

# INVESTMENT COMMENTARY

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## The Markets

Good news was hard to find during the third quarter of 2008. Equity markets around the world treaded water in July and August before crashing in September in the wake of unprecedented collapses in some of the world's largest financial companies. The table below shows the damages.

Table 1

Index	Quarter	Year to Date	Trailing 1 Year	Trailing 3 Years	Trailing 5 Years	Trailing 10 Years
<u>Domestic Equity (Large Cap)</u>						
Russell 1000	(9.35)	(19.50)	(22.10)	0.13	5.50	3.49
Russell 1000 Growth	(12.33)	(20.27)	(20.88)	0.04	3.74	0.59
Russell 1000 Value	(6.11)	(18.85)	(23.56)	0.09	7.12	5.55
<u>Domestic Equity (Mid Cap)</u>						
Russell MidCap	(12.91)	(19.50)	(22.36)	0.09	8.62	8.34
Russell MidCap Growth	(17.75)	(23.35)	(24.65)	(0.75)	6.53	5.51
Russell MidCap Value	(7.52)	(15.46)	(20.50)	0.51	9.97	9.19
<u>Domestic Equity (Small Cap)</u>						
Russell 2000	(1.11)	(10.38)	(14.48)	1.83	8.15	7.81
Russell 2000 Growth	(6.99)	(15.29)	(17.07)	1.45	6.64	4.67
Russell 2000 Value	4.96	(5.37)	(12.25)	2.00	9.45	10.14
<u>International Equity</u>						
MSCI World ex US	(20.67)	(28.42)	(29.57)	1.69	10.28	5.56
MSCI World ex US Growth	(22.83)	(27.73)	(27.68)	2.72	9.88	3.55
MSCI World ex US Value	(18.41)	(29.16)	(31.55)	0.57	10.58	7.32
MSCI Emerging Markets (Gross)	(26.86)	(35.37)	(33.01)	8.69	19.05	14.77
<u>Real Estate</u>						
Nareit Equity REITs	5.56	1.73	(11.17)	5.55	13.45	12.49
<u>Domestic Fixed Income</u>						
LB Aggregate	(0.48)	0.64	3.66	4.15	3.78	5.20

**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.

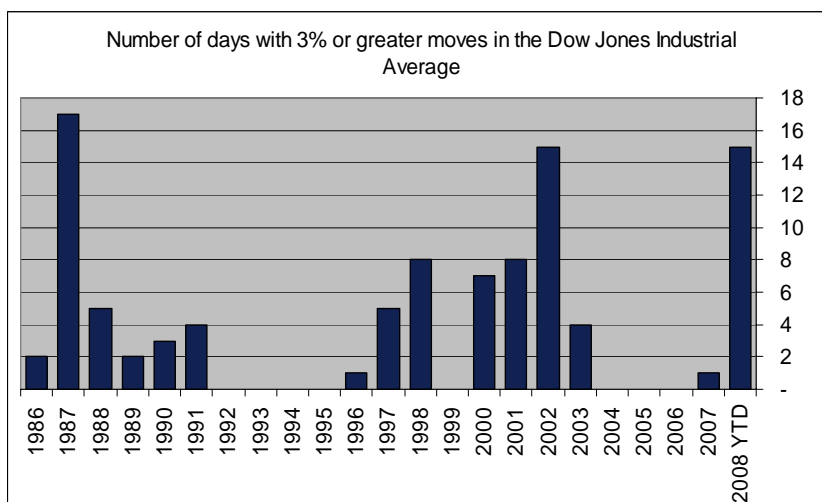
The only safe havens during the quarter were in small cap value stocks, real estate investment trusts, and U.S. government bonds. Investor confidence became so weak that many were questioning the stability of their money market funds. One well-known money market fund suffered losses from the bankruptcy of Lehman Brothers and was forced to lower its value from \$1.00, an almost unheard of action. Of course, after the springtime failure of the auction rate securities market, which had been assumed to be virtually risk-free, there should be little that surprises us anymore in these markets.

