

**2008 INVESTMENT COMMENTARIES:** 1st Quarter, 2008 in Review

Stocks were down sharply in the first quarter. A few strong days at the end of March were not enough to offset the pain of the roughest quarter we've seen in a number of years. Large-cap stocks (based on Vanguard's S&P 500 Index) were off by 9.5% for the first three months of the year, with growth modestly underperforming value. Mid- and small-caps were down by roughly equivalent levels of around 10%, and growth's underperformance of value was more significant as market-cap dropped. International stocks also had a rough quarter with the Vanguard Total International Stock Index Fund losing 8.9% for the first three months. Commodity futures and emerging-markets local-currency bonds both did very well, gaining 9.6% and 4.7%, respectively, based on their indexes. REITs managed a decent quarter, with a 2.2% gain.

**Model Portfolio Changes**

There were several changes to your portfolios recently. We eliminated your positions in commodity futures and put the proceeds into PIMCO Developing Local Markets Fund. The short explanation is that we think the increasing economic weakness combined with the strong run up in commodity prices in recent months outweighs the longer-term diversification benefits of owning commodity futures at this time. We also eliminated your positions in TCW Select Equities, which had a manager departure, and for some of you we invested half of the proceeds into Brandywine Blue and for others into the iShares Russell 1000 Growth Fund, both of which are large-cap growth funds. The rest went to cash.

**Our Investment Views**

There's a famous quote in the 2001 Berkshire Hathaway Annual Shareholder Report, where Warren Buffet wrote, "You only find out who is swimming naked when the tide goes out." Well the tide has gone out and it's not a pretty sight. Though we wore our swimsuits, we did not fully appreciate the economic risks that have become apparent. We have often said that accurate economic forecasting is difficult and therefore we rely on valuation work and scenario analysis as the basis for investment decisions. That approach has been helpful to us in this environment but it's likely that we are not yet out of the woods. Even though we made a number of risk adjustments to client portfolios in January after the start of a new tax year, it clearly was not enough to avoid bruising.

**What is my view of the U.S. economy?**

Though the label is unimportant, it's probable that we are already in a recession or on the verge of entering one. It's clear that the severely troubled housing and credit markets are beginning to have an impact on the health of the overall economy. The worst phase of the credit market problems could last for several more months, and the housing problems could continue into 2009. High energy costs don't help but are not the primary concern. The problems facing the economy are clear:

**Housing:** The housing market is in the worst downturn since the 1930s and the evidence strongly suggests there is still a ways to go. With a massive backlog of unsold homes and waves of foreclosed properties continuing to hit the market, it could take a year or longer to get inventory levels back to normal. The weakness in the housing market reduces wealth and spending, increases unemployment, and continues to contribute to dysfunctional credit markets.

**Dysfunctional Credit Markets:** The bottom line is that credit markets are not functioning properly at present. The ability to borrow money at a reasonable cost to support consumer spending and conduct business is essential for a healthy economy. Perhaps even more important to a stable economy is the ability to refinance maturing debt. The longer the problem lasts, the more damage there will be to the economy.

**Labor Market and Consumer Spending:** Not surprisingly, we are now beginning to see a clear weakening in employment and consumer spending. A weak labor market could feed back to trigger more defaults as people have a harder time servicing their debts. This could delay recovery in the housing and credit markets and become a self-reinforcing cycle. Meanwhile, declining consumer spending will impact corporate profits.

It is also worth noting that while most of the rest of the world is doing better than the U.S., Japan's economy is also struggling and Europe's is slowing. It seems likely that most of the developed world will continue to weaken. The emerging markets are in better shape, however, we don't expect them to be fully immune from economic weakness in the developed world.

**What are the positives?**

The biggest positive for the economy in the near term is the aggressive, and in some respects,

unprecedented action of the Federal Reserve. Though the Fed's moves have not been as effective as they would like, they have made it clear that they will do what it takes to stop a major downturn and they still have weapons in their arsenal, such as directly buying mortgage securities in the public market.

The dollar's weakness has also significantly improved the competitiveness of U.S. businesses versus foreign competitors. Export strength is already happening with exports contributing a significant one percentage point to economic growth over the last six quarters (annual rate). This almost offsets the economic impact thus far of the housing downturn. This benefit could diminish if the global economy weakens significantly, however.

### **Do today's economic stresses have any longer-term economic ramifications?**

There are two potential long-term ramifications. First, as the Fed and policy makers attempt to break the adverse feedback loop, the amount of stimulus that is being required increases the potential for higher inflation down the road—not 1970s style inflation, but more than we've been accustomed to. Inflation is unlikely to be a near-term problem because debt reduction and recessionary environment is deflationary not inflationary. But longer-term, the increased supply of dollars has to go somewhere and that raises the risk of inflation. It also undermines the dollar's value relative to other currencies. That's also inflationary as imported goods cost more.

The second ramification is the likelihood of continued debt reduction on the part of households for several years, resulting in slower credit growth (less borrowing) in the next recovery. If consumers borrow less and spend less, economic growth and corporate earnings growth will be slower than they would otherwise be. All this raises the risk of some stagflation in the next economic cycle.

### **How would you summarize Mullen Advisory's current investment posture?**

Currently, there are few compelling asset class level opportunities; however we do have several noteworthy tactical moves in play.

- 1) Our U.S. equity exposure is overweighted to larger companies and underweighted to smaller companies based on valuations and economic-cycle factors.
- 2) We continue to hold a portion of our fixed-income exposure in emerging-markets local-currency bonds (PIMCO Developing Market Fund).

### **What investment moves is Mullen Advisory considering?**

We plan to increase exposure to large-cap stocks by 5% if the market drops about 10% below its current level (we continue to view large-caps as offering better value than small-caps). Our plan is to buy an S&P 500 ETF or index fund by taking 2% from our investment-grade bond exposure and 3% from our emerging-markets local-currency bonds. Also, soon we expect to purchase shares in a real estate investment trust exchanged traded fund (symbol ICF) and/or a financial services exchange traded fund (symbol IYG)

In the event that stocks continue declining beyond that 10% point, we have identified the market levels at which we would make additional tactical purchases of equities. This is an important part of our discipline that helps to ensure that we will not hesitate when presented with good long-term opportunities in the face of what would be a very negative immediate stock market environment.

### **Closing Comments**

As I write this (May 12th), the S&P 500 has risen 5.2% since April 1st. However, we suspect this will continue to be one of the most challenging investment environments we've ever faced, at least for a while. We believe investors may still be underestimating the losses yet to be written off by the financial sector and the resulting economic ripple effects. But stocks are reasonably valued now, and if they reverse and fall much further, it will represent an attractive buying opportunity for long-term investors. And while we believe it is important for us to discuss the more negative possibilities, we reiterate that it is possible that we may have hit bottom. We can't know what the near-term is going to bring, but at times like this when economic uncertainty is high, our discipline and research process keep us grounded and give us confidence in our ability to make sound long-term decisions.

Thank you for your business and your trust.

### **Mullen Advisory, Inc.**

606 N. Larchmond Blvd., Suite 310

Los Angeles, CA 90004

Phone: (323) 469-0917 • Fax: (323) 372-3579