

# INVESTMENT COMMENTARY

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3500 Oak Lawn Avenue, Suite 240 · Dallas, TX 75219 · 214-752-5430

<http://www.larrythompson.net>

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## The Markets

Despite a late March rally, most of the world's equity markets ended the first quarter much lower than they began it. The lone exception was emerging markets, which gained 1.0%, led by strong returns in Latin America. The domestic bond market (Barclays U.S. Aggregate) was also positive, and boasts a ten-year average annual return of 5.7%, more than 8% greater than large-cap domestic equities (Russell 1000).

Index	Quarter to Date	Year to Date	Trailing 1 Year	Trailing 3 Years	Trailing 5 Years	Trailing 10 Years
<u>Domestic Equity (Large Cap)</u>						
Russell 1000	(10.45)	(10.45)	(38.27)	(13.24)	(4.54)	(2.57)
Russell 1000 Growth	(4.12)	(4.12)	(34.28)	(11.28)	(4.38)	(5.26)
Russell 1000 Value	(16.77)	(16.77)	(42.42)	(15.40)	(4.94)	(0.62)
<u>Domestic Equity (Mid Cap)</u>						
Russell MidCap	(8.98)	(8.98)	(40.81)	(15.53)	(3.53)	2.27
Russell MidCap Growth	(3.36)	(3.36)	(39.58)	(14.89)	(3.91)	(0.86)
Russell MidCap Value	(14.68)	(14.68)	(42.51)	(16.68)	(3.81)	3.13
<u>Domestic Equity (Small Cap)</u>						
Russell 2000	(14.95)	(14.95)	(37.50)	(16.80)	(5.24)	1.93
Russell 2000 Growth	(9.74)	(9.74)	(36.36)	(16.20)	(5.37)	(1.60)
Russell 2000 Value	(19.64)	(19.64)	(38.89)	(17.54)	(5.30)	4.87
<u>International Equity</u>						
MSCI World ex US	(13.14)	(13.14)	(46.31)	(14.10)	(1.74)	(0.39)
MSCI World ex US Growth	(11.71)	(11.71)	(45.28)	(12.65)	(1.43)	(2.00)
MSCI World ex US Value	(14.66)	(14.66)	(47.43)	(15.65)	(2.16)	0.97
MSCI Emerging Markets	1.02	1.02	(46.90)	(7.88)	6.25	8.14
<u>Real Estate</u>						
Nareit Equity REITs	(31.87)	(31.87)	(58.16)	(25.06)	(8.65)	3.88
<u>Domestic Fixed Income</u>						
Barclays U.S. Aggregate	0.12	0.12	3.13	5.77	4.13	5.70

**Investment Commentary** is a newsletter dedicated to the issues, trends, and strategies surrounding both the individual and institutional investor. It is published quarterly by Larry Thompson & Associates, an independent investment management consulting firm based in Dallas, Texas.

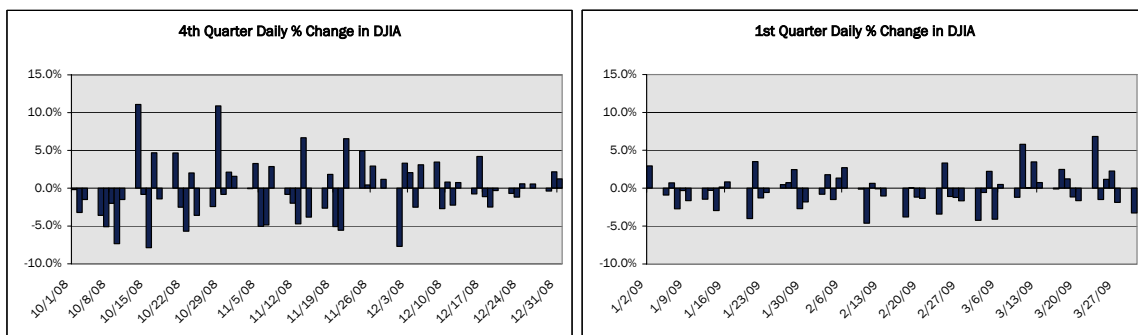
During the quarter, growth outperformed value and domestic equities outperformed developed international equities. The large disparity between growth and value can be explained by the performance of the information technology and financial sectors. The largest growth sector is information technology, and it was the only sector to be positive during the first quarter, up 3.9%. The largest value sector is financials and it was the worst performing sector during the quarter, losing 27.2%. The financial sector loss would have been much worse were it not for a 16.4% gain in March.

