by 59% over the last nine years (as of 12/31), the risk premium was one of the worst on record—matching the worst nine years during the Great Depression- but not quite as bad as the worst periods that encompassed portions of the inflationary 1970s. On a forward-looking basis, what is very encouraging is that the long-term returns were quite good following similarly horrible nine-year periods for risk premiums. Also, the end of these nine-year periods fell close to the bear market bottom.

**Worst Nine-Year Risk Premiums Since 1935**

Nine-Year Period Ending	Risk Premium	Cumulative Return		Annualized Returns in Following Years			
		S&P 500	T-bills	Next Five	Next Seven	Next 10	Next 15
Dec-08	-59%	-28%	31%	?	?	?	?
Jul-82	-58%	52%	111%	29.7%	23.1%	19.2%	19.7%
Sep-74	-67%	-5%	62%	16.8%	14.4%	15.6%	17.2%
Mar-38	-56%	-46%	10%	13.0%	13.4%	11.9%	14.1%

\* S&P 500 return less the T-bill return.

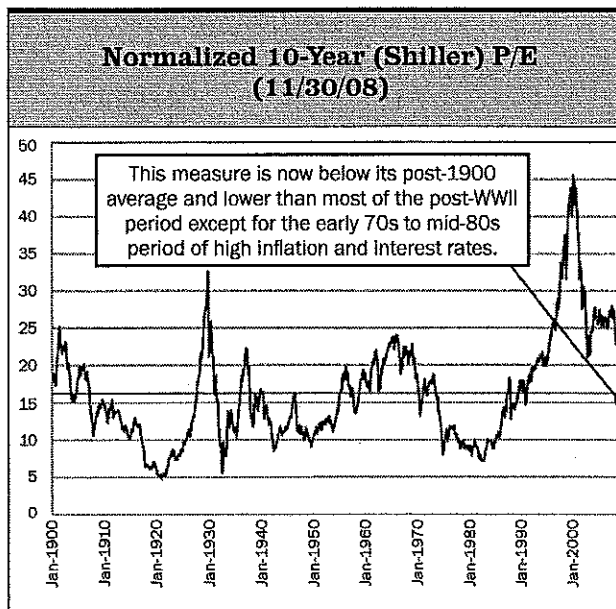
A somewhat similar analysis by the Leuthold Group looked at subsequent 10-year returns after stocks had suffered through a 10-year period with annualized returns of 1% or less (at the end of November the annualized 10-year return was -1%). The worst annual subsequent 10-year return was 7.2% and the average of 15 periods (many were overlapping) was



10.7%. The takeaway is that based on history the next 10 years is likely to deliver at least satisfactory nominal equity returns.

### Valuation Evidence: Shiller P/E

There are many ways to assess valuations. Most now suggest that U.S. large-cap stocks range from fairly valued to bargain priced. Assessing valuation is not a black-and-white exercise. Different valuation levels have been present in different eras and valuations can shift away from the long-term average for extended periods. Investors' propensity to take risk (currently a bearish factor) and the level of interest rates (currently a bullish factor) also impact valuation levels. One metric we have added to our valuation tool box is the so-called Shiller P/E, named after Robert Shiller, the Yale professor. Shiller calculates his P/E based on an average of the last 10 years' earnings in order to smooth out short-term earnings volatility. Earnings have been extremely volatile over the past 10 years as we've seen two bubbles (tech and housing) inflate and collapse, so we find the idea of a 10-year normalized number appealing. Shiller also inflation-adjusts his earnings and stock price levels.



The Shiller P/E adjusts stock prices and earnings for inflation. It is also a normalized P/E that is based on average earnings over the trailing 10 years in order to smooth out earnings volatility. Given the extreme level of earnings volatility over the past 10 years we find this method appealing.

The Shiller P/E tells a somewhat better story at present than most traditional P/E measures. The current P/E is 15x normalized earnings, which is lower than most of the post-WWII period except for the early 1970s through mid-1980s when inflation and interest rates were generally much higher (when interest rates are very high P/E ratios are often lower on average compared to other times). P/Es could go lower and stay in a low range for a period of years. But this level of P/E has generally been a good long-term entry point into the stock market. We have plotted subsequent 10-year returns against P/E levels, and found that the vast majority of subsequent annualized returns from levels this low fall in a range of 5% up into the low teens.

