

LARRY THOMPSON & ASSOCIATES, INC

ECONOMIC & MARKET REVIEW

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Confidence has been replaced by hesitation and indecisiveness. Gone are the days when investors committed investment capital with conviction, leaving today's financial markets volatile if not somewhat fragile. To understand the mindset of today's investor, one must look to the root of the investor's current psychology.

The Past

As institutions and individuals will remember all too well, the period from late 2007 through early 2009 left global financial markets in turmoil. The period, now dubbed the "Great Recession", was brought on by one of the worst credit crises in U.S. history, with tentacles reaching around the globe. In an effort to save their economies from a Great Depression, governments, all over the world, injected massive amounts of liquidity into the system in an effort to support their economies, hoping they would recover and stand on their own. Although emerging economies had the cash, much of the developed world fell farther into debt.

Public equity markets were crushed around the world. Likewise, private equity values declined dramatically as did the values of commercial real estate. While certain parts of our financial markets "lost less", only government bond markets appreciated in a significant way, as investors' only thought was "not losing more money" – even if that meant living with a zero percent rate of return in the cash markets.

Just as investors and their investment managers were wondering when, if ever, a "bottom" to the market would be reached, on March 9, 2009, public equity markets around the world abruptly changed course and began a much needed recovery. It was not a full retracement by any means, but a healthy step in the right direction. At the time, investors were optimistic that the economy would recover quickly and moved in to pick up stocks at prices that many had not seen before. Bond markets sold off as money flowed back into the public equity markets. Other investment strategies such as commercial real estate and private equity did not generally participate in the 2009 recovery – partially due to the economic characteristics of

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the asset classes, but also due to the illiquidity of many of these types of investments.

The Present

Although 2010 started out on an uptick, the year has been one of intense investor scrutiny, as many have been hanging on every word and action of the Obama administration, the Fed, and the media's daily headlines, summarizing the economic events both at home and abroad.

Today, investors are all still left wondering whether or not the government has been successful or is the U.S. economy facing deflation and an inevitable "double dip" recession. Exacerbating the tentative mentality problem is the fact that most investors have not experienced this type of environment in his or her lifetime. Actions taken by the government and the Fed are unprecedented, even leaving Bernanke to use such words as "unusually uncertain." As the data is released, and it becomes more "certain" that the economy is limping along, investors are still not convinced that things cannot get worse.

Investors have every right to be skeptical. On August 27th, the Commerce Department reduced second quarter Gross Domestic Product (GDP) growth from a previously reported 2.4% to 1.6%. The economy appears to be growing, although anemically. Unemployment remains high, above 9.5%. In reality, this number could be worse as some workers have given up looking for a job altogether. The housing sector remains weak. With the end of the first time home buyer tax credit, which pushed up existing home sales 7.6% in April, sales fell 2.2% in May, 7.1% in June and then dramatically fell 27.2% in

July. This was the biggest drop ever measured. Consumers are spending, but due to lingering worries about employment and the loss of wealth in their homes and investment accounts, many remain cautious. Core inflation has dropped to 0.9%. This is below the Fed's target of 2.0%, which is viewed as the optimal level for economic growth. Credit conditions remain tight, and corporations continue to hoard cash. Public sector debt is high and any move to reduce it, such as increasing taxes or cutting expenses, could have a negative impact on economic growth.

Much of the same can be seen in other developed nations. In the Euro Zone, growth appears to be expanding slightly, although much of this growth is the result of the relatively stronger growth in Germany and France. Countries such as Ireland, Spain and Greece continue to struggle. In Japan, the central bank is struggling with how to combat the potentially negative impact of a strengthening Yen on its important export market. Although the emerging economies have healthy balance sheets and strong GDP growth, they are not completely immune to the effects of a global slowdown.

The Future

As gloomy as the reports sound, we believe that the financial markets are forward-looking and already reflect much of the current economic scenario. After all, the Dow is some 4,000 points off its 2007 high.

Accordingly, we do not assign a high probability to a severe market selloff such as what we experienced in 2008 and early 2009. Even given the market uncertainty, we believe investors today know much more

about the value of both real and financial assets than they did during the 2008-2009 crash, and assets have been assigned more realistic values. However, we are not particularly optimistic about economic or market growth for the foreseeable future. While it is futile to assign very specific rates-of-return to market segments, particularly when considering relatively short time frames, we believe that most market components – real and financial – are poised to offer sub-par returns. This is a reality that is likely to persist until the economic growth in the developed world improves.

