2007 INVESTMENT COMMENTARIES: 3rd Quarter, 2007 in Review

The market volatility, credit crunch, housing market collapse, and hedge fund debacles make it hard to believe the overall stock market was in the black during the third quarter. But it was, with the S&P 500 gaining 2%. Moreover, through September the S&P 500 was up 9.1% for the year. While the numbers for the overall stock market were quite satisfactory over both periods, there was a wide degree of variation across asset classes. Value stock funds, like Selected American, were in the red for the quarter, with smaller-caps, like Laudus, doing even worst. Growth stock funds, like TCW Select Equities and Harbor Captial did quite a bit better, and for the year growth stocks are ahead of value by a wide margin after seven consecutive years of underperformance. International stocks gained over 4% in the quarter, extending their run of impressive returns. Bond funds had a solid quarter, with investment-grade bonds, like Managers Fremont Bond, climbing almost 3%, and emerging-market short-term bonds, like PIMCO Developing Markets, returning almost 5%. Commodity futures, like PIMCO Commodity Real Returns, gained over 6% for the quarter.

Looking ahead, the driving factor for returns over the next year will likely be the health of the U.S. economy and its impact on the rest of the world. The credit crunch and continued deterioration in the housing market, which drove this summer's volatility, make a recession more likely than it was earlier in the year; but it is not a foregone conclusion.

So where does this uncertain outlook leave us? Economic predictions are not accurate enough to serve as a basis for investment decisions. Therefore, I am more confident in using valuation work as a basis for decisions (i.e. which areas of the stock and bond markets are over-valued, under-valued, or in Goldilocks term, "just right"). I know the economy could fall into recession, but it could also avoid recession and surprise on the upside with the aid of Fed easing, a weaker dollar that stimulates exports, and global growth driven by emerging markets. Getting defensive in your portfolio allocations could result in missing out on returns that could be captured during, potentially, a few more years of economic growth. On the other hand, I recognize that stocks could drop 10% to 20% if we experience a cyclical bear market.

What I do first in setting your portfolio allocations is draw upon my basic building blocks of diversification, such as using investment-grade bonds to protect against recession. My historical, common-sense framework helps me understand how asset classes perform in a variety of environments, including cyclical bear markets. Moreover, that framework allows me to understand the factors that drive the performance of each asset class from one cycle to another. Not every cycle is the same.

Second, I factor in the valuation analysis that my research company does for each asset class. Currently, I believe the major asset classes are in neutral territory—meaning they are neither very attractive nor very unattractive on a long-term valuation basis, and I therefore see no reason to currently over- or under-weight any of them.

Third, I consider my understanding of your maximum loss thresholds, which allow me to accept a certain amount of near-term risk (less than one year) in exchange for some flexibility to capture long-term return (three years or more). The research company "stress tests" each portfolio strategy against different possible scenarios so that I can assess the amount of downside one-year risk I think each portfolio would be exposed to. If this scenario analysis suggests that I am taking on too much short-term risk relative to the potential long-term return benefit, I will adjust the portfolio allocation accordingly.

This disciplined approach allows me to capture long-term returns that are driven by factors in which I have the highest confidence (valuations), while still keeping risk in line with each portfolio's profile.

Today, this process leads me to leave your portfolio allocations right where we have been, meaning stocks vs. bonds. For quite some time I have written that most equity asset classes to be in a fairly priced range—suggesting that over the long run you will make more money in equities than you would in more defensive asset classes (e.g., bonds). And, both of us have been rewarded for taking that view. But I also recognize that, as always, there are troubling risks. Stock-type asset classes have not been at low enough levels enough to ignore these risks and entice me into more aggressive positions (you know, the old "buy low" mantra). And I have been concerned about the likelihood that corporate earnings growth will slow from its historically high recent levels. So I've stayed relatively neutral in terms of your risk exposure, though I have a bit more exposure to recession risk than I would in a normal scenario. The analysis of the research company supports a continued balance between the return opportunity from equities and hedging of these risks so I will continue to maintain a middle ground. However, as the economic expansion continues to mature I will reassess the degree to which I want to hedge against the possibility of recession.

There is one major change I am making to many, but not all, accounts. The under-performance of Artisan International has finally run its course with me and I will be selling many, but not necessarily all, positions. In retirement accounts I will be selling all positions because I do not have to worry about capital gains taxes, but in taxable accounts I will go client by client assessing the risk-reward factor – i.e. capital gains taxes due but better possible returns or lower possible risk. By the time you receive this, the decisions may have already been made, but please call with any questions.

Mullen Advisory, Inc.
606 N. Larchmond Blvd., Suite 310
Los Angeles, CA 90004
Phone: (323) 469-0917 • Fax: (323) 372-3579