

Commentary – July 10, 2008

Answers to Questions about the Markets and Investing in Today's Uncertain Environment

Q. What is your current economic outlook?

A. The increases we are seeing in unemployment have never existed outside of a recession, so while GDP numbers may not yet confirm a recession, we are pretty clearly in one. Leading indicators such as consumer confidence, housing and credit conditions are still heading down, suggesting that the upturn is not yet at hand.

Q. Then shouldn't we be out of the stock market?

A. Not unless we are market timers. Also, remember, the stock market looks out into the future. By the time it is clear that the economy is in recession, most of the damage may have been done to stocks. According to the Vanguard Group, stocks have actually gained ground during 5 of the past 9 recessions. Past performance is not a guarantee of future returns, but the fact that the economy is doing badly doesn't mean stocks are a sell.

Q. I know market timing doesn't work, but the economy is really bad now and my accounts are down. Isn't it obvious that we should do something different?

A. Not necessarily. Remember, when we started working together, we talked about various market scenarios. We discussed that down markets are an inevitable part of investing. We discussed that down markets happen and that you would experience them. Together we determined that the amount of risk we have assumed was appropriate and comfortable for you. Unless that has changed, we shouldn't need to revisit our approach.

Q. But my accounts are down and I don't like it. Shouldn't we do something?

A. If your goals have changed or you need cash now, or you feel you misjudged your risk tolerance then we should reduce stock market exposure. Otherwise, we should stick to the approach we agreed on prior to the decline. The reason we discussed the downside risk of stocks and how different asset allocations perform is that we expected that at some point the market would drop.

Q. Can't we sell now and get back in later when things are better?

A. Sure. But knowing when to get out is only half the battle. If you sell now, you will also have to know when to get back in. There are no guarantees, but by the time it is clear that the storm has past, stocks could be much higher. Most of the best gains in the market have been compressed into relatively short periods that occur suddenly when nobody is expecting them. If you exit the market, it is highly likely that you will miss those gains and miss out on the long-term growth stocks may offer.

For example, over the 10 years from 1997 to 2006, the S&P 500 was up +6.7% compounded per year not counting the impact of dividends. (You can add another couple of points for dividends, bringing the total to just under 9%.) If you missed the 15 best performance days in those 10 years (i.e., 15 days in total, not 15 days each year), your annual return was actually negative.

Q. What if the entire global financial collapses and we fall into a global depression. Wouldn't you advise we get defensive if that appeared likely?

A. Yes, but it isn't likely. The whole depression scenario is an unlikely worst case scenario, not a probability. Most of the commentators calling for these types of extreme bearish scenarios are not credible anyway, so ignore them. Some of these characters have been at it since the 1970's and we don't expect them to suddenly start making good calls after 30-40 years of consistently getting everything wrong. They could be right, but we are not going to bet on it.

Q. Assuming the bear market ends, how long will it take for the market to come back?

A. There is no way to know. Historically, most normal (20-30% decline) bear markets have lasted about 14 months from peak to trough. It took about one year on average for a full rebound.

Q. What about really bad bear markets?

A. The mega-bears, like 1972-1974 and 2000-2002, that each saw 50% shaved off popular market averages and took a few years to recover from if you were properly diversified. But those come along once or twice in a generation and they rarely occur back to back. So, while we could be wrong, we'd be surprised to see a mega-bear.

Q. But the economy is terrible and our country is a mess right now. Doesn't that mean we are due for a major bear market?

A. Not necessarily. Historically, the really bad bear markets have come following periods of

excessive stock market speculation and extreme valuations. We simply haven't had that this time around.

Q. I don't think the stocks some of our funds own make sense. Shouldn't we sell those funds?

A. The fund managers who run the funds we own are highly regarded experts, with advanced degrees and exceptional track records. Remember, they read the paper, and watch the news just like you and us. They know all about the high price of oil, housing and the credit crunch. They make mistakes, but the odds are overwhelming that they know more about picking stocks than any layperson or any stockbroker. We are inclined to give them the benefit of the doubt.

Q. A friend told me about an investment that will give me the return of the stock market, but where I can't lose my principal. It sounds like a no-brainer. Is it?

A. We have evaluated many of these "high return-no risk" products and none of them had any merit when subjected to a rigorous and unbiased analysis.

As always, we encourage you to reach out to us with any specific concerns regarding your investments. We are grateful for your continued trust and confidence.

Best Regards,

Berthann & Craig