**Table 2**

2008 Russell 3000 Monthly Returns													
Sector	Index Weight											Index Weight	Year to
	12/31/07	January	February	March	April	May	June	July	August	September	09/30/08	Date	
Consumer Discretionary	10%	-2.3	-4.8	-1.1	4.3	0.9	-12.7	0.5	6.7	-8.6	9%	-17.2	
Consumer Staples	9%	-5.2	-0.3	3.0	-0.0	1.4	-6.7	3.2	2.6	-1.6	11%	-4.0	
Energy	12%	-10.5	7.4	-2.5	11.2	4.7	3.4	-14.7	-0.8	-13.7	12%	-18.5	
Financials	17%	-0.3	-10.4	-2.2	5.8	-4.6	-17.3	7.0	0.0	-3.2	16%	-26.4	
Health Care	12%	-5.1	-2.4	-4.3	1.5	2.2	-4.6	6.0	2.1	-6.3	13%	-11.2	
Industrials	12%	-5.1	-2.3	2.1	2.5	2.4	-11.4	1.9	1.6	-13.0	12%	-22.0	
Information Technology	17%	-12.5	-3.8	0.7	6.9	6.2	-9.1	-1.2	2.5	-12.9	16%	-23.2	
Materials	4%	-4.6	3.0	-1.5	5.9	5.6	-5.5	-3.7	-2.8	-19.0	4%	-22.9	
Telecommunication Services	3%	-9.2	-9.5	3.9	5.8	4.0	-11.4	-4.8	2.7	-13.4	3%	-29.5	
Utilities	4%	-6.8	-4.2	1.0	5.9	3.2	-1.5	-6.4	-0.5	-11.5	4%	-21.1	
<b>Russell 3000</b>		<b>-6.1</b>	<b>-3.1</b>	<b>-0.6</b>	<b>5.0</b>	<b>2.0</b>	<b>-8.3</b>	<b>-0.8</b>	<b>1.6</b>	<b>-9.4</b>		<b>-19.5</b>	

Despite the overall losses, there were some positive performing sectors during the quarter, although all sectors are negative on a year to date basis. Within the Russell 3000 index, which we are using as a proxy for the overall U.S. stock markets – large and small, the consumer staples, health care, and financial sectors (believe it or not) were positive during the quarter. Having avoided much of the financial distress of the past year, several financial companies had very strong stock performances. Bank of America’s stock was up 50% during the quarter, Capital One’s was up 35%, Citigroup’s was up almost 25%, and J.P. Morgan’s was up close to 38%. There were some bargains to be found, but investors had to look hard to find them.

Another major story is the remarkable volatility that we have seen in the markets in 2008. The chart below shows the number of 3% or greater moves in the Dow Jones Industrial Average by calendar year. After not seeing any 3% moves from 2004 to 2006 and only one in 2007, we have seen 15 so far this year. The financial names mentioned above might



have had strong quarters, but their returns, and the returns of many stocks, have been very volatile. It seems that every day brings a new market, one which is almost unrelated to the prior day’s. It is important for investors to remain focused on the long term and do their best to ignore the daily market movements.

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## How we found ourselves here

The past year has seen unprecedented events involving financial companies. The news has been breaking so quickly that there is little time to digest each event. It is sometimes hard to step back and realize that we have only been discussing these issues for just over a year, although the first “major” event (the collapse of Bear Stearns) did not happen until March. Below is a timeline of the events that have occurred so far.