Looking at the four major developed world markets (the U.S., the U.K., Europe, and Japan), the best performers were the U.S and the U.K., which had very similar returns. Both Europe and Japan struggled, losing 16.2% (MSCI Europe ex. U.K. index) and 16.6% (MSCI Japan index). A strengthening U.S. Dollar drove much of Europe's and all of Japan's relative underperformance. In local currency terms, Europe lost 12.1% and Japan lost 9.2%.

Of the four major emerging markets of Brazil, Russia, India and China, Brazil was the best performer, gaining 12.5% in the quarter. Russia gained 5.9%, India was down 1.5%, and China gained 1.3%. Eastern European countries were the worst performers as the worldwide recession continues to hit the region especially hard. Although Latin America was the emerging world's best performing region, Argentina lost 15.1% as MSCI announced that it would be downgrading the country from the MSCI Emerging Markets Index to the MSCI Frontier Market index. Argentina will now join the likes of Kuwait, the United Arab Emirates and Nigeria as a major frontier market.

### Additional Market Thoughts

There has been no shortage of major economic and market events over the past two quarters and the media has not been timid in its coverage of the stories. However, the events of the first quarter of 2009 did not seem to have as significant an impact as they did during the fourth quarter of last year. The charts on the next page show the daily percent change in the Dow Jones Industrial Average (DJIA). During the fourth quarter, there were four days when the DJIA gained more than 5% and eight days when the DJIA lost more than 5%. During the first quarter, there were only two days of greater than 5% gains and no days where the market lost more than 5%. The encouraging sign is that the panic selling that permeated the markets at the end of last year may be behind us. Discouragingly, equity prices fell through much of the first quarter, just not as quickly.

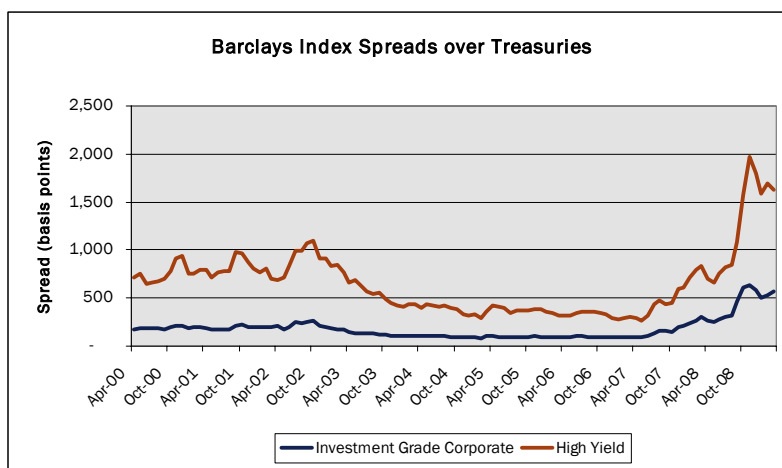


It seems that a major financial news story breaks every few days. Just in the final few weeks of March, investors had to form opinions on bonus payments to AIG executives, the Treasury Department's plan to save the banks through a public/private partnership, and the seemingly inevitable bankruptcy of a major U.S. automaker. This does not even include the

beginning of a summit of world leaders to discuss such topics as the continuance of the U.S. Dollar as the world's reserve currency and an increasing rise in global trade restrictions. We believe that investors are overloaded with information and the majority has decided to sit on the sidelines until a clearer picture has emerged.

We think the fact that the DJIA has gained over 15% in the past few weeks could be a sign that investors are willing to come back to the market, but want to know if the investing "rules" of the past few decades are still in effect or if we are embarking on a new era of investing. The biggest one-day gain in the first quarter was the day that the Treasury announced their plan to loan private companies funds to purchase debt from struggling banks. It might take years before we know whether the announced plan will work, but at this stage, investors do not seem to care. The fact that the government has settled on a plan was enough encouragement for many investors. It will be interesting to see how the investing community responds when the government crystallizes its plan with respect to the auto industry.