### Dry Powder

There is a mountain of cash sitting on the sidelines. In fact, since the advent of money market funds almost 30 years ago, money market assets relative to total stock market capitalization has never been higher. Some of that cash is likely to find its way into stocks and bonds at some point as investors become more willing (or realize the need) to



take on more risk in order to earn higher returns than what they can get from holding cash. So this is another factor that can be viewed as a bullish indicator.

## Cautionary Signs

All of this evidence as it relates to the long-term potential in stocks is encouraging, but the near term is much less clear.

- Secular bear markets usually end at extreme levels of undervaluation. Most valuation measures suggest stocks are attractively priced now, but only one (price to free cash flow) puts stocks at the screaming buy levels seen in the 1930s or 1970s and early 1980s. The counter argument is that the 1930s economic collapse was much more severe than the current one is likely to be and that in the 1970s and early 1980s inflation and interest rates were much higher than they are 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, though slightly improving, remain dysfunctional and the housing market remains highly stressed. And while 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 the consensus expects. This could lead to an extended period of deflation, something that we are already getting a whiff of. In the near term, a significant deflation scare is not fully priced into the stock market.

## Weighing the Evidence

Overall the evidence does not clearly suggest that stocks are at highly compelling valuation levels. It also doesn't make an iron-clad case that the stock market bottomed in late November after the S&P 500 hit its lowest level since 1997. While it is quite possible, maybe even probable, that we have seen the bottom, we can't be sure. Forced selling by hedge funds and others may not be quite done and more individual investors could simply give up if the market heads back down towards its prior low. Taking into account technical factors together with interest rate considerations and valuations at past secular bear market lows, a bottom somewhere in the 600s on the S&P is not out of the question (if that happened we believe a rebound off that bottom would probably be quick and significant). *Despite the near-term caution, the weight of the evidence overwhelmingly suggests, in our opinion that investors are very unlikely to get hurt owning equities over the next five to 10 years and are likely to reap at least satisfactory returns.* That is a start and a justification for owning stocks with capital that is not needed in the near term. Thus far this discussion has focused on stocks, but they are not the only game in town.

**Investment-Grade Bonds:** Other than U.S. Treasury securities, opportunities abound in the bond market. Corporate, mortgage-backed, and municipal bonds all offer good value. We believe investors are likely to capture their yields and possibly some additional return through price appreciation over the next few years or sooner. These returns won't be eye-



popping, but we believe they could be quite good relative to our assessment of the risk in the asset class.

As we write this, the average BAA (the lowest investment-grade category) bond yield is over 8%. This market has begun to improve (yields have declined from the fourth quarter peak of about 9.6%) but yields remain attractive. Even accounting for higher defaults and an expectation of higher inflation several years down the road, bond prices are appealing.

Municipal bonds have also sold off sharply because of a combination of factors. Technical factors have hit the market with significantly reduced support for the market from broker/dealers and forced selling from hedge funds and mutual funds. Stressed municipalities and other tax-exempt issuers have also raised investor fears of defaults, though they have been rare in the past. Yields are currently widely out of line with likely inflation rates over the next few years and clearly out of line with the yields offered by most taxable bond sectors. Even with the risk of higher defaults, we believe tax-exempt bond investors are being well compensated.

**REITs:** The economy and the lack of reasonably priced financing (except for the apartment market) have raised expectations for severe stress in the commercial real estate market. REITs, which have been in a bear market for almost two years, were slaughtered in the fourth quarter. In November, at prices that were down well over 60% from their peak, they reached a level that we viewed as a fat pitch. At that level REITs were pricing in a better than 40% decline in underlying property values and a cumulative dividend decline in excess of 25% over five years. Historically, real estate cash flows and dividends have been far more stable than corporate cash flow because much of the revenue base is contractual with a portion of it locked in at below-market levels (which means that when the property is vacated or leases roll over there is the potential for a jump in rent). But in this environment we expect REIT cash flows to take a bigger hit than in past recessions because of an abnormally high level of tenant bankruptcies and soft rental markets. Even so we believe REIT prices briefly reached ridiculous levels in November.