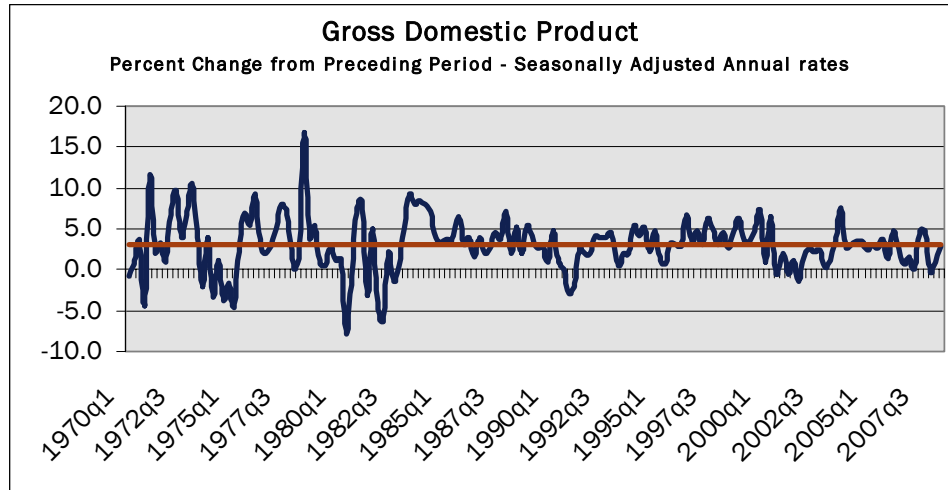
- August 2007 - Two Bear Stearns hedge funds collapse as the sub-prime mortgage market begins to deteriorate. The funds hedged their positions with credit default swaps, but not adequately as events in the market unfolded more extremely than the managers expected. The over-leveraged funds began receiving margin calls from creditors as the securities used as collateral began to fall in value. Because the funds lacked sufficient liquidity, they were forced to sell the securities to meet these calls, resulting in a downward spiral. These events sparked the rise in perceived risk of the sub-prime mortgage markets.
- September 2007 – The Federal Reserve begins the most aggressive round of interest rate cuts in 20 years to increase liquidity and boost the slumping economy. Over the next six months, the target fed funds rate was cut by 325 basis points (3.25%) to its current level of 2.00%.
- January 2008 - Countrywide Financial is acquired by Bank of America after six months of struggling with adverse credit markets. Countrywide came under pressure as the market for non-conforming mortgages dried up in August 2007. At the time, Countrywide issued about 17% of all mortgages in the U.S., with many offered to less qualified borrowers (i.e.. sub-prime and Alt-A). Subsequent credit rating downgrades put the firm and its stock under intense pressure.
- March 2008 – Bear Stearns collapses due to rapidly deteriorating value of its assets. The Federal Reserve steps in and assists J.P. Morgan with its takeover of the firm for \$10/share. This was a dramatic drop from its January 2007 value of \$172/share.
- Second Quarter 2008 – The federal government passes a Fiscal Stimulus Act in an attempt to jumpstart the consumer and provide relief for rising prices in food and energy. The stimulus provides some relief in the short run, but does not prove to be enough to overcome a crisis of confidence.
- September 8, 2008 - The federal government places Fannie Mae and Freddie Mac in the conservatorship of the Federal Housing Finance Agency. Their balance sheets were rapidly deteriorating due to rising mortgage delinquencies and strained credit markets. It was argued that their failure would have significantly “affected the ability of Americans to get home loans, auto loans and other consumer credit and business finance.” Together, the two firms backed half of the nation’s mortgage debt, or \$5 billion. The move initially resulted in a sharp decline in mortgage rates in the following days.
- September 14, 2008 -
  - Lehman Brothers files for chapter 11 bankruptcy as attempts to sell assets and raise capital over the weekend fail when potential buyers walk away.

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- Merrill Lynch agreed to sell itself to Bank of America for \$29/share as the spotlight was turned on it in the wake of Lehman's failure.
  - September 16, 2008 – AIG narrowly avoids bankruptcy as the government lends the company \$85 billion. AIG is in the process of selling assets to repay the government loan. The government did not allow AIG to fail, as in the government's view, its failure could have severely disrupted the credit markets.
  - September 17, 2008 - Money market funds come under intense scrutiny when the Reserve Primary Fund broke the \$1 NAV mark. This led to an immense "run" on money market fund assets and caused short-term treasury bills to temporarily trade at negative yields.
  - September 19, 2008 - Treasury Secretary Henry Paulson proposes a \$700 billion plan to alleviate stress in the credit markets by buying the "toxic assets" held by financial institutions. Due to market conditions, these assets are being held on balance sheets at a small fraction of face value. The plan aims to purchase these securities at a price in between current market prices and their perceived intrinsic value with the intent to sell them at a later date in more favorable market conditions. The bill was initially rejected by the House, and a revised bill including many more tax breaks and relief for consumers was passed by the Senate and House later in the week.
  - September 21, 2008 - The two remaining independent investment banks (Goldman Sachs and Morgan Stanley) were granted the ability to change their status to bank holding companies, effectively ending the independent investment bank era. This will result in much tighter oversight and regulation by the Federal Reserve, as well as a significant de-leveraging process to come in accordance with the capital requirements of commercial banks.