Overall, bonds were modestly positive during the quarter, but both U.S. Treasuries and corporate bonds were negative. Residential mortgage and asset-backed bonds were the strongest performers. Currently, investment grade corporate bonds offer a 5.7% yield premium and high yield bonds offer a 16.3% yield premium over Treasuries. Both premiums are lower than their peaks in the fourth quarter, but still appear attractive – at least compared to historical premiums. The chart below shows the spread histories.



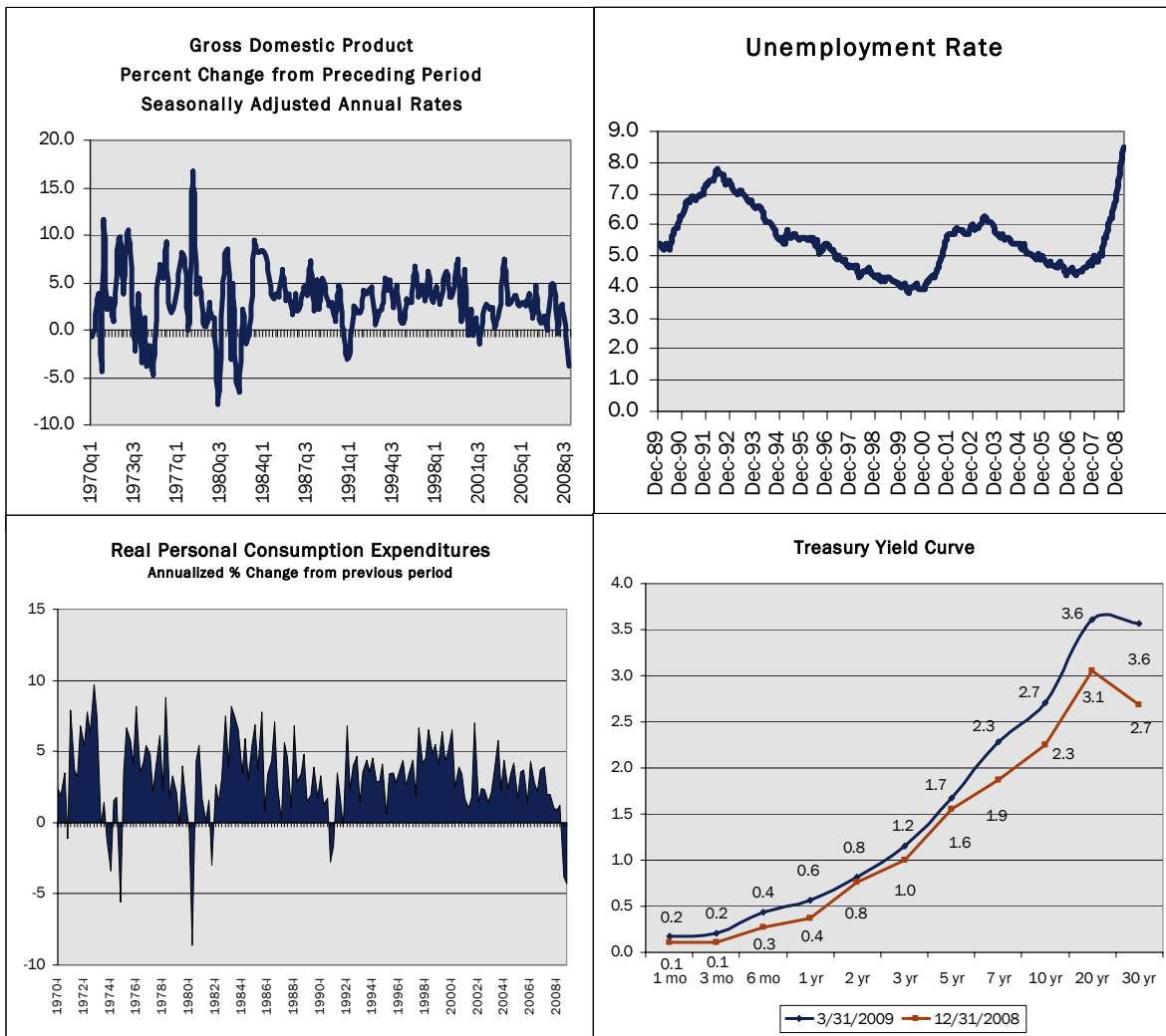
The current debate among bond investors is whether the market has appropriately priced corporate issues or has it priced at least some of these issues too low, thereby presenting opportunities. There is no doubt that bond defaults are on the rise and issues are being downgraded as the economy weakens. However, we do not believe that investment grade corporate bonds will see the default rates that justify such a large yield premium over a comparable U.S. Treasury. We believe there are opportunities in investment grade corporate bonds, although care must be taken to avoid the potential landmines. As with equities, a clearer picture of how the government may or may not be involved in corporate America would go a long way towards settling these valuation debates.

