

**Mullen Advisory  
Investment Commentary  
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**Margie Mullen, CFP**

As I look back on a tumultuous first half of the year, I am struck by the degree to which conflicting signals characterize the investment and economic environment. After a horrendous 2008 and a dismal first quarter in 2009, the second quarter saw robust gains – stocks in fact had their best quarter in more than 10 years. As you know, my clients did not fully participate in that rally and the partial participation was with 20% (or less) positions in traditional stock mutual funds or exchange traded funds.

**The Market and the Economy – Uncertainty Reigns**

The conflicting signals on the economy include several positives that helped drive the market's rebound from its March low. The prospect of a meltdown of the financial system appears past; the government has demonstrated it will do whatever is necessary to avoid a disaster of this scale. And though economic activity continues to worsen, it is doing so at a slower rate, which suggests that it is getting closer to an economic bottom. However, the global economy remains in a fragile state as the effects of massive wealth destruction and the unwinding of huge debt bubble continue to play out. The ultimate result will likely be lower spending by both consumers and businesses in the years ahead, as the economy in effect resets to the level where it might have been without the artificial boost of the credit bubble. While it possibly allowed us to avoid a depression, the massive bailout and stimulus spending (along with longer-term demographic factors such as spiraling health-care and other entitlement spending) is causing the federal deficit to balloon, which could lead to dollar weakness and inflation down the road.

Other conflicts are at play that will influence how the environment unfolds in the years ahead. One of these is housing, which started the cycle of damage we are now in. There have recently been a few positive signs including stronger demand and historically high levels of affordability. But a wave of new supply from foreclosures over the next two years suggests the market will continue to struggle. (There are more than a trillion dollars in adjustable mortgages that are underwater and that have yet to reset to higher payments, and high unemployment will make things worse.)

Another question is whether we should be worried about inflation or deflation. At present, there is an enormous amount of excess manufacturing capacity and available labor so it is unlikely there will be higher costs to pass along. Demand-driven inflation also is unlikely. Over the intermediate-term there is even some concern that deflation could take hold if the global economy doesn't experience a sustained rebound. However, looking out a few years, the bigger risk is that policy makers' efforts to avoid a deflationary cycle are too successful and trigger a run up in the inflation rate to modestly high levels or worse.

That brings me to another issue, which is the tightrope that policy makers have to walk with respect to stimulus. I believe that in aggregate, government intervention probably saved us from an economic depression, but have we dodged the only bullet? Given the actions to date, the Fed and the Treasury are clearly committed to doing whatever it takes to help the economy find a floor so that it can grow again. On the other hand, if there are no more bullets to dodge, it will be difficult to know

when the timing is right to unwind the stimulus. If it is unwound too early the economy could relapse (as happened in the U.S. in the 1930s and Japan in the 1990s) and if it is extended too long it will add to budgetary woes. In any event, there will be great political pressure to deal with on both sides of the issue.

## **I Consider a Range of Outcomes in Making Portfolio Decisions**

Broadly speaking, these conflicts create a very wide range of possible outcomes. My intellectual honesty demands that I recognize that no amount of analysis will allow me to determine exactly how the coming years will unfold, so I direct my analytical effort toward thinking carefully about what would happen across a range of outcomes. This process of scenario analysis gives me important insights about how to position your portfolios.

In all but my most optimistic scenario, I believe returns from stocks and bonds over the next five years will be no more than mediocre – resulting in average annual returns for the types of stock/bond allocations in your portfolios that probably won't get above mid-single-digits. Fortunately, as I invest for my clients I am not limited to just what the markets give us and this is a source of optimism for me. Because this is an environment in which many securities have traded at prices below what their fundamentals suggest they are worth, our mutual fund managers have made investment selections that added a lot of value over their market benchmarks. While some of the lowest-hanging fruit may have been taken, pricing disconnects remain that I think could continue to give our managers a tailwind in the years to come. Importantly, this includes our bond managers, who are also using their flexibility to take advantage of undervalued areas of the bond market when they consider the long-term opportunity to be sufficiently compelling.

Pricing disconnects exist at the asset class level as well, though they are not as compelling as what we saw a number of months ago. You have already enjoyed strong returns from your tactical position in gold and silver exchanged traded funds (IAU and SLV) and you still have meaningful positions that I expect will continue to add value. Except for one client who needed to completely exit the market in March, all clients have enjoyed positive returns from these metals. For those accounts I invested in gold and silver last summer, those investments have returned a combined 20% or more. For others that did not get in until later in the game, the returns are still positive from 6% to 19%. I will not always have 15-20% of your investments in gold and silver, but I still believe that those metals are in a bull market that still has time and growth to go.

While stock investment opportunities are less compelling than they were earlier this year, I believe that we will experience further periods of high volatility that could provide me with additional opportunities. As I have written a number of times, I think there is a strong possibility that the market will “crash” again later this year and complete the “third leg” of this bear market. If there is no “crash”, my next best scenario is the stock market getting stuck in a range for a year or more where no one makes money. The third scenario would be that we are already in the next bull market, but I highly doubt this scenario.

Here is a quick review of some of the asset classes I am watching closely and how they would fit into a portfolio strategy:

**Emerging-Markets Currency Exposure:** This would be through an emerging markets bond fund of some sort—possibly PIMCO Developing Local Markets (which we've owned in the past) or PIMCO Emerging Local Bond (whose duration is not as short as its sibling). I believe the dollar is

likely to weaken over time versus many emerging-markets currencies. So this investment would provide you some dollar hedge, though the primary driver of my decision will be the potential returns from interest income. Based on my current analysis, returns could range from high single-digits to very low double-digits. From a return standpoint the asset class already looks attractive to me, but I am still in the process of assessing the risk in these markets from the global recession.

**Commodities:** Gold and silver, which most of you already own, is also an inflation-hedge option. I do not expect to add to already existing positions, and until I run out of cash in your money markets to invest in more stock funds, I will likely not be selling any.

**Non-Agency Mortgages:** This is an area that was at the center of the bubble that triggered the global economic collapse. My research suggests that very high-quality non-agency mortgages (bonds issued by commercial entities such as banks versus government-sponsored agencies such as Fannie Mae) are now priced at levels that should deliver attractive returns (high single-digits and potentially quite a bit better) for investors willing to brave potential near-term risk if the housing market proves more disappointing than investors already expect.

I will not be putting any of your money directly in these types of investments. I do not need to, as Bill Gross and the PIMCO funds think very highly of this asset class and they have been adding these mortgages to the PIMCO Total Return Fund and the Managers Fremont Bond Fund.

**Treasury Inflation-Protected Securities (TIPS):** I have added TIPS to some accounts, but since I already have gold and silver to help hedge inflation, I do not expect to add TIPS to all accounts, but I remain open to it.

Overall, your portfolios have quite a conservative bias. The equity exposure is quite lower than in “normal” times. Your high-yield bond and global bond exposure (via Loomis Sayles Bond Fund) has some equity-like risk, though I expect much less than a pure equity play. The lower investment grade bonds that Loomis Sayles Bond Fund has is the reason the fund was down 21% in 2008 and is up 23% so far this year (August 10<sup>th</sup>).

Looking ahead, I remain diligent and my feet are not in the “cement of my expectations or pronouncements,” which means that if the markets start recovering and there does not seem to be any looking back, I will invest the rest of money in the stock market according to our written agreements.