These are truly unprecedented times and we do not think we have seen the end of the news.

### **The Economy**

Over the past few months, the word "recession" has been tossed around by seemingly everyone, including our firm in our last quarterly commentary. The combination of high energy prices, high inflation, falling housing prices and the never ending saga of the financial markets has convinced everyone that this must be a recession. Actual economic data, as it stands now, continues to say otherwise. Obviously, the issues facing the housing, financial, and banking systems around the world are real and serious. They have the *potential* to bring the entire U.S. economy into recession, but the economy has, so far, stubbornly fought off all attempts to do so. In fact, when compared to past recessions, we have been very fortunate that the damage has been as light as it has. Hopefully, this does not signal worse times ahead.



As we have stated many times in the past, the consumer is the heart of the economy. Consumer spending currently makes up 71% of the economy, while the government contributes 20%, “gross private domestic investment” adds another 14%, and the balance (-5%) is lost to the trade deficit (exports minus imports). Gross private domestic investment is largely corporations spending on factories, machines and equipment and is often used as a measure of corporate spending in the economy. Now that you know the components of GDP, how are each of these areas doing?

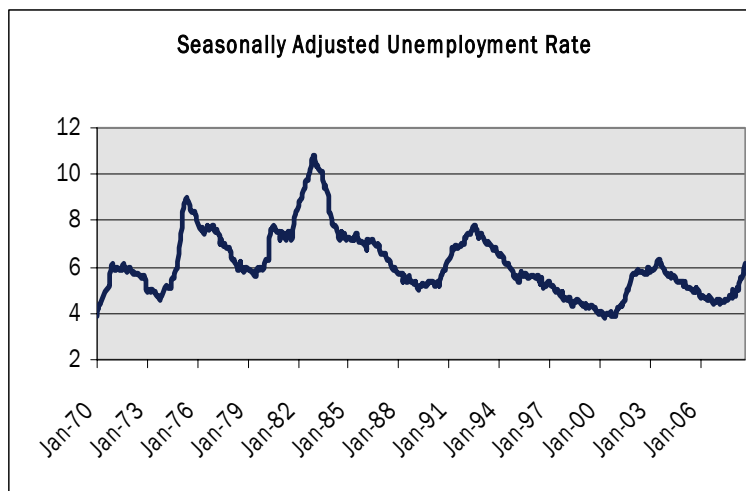
The consumers have held up remarkably well given all the events of the past year. Not only have their houses lost close to 20% of their value, but their stock portfolios have lost a similar amount. On top of that, they have been hit with high energy prices, which have indirectly increased the costs of almost every good they buy. Despite all these troubling events, the consumer has continued to spend. They have spent more slowly in the past few quarters, but more than they spent in the quarter before. Consumer spending rose 1.0% in the fourth quarter of last year, 0.9% in the first quarter of 2008 and 1.2% in the second quarter. This is similar to what was seen in the most recent recession, earlier this decade. In the first three quarters of 2001, consumer spending rose 1.7%, 1.0% and 1.8%. Of course the recession in 2001 was seen as a small recession, at least for those who did not work in the technology sector. For a more dramatic comparison, compare the recent consumer spending with what we experienced in the 1970s, 1980s and 1990s.

Periods of Negative Consumer Spending in the United States since 1970	
09/30/1973 to 12/31/1974	-6.8%
12/31/1979 to 06/30/1980	-9.1%
09/30/1981 to 12/31/1981	-3.0%
09/30/1990 to 03/31/1991	-4.5%

Consumer spending was no less important to our economy then as it is today. It is not a coincidence that these sharp falls in consumer spending were associated with very serious recessions. These were periods of very weak consumer spending, not at all what we are seeing in 2008. Are we on the verge of entering a time period of negative consumer

spending? The answer is unclear, but given the issues that are hitting consumers, the possibility remains.

Most worrying is the recent rise in unemployment. As the chart below shows, the national unemployment rate is very cyclical and changes very slowly. The latest data shows unemployment at 6.1%, just below the previous peak 6.3% unemployment seen in June 2003. Given the uncertain short-term future of our economy, the unemployment rate could rise past 6.3%, which would put it at the highest level since April 1994. Previous peak unemployment rates were 7.8% in June 1992, 10.8% in December 1982, 9.0% in May 1975, and 6.1% in August 1971. At this point, we do not see the current rate rising to those high levels of the past, but it does not need to go that high to be very harmful to economic growth.