### The Economy

The first quarter of 2009 has passed and the economy has not shown many signs of improvement. The following charts provide current key economic statistics. Gross Domestic

Product (or GDP – a broad measure of our country’s economic growth), lost 3.8% during the fourth quarter, the worst result since early 1982. The first quarter data will not be available for another few weeks, but it is expected to be even lower. We have seen large negative values before (-7.8% in 2Q 1980, -4.9% in 4Q 1981, and -6.4% in 1Q 1982), but they are very rare. Economic growth has been very stable the past 25 years, which makes this deep recession that much more difficult to cope with.

As the economy weakens, so does the unemployment picture. The current unemployment rate is 8.5% and growing. We continue to be optimistic that the markets will rebound before the unemployment picture improves, but we remain concerned that this economic cycle is much worse than our last one. During the past few recessions, the market began to fall prior to employment declines and it moved much higher before the employment picture improved. This time, employment worsened as early as April 2007, six months before the market peaked. Investors’ psychology may be so damaged that they may wait to see clear signs of improving employment prior to investing in equities again.



There have been no good developments in consumer spending and consumers are spending less today than they were a year ago. This is only the sixth time this has happened since

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1970 and the first since 1991. We have repeatedly discussed this issue in the past and continue to believe that the economy cannot recover until the consumer is spending again.

The yield curve is very steep and steepened even more during the first quarter. Steep yield curves are historically a good predictor of economic recovery. First, the very low rates on the short end of the curve tell us that investors are earning almost nothing on short-term deposits. In the past, investors would only tolerate this for so long and eventually begin to either invest in more risky assets or spend some of their savings. Second, rising long-term rates suggest falling bond prices. This indicates that bond investors may be becoming disenchanted with Treasury returns, believing their capital could earn better returns elsewhere. Finally, banks can be very profitable under a steep yield curve environment. Banks have the ability to loan money at the higher long-term rates, while they pay depositors the much lower short-term rates. This encourages banks to lend and capture the spread between the long and short-term rates.

Despite how attractive it might be for banks to lend in the current environment, many are not doing so, mostly because banks are worried about the creditworthiness of the borrowers, but also because they are concerned about their survival. The government has been working with the banks in an attempt to increase their lending, which it sees as critical to the normal operation of our economy. So far, most government programs have been designed to increase equity in banks, allowing them to make new loans, while maintaining the minimum reserve requirements. The government has so far chosen to “inject” capital into the banks, but not enough to take controlling interests or nationalize them. Because of the public’s dislike of the idea of nationalized banks, the government has had to come up with another plan.

The newest plan is to have private firms buy troubled assets from public companies, using cheaply borrowed government funds. The idea is for investors (mostly private equity and hedge funds) to begin buying the so-called “toxic assets” from the banks. *In theory*, the banks win because they clear their balance sheets of the toxic assets and replace them with cash. With their balance sheets clean and reserve requirements no longer threatened, they can resume their normal lending operations. The private equity and hedge funds hope to win by being able to buy assets at pennies on the dollar that they hope to sell for profits in the future. Because these types of investors typically have longer investment time horizons, they can afford to hold the assets for several years if need be. What makes the deal *seem* even better for them is that the government is giving them much of the funds to make the purchases, presumably reducing the investment risk of the strategy.

