

September 30, 2008 Market Commentary and Outlook

Once upon a time there was a tiny chicken named Chicken Little. One day Chicken Little was scratching in the garden when an acorn fell on her head.

"Oh," cried Chicken Little, "the sky is falling. I must go tell the King."

Excerpt from a children's fable

As the tale progresses, other animals—concerned over Chicken Little's claim the sky is falling—accompany her on the quest to inform the King. They encounter Foxy-Loxy who, offering his help, ends up instead eating all the animals.

An indicator some look for as a sure sign the market is about to turn around is "panic selling." And in those many instances when investors have believed that "the sky was falling" and sold their stock holdings (only to have the market bottom and stock prices rise), the investment fate they suffered was as dire as Chicken Little's and her friends.

What would Chicken Little think of the precarious events of September, 2008: a financial "giant" abruptly sold (Merrill Lynch), a declaration of bankruptcy (Lehman Brothers), the takeovers by the US Government (Freddie Mac, Fannie Mae, and AIG), changes in charter to a commercial bank (Goldman Sachs and Morgan Stanley), bank takeovers by the FDIC (Washington Mutual and Wachovia), the failure of Congress to pass a bail out plan and the one-day drop of 777 points in the Dow Jones Industrial Average (DJIA)?

Chicken Little would be squawking, "The sky is falling!" And even though her alarm has become a common idiom indicating a hysterical or mistaken belief that disaster is imminent, it would be tough today to refute Chicken Little's cry of impending catastrophe.

Concerned about the safety of their portfolios, investors are asking, "Should I be selling?" We'll try to answer that question.

Let's first distinguish between two types of portfolio risk: custodial risk and market risk. A brokerage firm or trust company will act as the custodian of their clients' assets. The assets in custodial accounts are not the assets of the custodian. The custodian can go bankrupt and the custodial assets remain intact for access by the portfolio's owners. Losses due to custodial risk are primarily limited to theft, fraud and mishandling of funds—for which there is insurance protection (SIPC).

The failure of Lehman Brothers—one of Wall Street's biggest firms—did not result in any custodial loss of client securities. The portfolio which incurred huge losses that ultimately brought Lehman to its knees was Lehman's own investment portfolio, not that of its clients.

No doubt there could have been custodial accounts at Lehman in which Lehman stock or bonds were owned. In that instance, the portfolios would have suffered losses when

Lehman failed, but that type of risk is market risk. The failure of a major financial institution like Lehman negatively impacted the overall financial markets, resulting in losses across most stock holdings. But then again, that is market risk.

We think investors concern over the safety of their investments should be about market risk, not custodial risk. The Dow's decline of 777 points resulted from market risk.

When discussing market risk in "normal" times, we would speak about the benefits of diversification, the opportunities to "buy the dip," the pitfalls of market timing, or the importance of maintaining an investment strategy. We would "normally" have counseled prudence and advised against selling. But these are not "normal" times and such axioms might appear trite, if not outright hackneyed.

Previous market downturns (at least since the end of World War II) have almost always led into the slowing of the economy—regular occurrences that are part of the normal business cycle. Excesses get washed out, market valuations get reset at lower price/earnings multiples, and prices begin to rise again as earnings increase and/or multiples expand.

What is different this time—and should be a cause for concern—is that the sector of the economy that has been hurt the most is the financial industry. Think of the stock market as the human body. Previous bear markets would be like broken bones; they heal readily. This market downturn is more like a heart attack: not fatal, but recovery will be long and arduous.

Financial institutions are woefully undercapitalized. Their investment portfolios—their capital—are the basis on which they can lend money: There is a regulatory need to maintain certain "reserves" for each dollar they lend. When their capital is of poor quality, e.g., sub-prime mortgages or distressed debt, or their capital is low, they cannot lend as much money. As a result, credit is not readily available to other parts of the economy to help those sectors grow. Banks will now have tougher lending requirements, further restricting the availability of credit. In the near-term that's not bullish for the economy or the stock market.

Given that the events of the second half of September are without precedence (unless one looks as far back as 1929), it is extremely difficult to provide prescient counsel about the near-term outlook for the financial markets.

Notwithstanding the challenges today's market poses for prognostication, we think selling stocks is an appropriate response to the current market environment if your asset allocation is inappropriate to your circumstances or "temperament." Successful stock investing requires that you have a long enough time horizon consistent with your need for the expenditure of your invested funds. The portion of your portfolio which will be funding short-term budget needs should, as a general rule, not be invested in stocks, but rather cash equivalents and high-quality, low-duration bonds.

What is “short-term”? Depending on your tolerance to accept investment risk, short-term can be anywhere from 3 to 10 years.

