2008 INVESTMENT COMMENTARIES: 2nd Quarter, 2008 in Review

The first half of 2008 dramatically reinforced the idea that over the short term the stock market is predictably unpredictable. A sharply negative first quarter was followed by two months of positive returns, but the stock market selloff resumed in June. The S&P 500 is down 12% for the first half of this year. There were some bright spots, specifically investment-grade bonds (Managers Fremont Bond Fund, for instance), which are up 1.1% for the year, and short-term emerging-market local-currency bonds (PIMCO Developing Markets Fund), which gained 8.7% year-to-date.

As always happens in an environment of fear, there are a lot of questions: What is going on? How bad could it get? What should be done in investment portfolios? This particular environment is in many ways unique and presents its own set of challenges, but I want to reiterate that I've successfully navigated through a number of financial crises in my more than two decades of managing investments. While each of these periods presented its own particular challenges, one thing that was common to them all was a sense of accelerating bad news, escalating risk, fear, and panic. I will say, though, that this time seems a little different, so I have had to take a different approach, not always successfully.

Looking back a few months, the Federal Reserve's unprecedented actions to shore up credit markets and create liquidity led many to hope that we were past the worst of the financial crisis and that the stock market had hit bottom. Today it seems that while the Fed's actions may have significantly reduced the risk of a financial meltdown, the losses from bad loans are continuing to be worse than expected. Meanwhile, the positive feedback loop of soaring home prices and easy credit is now gone, and with it has gone a major source of consumer spending – a major driver of the economy. As always, there are positives as well. Outside the financial sector, corporate balance sheets remain generally healthy and earnings have been decent. One source of strength has been exports, which so far have managed to offset much of the impact of the housing decline on U.S. economic growth.

Though I have seen a number of market crises over the years, I also recognize that history never repeats itself exactly, and almost anything can happen from here. I do believe, but cannot guarantee, that things in the stock market will get worse before they get better. Even without a bad recession, fear and pessimism can take hold of investor psychology and send the market down further than what would be justified by long-term economic fundamentals. In this type of environment, a sense of perspective and a reliance on thinking outside the box might help me avoid becoming panicked by short-term concerns and paralyzed by longer-term uncertainty.

Regardless of my past experience, I have felt let down by the research firm I have been using. The strength they provide me that I do not have on my own, is an in depth analysis of the mutual funds and managers as well as a strong ability to give analysis of the economy. They definitely have a long-term perspective, but I have discovered that many of the clients do not have same long-term horizon they thought they once had.

For that reason, I have felt something missing and I went out looking for it. What has resulted is that I have recently added two more research companies to my stable. One does provides solid information on funds (exchange-traded funds) that invest in certain sectors of the market but using sophisticated ratio trend analysis. They provide a short-term approach and a long-term approach. The second company does "charting" which is another way to analyze the direction of the stock market for big company stocks, small company stocks and some others that I do not use. Again, they give both short-term and long-term analysis. Both companies provide completely objective information. I first heard about them both in January and have studied their analysis by reading their various reports going back a few months and then been able to see what actually happened after the dates of their reports. They are not foolproof and we know I am not either.

In past markets I did not get defensive, as I used bonds to protect the downside. However, since the beginning of the stock market decline in mid-October, bonds lost value too in the first 6 months of the decline. They have reversed into positive territory now that the credit issues have simmered.

Even though bonds are now pulling their weight in helping to protect against a stock market decline, I feel like more help is going to be needed going forward, as I believe that this current little rally in stocks (as of 7/23) will reverse itself and decline even further within the next few weeks. Some of the ways I have tried to strengthen portfolios is by holding cash in the money market, selling stock funds that did not work out in the time-frame I used, and using some cash to buy an investment that goes up when the S&P 500 goes down. This last investment will help neutralize a decline for a portion of your portfolio. Additionally, when this current rally fizzles, as it will, in some portfolios, I will bring the stock percentages down even further than they are if it does not generate capital gains.

I suspect this will continue, at least for a while, to be one of the most challenging investment environments we've faced. I also know that many of the managers of the mutual funds you own tell my research company that they are buying shares of high-quality companies at bargain-basement prices. Consequently, even though the overall market does not look compelling now, the mutual fund managers are adding to their portfolios and will hopefully outperform the stock market when this bear market dissipates.

So, for those of you who have made it this far and are still reading (at least I still have my humor), I admit to you that I was wrong. We are in a recession (even though not "technically') and I think this down stock market still has a ways to go. My "glass half-full" perspective in the first half of this decline did not serve you well and I apologize for that.

I continue to thank you for your business and your trust. I am not infallible, but I am willing to admit mistakes and accept responsibility.

Sincerely,

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