Investors initially saw the plan as a great solution, but their enthusiasm quickly cooled. First, the banks, as potential sellers, and the private equity and hedge funds, as potential buyers, may not be able to agree on a price for these troubled assets. This seems to be the case so far. Banks are reluctant to sell these assets too cheaply. If a bank owns a pool of similarly structured poorly performing mortgage loans and sells one of them to a private equity fund for a discount, it may be required to mark the remaining loans at the new price. This reduces the bank’s assets and further hinders its ability to make loans. Likewise, many private equity funds – some already sitting on plenty of cash – have shown little interest in paying current prices. Investors are troubled that private equity funds may only be willing to purchase these assets if they can do so with an ample portion of government (yours and mine) money.

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There are other concerns as well, but perhaps the single biggest fear of investors and investment managers is that a long-term arrangement will be entered into under one set of rules, only to have those rules change after the fact.

Most likely, solutions to these problems will be found, but the new plan will not likely be the full savior of the banking sector and the overall economy. The government will need to continue to find new solutions, and most likely demand additional funds, increasing the national debt. Our current national debt totals \$11.1 trillion and we are adding to it each month.

Clients often ask us how the government plans to pay for all of the new government initiatives, which now total several trillion dollars. The answer is by borrowing the money through the Treasury market. The U.S. is fortunate to have a Treasury bond that is regarded as the safest investment in the world. Its solid reputation has always ensured strong investor demand and has allowed our government to run deficits, knowing that they could always finance them with Treasuries. This strong demand has kept Treasury yields lower than most bonds, but investors have been willing to trade a slightly lower yield for the absolute certainty that the bond would not default. With billions of dollars in Treasuries to be auctioned in the coming quarters, the Treasury will be testing the limit of investors' appetite for Treasuries.

The U.S. government is not alone in issuing large amounts of new debt on the market and other countries' debt could compete head to head with the Treasury for investors' money. On March 25, the U.K. had a bond auction that failed, a worrying sign for all future bond auctions around the world. The U.K. government attempted to auction off £1.75 billion in 40-year bonds, but only generated bids for £1.63 billion. It was the first failed auction in 14 years. In early April, the U.K. did successfully auction off £2.25 billion of 30-year bonds, receiving bids of more than £3.5 billion. The failed 40-year auction may prove to be an anomaly. If it is not and represents a sign of what may lie ahead, governments around the world may need to offer better coupon rates to generate sufficient demand for the increasing amounts of debt. While higher coupon rates make the debt more attractive to investors, it also makes them more expensive for the government to maintain. Our firm remains concerned with the level of upcoming new issuance and how it might swamp a stretched bond market.

### **In Summary . . .**

However encouraging the recent financial market rally has been, our economy is not yet improving. What is different today is that we can begin to see how the improvement might occur. GDP is still slowing, but many economists expect the first quarter to be the low point, before improving later this year. All facets of residential real estate are still in the firm grip of the recession. Now, commercial real estate is following suit. On the bright side, mortgage rates are extremely low, which has spurred a new round of refinancing activity. The lack of consumer spending remains a major hindrance to an economic recovery. Our economy simply cannot recover without consumer participation. Part of the consumer pullback has to do with the growing levels of unemployment. Corporations continue to lay off employees in response to weak earnings. In many cases, weak earnings are the result of – you guessed it – a lack of consumer spending. The vicious cycle continues. How can it be broken?

Simply stated, consumers have lost their confidence. There are too many uncertainties for the typical consumer to digest. Consider the potential demise of the domestic banking system. Who would be saved? Who would be allowed to perish? What will become of the

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domestic automobile industry? What will the government's role be in corporate America? Will capitalism be traded in for some form of socialism?

The recent strength in the equity markets indicate that investors really do want to return to the markets. We believe that prospective consumers as well as investors will return to their normal ways only after they are confident that answers exist for the major economic questions of today – even if they do not always like or agree with the answers. Americans can weather any contest, but it would be helpful to at least know the rules of the game.