The Investment Portfolio

The question before us is how to develop a portfolio strategy given our current economic and market backdrop.

While institutions must consider a number of factors when building a portfolio around their specific needs and circumstances, there are two that are common among all investors. Stated somewhat simplistically, they are “risk” and “return”. Traditionally, most investors have looked to the public equity markets as the main driver of portfolio growth. The primary diversifying asset class was domestic fixed-income. Secondary diversification was attempted through sub-allocations among the public equity components. This has proven to be an inadequate risk mitigation strategy during severe equity market dislocations, such as what we experienced during the 2008-2009 market crash.

We strongly encourage investors to move towards a strategy of *true* portfolio diversification by including asset classes and investment strategies other than public equities. Not to pursue this strategy allows the public equity component to simply drag the portfolio

in whichever direction it takes, which unfortunately is not always up. **It is critical to understand, however, that a truly diversified portfolio is mostly about risk containment and NOT return enhancement.** Not suffering significant portfolio losses is not a trivial matter, but having a great defense is not enough. This brings us to the second consideration, portfolio return.

Institutional portfolios exist for a reason – typically to fund grants, scholarships, operations or pensions. Unfortunately, these funding needs do not go away during economic slowdowns and/or periods of market turmoil. Institutions still need to have an investment strategy. Our outlook for the U.S. economy and the economies of most developed countries is one of slow, but positive, growth. Certain emerging economies are likely to grow more rapidly, but will be influenced to some degree by the growth of their developed counterparts. While it would be nice to simply shift from asset classes and strategies with sub-par return expectations to those asset classes and strategies that are expected to meet required (desired) rates of return, we are concerned that returns across “all” core asset classes may be muted for the foreseeable future.

While it is beyond the scope of this writing to offer specific recommendations, institutions should consider the following portfolio strategies.

Due to uncertainty and the potential for continued financial market volatility, we strongly encourage institutions to reduce any asset class that currently dominates their portfolio (often public equities) in favor of additional asset classes and strategies – specifically those that historically offered equity like re-

turns, but did so with a different return pattern. As noted earlier, this is a risk mitigation strategy, and will not necessarily improve performance. However, it is designed to reduce the magnitude of losses when a dominating asset class suffers a severe selloff as global equities did in 2008 and early 2009.

Institutions should consider both passive and active solutions for a presumably smaller public equity component. Allocations to emerging markets equity and debt should be considered, as the growth rates in many of these economies should remain strong for years to come. As a general theme, a greater percentage of a portfolio – across most asset classes – should be invested following a more opportunistic approach.

The term “opportunistic” could include the distressed segments of the real estate, private equity (secondary partnership interests) and debt markets. Likewise, it may also refer to thematic investment strategies such as “global macro” funds and other event driven strategies. Investing in distressed assets is a play on the undervaluation of an asset. On the other hand, global macro managers typically invest around major economic themes and are often positioned to profit from negative outcomes. Recent examples include strategies that were positioned to profit from credit problems in real estate (the sub-prime debacle) and more recently the credit crisis in Greece.

Both of these investment strategies are different from the more traditional investment protocol that is dominated by public debt and equity. Although markets can, and will, temporarily disconnect from the underlying economy, investment markets such as the S&P 500 are generally efficient and require rea-

sonably strong economic growth for equity investors to be suitably rewarded. Our concern with the mainstream debt markets revolves around historically low interest rates and the difficulty in earning meaningful returns absent another market crisis.

The reality, in our opinion, is that it is much more difficult to earn an institution’s required rate of return today than it has been during previous post crash periods. It was easy to look smart and be successful during the latter half of the 1990s. Likewise, it was hard not to make double digit returns during the 2003 – 2007 period. Manager underperformance was often dismissed as absolute returns were often several times higher than expectations. These days are gone – at least for now. Likewise, we are beyond the days where the textbook 60/40 equity to debt portfolio would easily meet an institution’s required rate of return.

Today’s environment requires more time and attention, a greater acceptance of non-traditional investment strategies and the development of investment management teams that have the proven ability to exploit market inefficiencies AND a broad enough investment mandate to be able to pursue these opportunities.