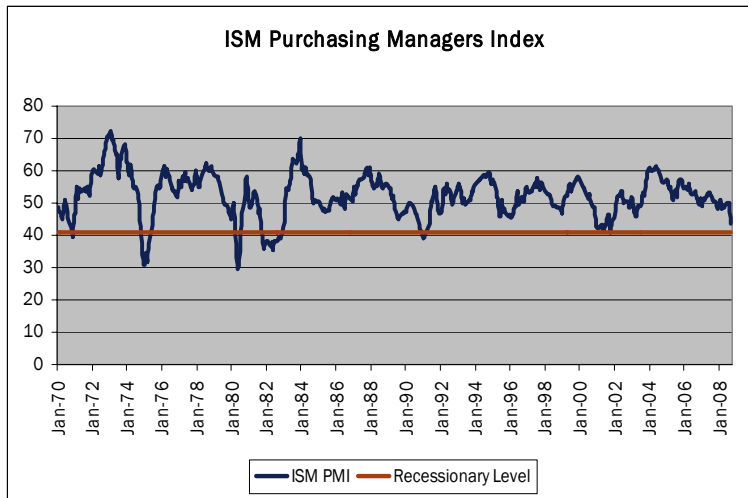


As the second most important contributor to our economy, the government has a very large role in determining how it performs. Currently, it is doing its best to keep the economy out of recession. The tax rebate that was passed last spring and distributed this summer did provide a boost to the economy, probably keeping it from slipping into a recession. More recently, the government has been providing cash to

corporations to help them fight off slowing consumer spending. The passing of the TARP (Troubled Asset Relief Program) is another example of the government attempting to get cash into the hands of corporations, specifically financial companies. \$700 billion is set aside to buy troubled assets of financial companies, allowing these companies to remove bad assets from their books and replacing them with cash. Another several hundred billion was tacked onto the bill in the days before its passing to assist certain non-financial companies and some individuals. The plan sounds very promising, but only if the financial companies manage to get that cash into the hands of the general public. Simply improving the balance sheets of financial companies will not improve consumer spending and will not prevent the economy from sinking further. What it will do is likely improve the performance of financial stocks, which, as mentioned above, were the best performing sector in the third quarter. While it is too early to judge the success of the TARP, we are not optimistic. Just as the tax rebates of the summer provided the economy with a short term boost, we feel the TARP will only provide us temporary relief. Unless the government can fix what is fundamentally wrong with the economy (i.e., wages that are not keeping up with our spending – discussed below), we will not be able to keep the economy afloat for long. Much of the responsibility for economic growth lies in the hands of corporations.

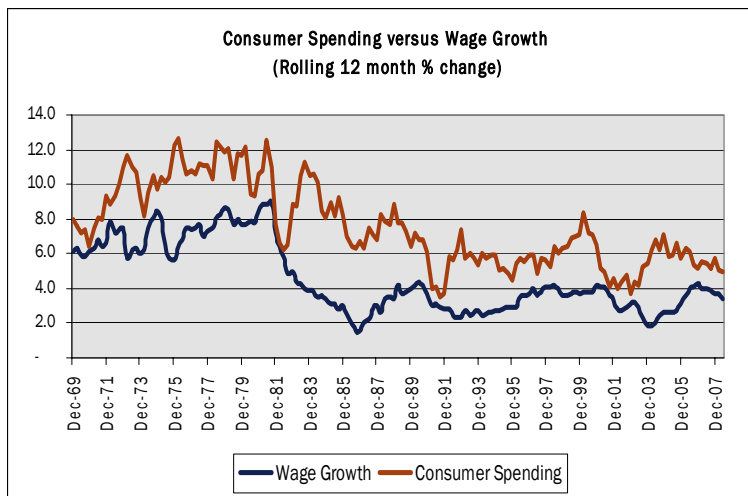
If consumers cannot maintain their spending and the government is not offering much more than a temporary solution, are corporations prepared to make the changes that might point the economy in the right direction? In short, we do not think so. The latest Institute for Supply Management's Purchasing Managers' Index showed a sharp drop. The index is a measurement of manufacturing activity in the U.S. A level of 50 is breakeven. Values above

50 show growth in manufacturing and levels below 50 show a contraction in manufacturing. Levels below 41.1 have historically meant a full blown U.S. recession. The September reading was 43.5, down from the August reading of 49.9. U.S. manufacturers are clearly expecting very difficult times.