The shocking volatility REITs have exhibited recently can't be explained by underlying fundamentals. There are indications that speculation tied to ETF trading may explain some of the extreme volatility we've seen. While we don't believe this level of volatility is likely to last or spread to other asset classes, unusually high volatility for many asset classes may come and go for a while.

## **What The Future Might Look Like For Investors**

This recession is likely to be with us for a while, probably at least through the first half of 2009 and very possibly into 2010. Home prices are still declining and the inventory of unsold homes remains extremely high relative to sales volume. Without dramatic government action there will be additional waves of foreclosures to come including many Alt-A mortgages. The credit markets also continue to be a major problem, with a



shrinking capital base and high borrowing rates for many corporations, municipalities, and consumers. Downside risks remain. However, the huge fiscal and monetary stimulus that is likely to carry on beyond the next year should be a major offsetting factor that will provide support to the economy. Still, the recession will be one of the worst of the post-WWII era and could turn out to be the worst since the 1930s. After it ends, we believe it will take quite a while for economic growth to get back to its long-term trend level.

In the near term of 2009, it is critically important that the marginal improvement we've seen in the credit markets takes hold and gathers strength. That is a prerequisite to an improved economy. As the Fed and the Treasury take whatever actions are necessary to make this happen it is possible that we will see direct government purchases of corporate bonds. We believe that credit markets will improve over the course of 2009 and if we are right it will be a good year for bonds. We are less certain about equities. For reasons mentioned above it is possible that stocks could revisit their lows and possibly move lower at some point during the year. *This is not a prediction but is an acknowledgement of a possibility.* However, by the end of 2009 we believe it is likely that stocks will be at least somewhat higher (compared to the year-end S&P level of about 900) and returns could be rewarding. By that time the recession will either be over or the longest downturn since the Great Depression, when the economy contracted for three years and seven months. Either way, it is likely that the stock market will be anticipating a recovery by that time.

We are prepared for volatile markets (though we think they will be less volatile than this past fall) and the possibility that many equity-type asset classes will experience wide performance swings with occasional strong rallies and subsequent sell-offs. Rallies could last for months with sizable returns, followed by sharp pullbacks. We have already seen a stock market rally of 18%, followed by a 25% decline, and a 21% rebound within the last few months. Sizable ups and downs in equity markets could play out over a period of a few years even as some equity markets stay within an overall trading range or move only marginally higher before beginning a new bull market. We don't know if this is what the next few years will look like, but we believe this to be a possible scenario because this is how other secular bear markets have petered out over time. This grinding process is one way to get at more bargain-priced markets as earnings start to recover faster than prices (this could happen even if earnings growth is subpar).

## **Final Thoughts**

We believe that at some point in the future we will be able to look back and see that our commitment to doing what we believe is right for our clients during this time period led to good long-term decisions. For example, there are times (not often) when what we believe is right for our clients is at odds with what they believe. At times like these, our disciplined approach is an important element of what we offer our clients. We are fortunate to have a great group of clients, who have been amazingly supportive and confident in our abilities in a year in which the markets were uniquely challenging. We



believe that this confidence is the result of more than a decade of hard work, mostly good decisions and results, and honest thinking and communication.

Through this period we believe we have stayed true to our responsibility of focusing on fundamentally based, rational decision-making. However, while we maintain a primary focus on the long term, we have also become more sensitive to short-term concerns given the historic levels of volatility and risk, and we have factored that into our thinking as well. Put simply, given the levels of losses we've already seen, some clients are more sensitive to additional incremental declines and are equally or more concerned about short-term risk management than long-term return. For this reason we have been more cautious than usual about establishing an equity overweight, especially given the compelling alternatives available at lower risk (such as bonds).

We know that 2009 and beyond will remain challenging but we believe we are well equipped to navigate treacherous waters. We also believe that financial assets have priced in enough damage so that sustained losses (as opposed to temporary down market blips) over multiyear periods are now very unlikely. We look forward to working with you to achieve your financial goals in the New Year.

## **Tarpley & Underwood Financial Advisors, LLC**

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