Should you sell today? As a general rule, we are loathe to sell into the teeth of a market decline. Why? Let’s look at the 3-day performance of the DJIA last month from September 15th through the 17th: Down 504.48, up 141.51 and down 449.36 for a total loss of 812.33 points. On the 18th and the 19th, the DJIA rallies 778.78 points to close the week down 33.55 points. Better to have sold on the 19th. Selling on the 17th would have meant a missed opportunity to enjoy the short-term recovery of the markets. The corollary to “Buy the dips” can be good advice: “Sell into a rally.” Often one or two-day precipitous declines are followed by rallies, albeit sometimes short in duration.

Our hope is that Congress will quickly pass a bailout bill (and one that is better than the one that was defeated on 9/29), and the passage (or the prospects of passage) will produce a rally in the stock market equal in intensity to the decline when the bailout bill failed to pass. That would be a great opportunity to sell to get your asset allocation right. With Washington, one never knows; it might take Congress a while to get a bill passed, and the bill may not be any better than the one they failed to pass. What will the markets do in the interim? (This commentary was written September 30. After a 777 point decline yesterday, the market did recover 485 points today.)

What about longer-term prospects? The current credit crisis resulted from years of excesses. The events of September 2008 or the passage of a bailout bill will not remedy the problems overnight. And unfortunately, there are other difficulties that the U.S. and world financial markets face.

The housing market is still facing huge problems. Prices continue to decline. Huge inventories of unsold units exist. Defaults and foreclosures are on the rise. Unemployment is at a 5-year high and rising. The U.S. consumer, the pump that has primed the world’s economic engines for years, is tapped out and burdened by debt. Credit is very tight. Oil is at \$100 per barrel. Gas is expensive. (What will home heating oil prices be like this winter?) The national debt ceiling will rise with the bailout bill (to \$11.3 trillion, Federal debt now standing at roughly \$9.5 trillion). The U.S.’s annual budget deficit will be huge (exacerbated by the costs of the Iraq war). Will further write-offs be required of banks and other financial institutions?

Some of these difficulties could translate into market risk that could take the market lower from here. We think it’s going to be a tough recovery, both for the economy and the financial markets, here and abroad.

At this juncture, we could not criticize an investor for wanting to sell and sit on the side lines for the near future.

Longer-term investment needs generally require the higher, long-term returns that are possible from investing in stocks. If under “normal” circumstances your portfolio should

have some allocation to stocks and you decide to sell all your stock holdings, devise a plan in which you systematically get back into the market. Set some benchmarks at which you purchase stocks again, e.g., once each month; at each X number of points decline in the DJIA—some trigger that is different than figuring the market has bottomed.

If you didn’t know when stock prices had peaked last October and you didn’t sell then, how will you know when stock prices have bottomed? The risk is that by the time you have been convinced the market has recovered, you might be buying back in at a higher valuation than when you sold. In such an event, you generally would be better off to have ridden the roller coaster.

Remember that the initial stage of a bull market generally produces some powerful returns. And that train often leaves the station before you know it. Bear market declines historically result in deeply depressed valuation levels as calculated by price/earnings ratios of stocks. Bull markets bring pricing back from deeply depressed levels towards “known values.” The S&P 500 is currently trading at about 15 times prior peak earnings. Bear markets have regularly troughed below 11 times prior peak earnings, with an average closer to 9 times prior peak earnings, and sometimes below a P/E of 7, as we saw in 1974 and 1982. So things could get a lot worse before they get better. A return to valuations of 15 times earnings—the multiple at which the 2002 bear market bottomed—will produce some attractive performance. Admittedly, that might only get you back to even. But if you sell now and do not buy back in at the proper time, getting back to even might be impossible.

What are we as Investment Managers doing for you? We had already taken steps to minimize the credit risk in your portfolio. We felt equity exposures in our portfolios were appropriate for “normal” market occurrences. Had we anticipated the magnitude of the credit defaults, bankruptcy risk and government bailouts we are now seeing, we would have raised more cash. We are re-examining positions we have in our current funds to be certain we have good managers. No doubt, we will be making some re-allocations among the types of funds owned within our managed portfolios, e.g., value vs. growth, geographic exposure, and bond duration.

Will we sell stocks? If we do, it will most likely only be within a market rally.

Northwest Capital Management, Inc.
September 30, 2008

Past performance is no guarantee of future results. This article has been distributed for educational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Opinions are subject to change without notice. No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Northwest Capital Management, Inc. Northwest Capital Management, Inc. is a firm registered with the Securities and Exchange Commission. Northwest Capital Management, Inc. ©2008