Because of the economic weakness and trouble in obtaining financing, corporations have been building cash reserves to keep themselves in business. Excluding utilities and financial companies, U.S. companies had a record level of cash on their balance sheets at June 30<sup>th</sup>. The cash raising has come at the expense of their employees' wages. The

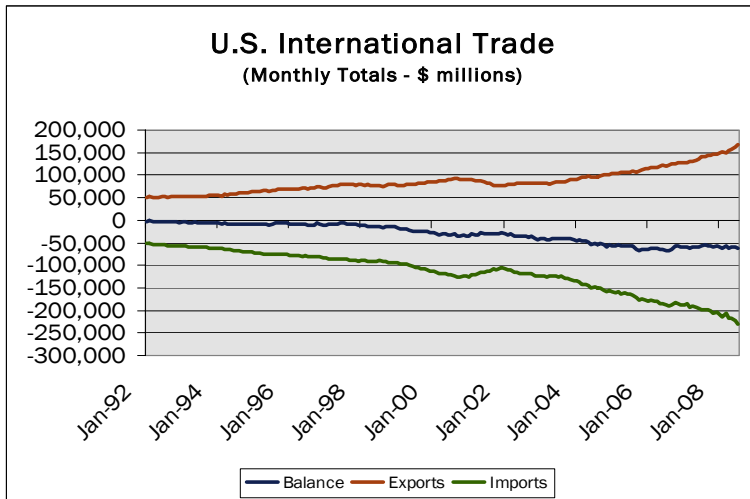
Bureaus of Labor Statistics estimates that wages grew only 3.4% in the past year, well behind the 5.4% that inflation has gained in the past year. Wages have historically followed the rate of inflation. As we have experienced lower inflation in the past few decades, we have seen lower wage growth.



What is more worrying is that consumer spending has outpaced wage growth, meaning that consumers have used other sources of income (mostly borrowing) to fund their spending. We have covered this issue in many previous quarterly commentaries. It is difficult attempting to figure out what will fill the gap now that borrowing has largely been eliminated as a source of

funds. There can only be two options. Wages will have to rise to match consumers' love of spending, or our level of spending will have to fall to equal our level of incomes. We hope it is the former, but past recessions have taught us that consumer spending will likely fall.

The final component of GDP growth is the balance of trade, which is equal to exports minus imports. For countries that export more than they import, this can be a strong boost to GDP growth. The U.S. has had a trade deficit for years, meaning that we as a country import more than we export. Currently, we are importing approximately \$60 billion more a month than we are exporting, which has been detracting from GDP growth. A weaker U.S. Dollar has helped increase exports in the past few years, which lowered the trade deficit from its October 2005



peak of just over \$67 billion to a September 2007 value of \$55 billion. Unfortunately for GDP growth, the deficit has been increasing since that time. International trade has a much smaller impact on our GDP growth than consumer spending, but it is piling on to an already poor situation.

### In Summary . . .

There is not much good to say about our markets or the economy. Equity markets are down over 30% in the past year, with the Dow Jones Industrial Average falling from over 14,000 to 9,500. We see the economy weakening and we expect more upsetting economic headlines in the coming months. If there is a positive statement, it is that the market has fallen as far and as fast as it has. It appears that the market has priced in a lot of bad news, not all of which has been revealed. Historically, markets tend to swing too far, both positively and negatively. Did the Dow Jones deserve to be above 14,000? Maybe not. Does it deserve to be trading below 9,000? We do not think so. Perhaps, the true value is somewhere in between. Are we at or near the bottom of the market? No one knows for sure. What we do know is that the market today is cheaper than it has been in years and long-term investors should view the current market level as an opportunity to rethink their risk tolerance and return expectations. Now is a good time to make asset allocation changes to prepare the portfolio for the inevitable rebound, which may not come tomorrow, next week, next month or even next year, but it will come.