

Investment Views in Brief – Third Quarter 2011

Summary

Concerns about Europe's debt woes and negative global economic news sparked recession fears and drove stock markets down steeply in the third quarter.

Even after the recent market declines, our analysis suggests that equities are still not fully pricing in the effects of the aftermath of the global financial crisis of 2008–2009.

But, as the stock market has declined, stocks have become more attractive in terms of higher five-year expected returns across our scenarios and we have incrementally reduced our underweighting to equities on two occasions this quarter.

Likely returns from bonds are even lower than stocks, especially after investors' recent fear-driven flight to Treasuries.

These shorter-term macro swings could well continue in both directions for a long time to come given the ongoing macro challenges and uncertainties we face, and is the reason we invest with a long-term time horizon.

Concerns about Europe's debt woes and negative global economic news sparked recession fears and drove stock markets down steeply in the third quarter. Large-cap domestic stocks fell 13.9% during the third quarter and have lost 8.8% year to date. Smaller-cap stocks suffered larger losses, down 21.8% for the quarter, and 17% for the year through September. International stocks also suffered double-digit losses, with developed-market equities losing 20.9% for the quarter and 18% year to date. Emerging-markets stocks were hit hardest, losing 24% for the quarter and 23.4% year to date.

Domestic high-quality, intermediate-term bonds gained 4% in the third quarter and are up 6.6% year to date, driven by investors' flight to the relative safety of Treasuries. Developed-market international bonds were up 2.4% for the quarter and have gained 6.5% year to date. Local-currency emerging-markets bonds dropped significantly in September as capital flowed out of emerging-market currencies, and ended the quarter down 8.5% and are now in the red by 2.2% year to date. Floating-rate loans fell 3.9% in the quarter and have lost 1.4% year to date.

Since 2008, we have been in a period where macroeconomic forces are particularly influential and must inform our portfolio strategy. This quarter's developments – in which we saw heightened concerns about a global economic slowdown, political gridlock, and serious concerns about shorter-term European and longer-term U.S. debt problems – are consistent with the risk scenarios we've been discussing for the past several years.

Spooked by macro events, investors have flocked to Treasuries, forcing their prices even higher and their yields lower. This has resulted in short-term underperformance by our portfolios, which are underweighted to core investment-grade bonds.

Scary headlines and market volatility, while unnerving, can also create buying opportunities for disciplined investors. In the third quarter, we took advantage of stock market declines on two occasions to incrementally reduce our underweighting to equities. We made our first move in early August, typically adding 5% to larger-cap U.S. equities in our more risk-tolerant balanced portfolios. Then, in late September, with emerging-markets equities down sharply, we initiated a 3%–4% dedicated emerging-markets equity position in our more risk-tolerant global balanced portfolios, and added a 3% global equity position in our most conservative portfolio. As a result of these recent portfolio changes we are now roughly one increment (5%) underweighted to "equity risk," with a slightly higher underweight in our more conservative portfolios.

These portfolio moves demonstrate our incremental, scenario-driven, disciplined approach to tactical asset allocation. Even after the recent market declines, our analysis suggests that equities are still not fully pricing in the effects of the aftermath of the global financial crisis of 2008–2009, and therefore do not offer sufficient return potential to justify full equity risk exposure in our balanced portfolios.

These shorter-term macro swings could well continue in both directions for a long time to come given the ongoing macro challenges and uncertainties we face, and is the reason we consider multiple scenarios and invest with a long-term time horizon.

Investment Outlook

At Litman Gregory we've never believed that we could add value using an investment strategy that relied on accurately forecasting the direction of the economy over the near term. Instead, we try to focus our efforts on the areas where research, analysis, and common sense can give us an edge over the long term. Forecasting big-picture outcomes isn't one of those areas, but applying ourselves to understanding the overall environment and assessing the ways it might affect financial markets and the investments we own is an important part of our decision-making process.

Politics and Policy

One of the challenges for investors today is that government policy is likely to determine the path taken by the global economy. This creates tremendous uncertainty because not only is it impossible to predict what will be decided by legislative bodies, it is also difficult to have confidence in what the ultimate effects of those decisions will be.

The past three months saw much debate and little progress on the U.S. fiscal deficit, as topics like tax policy continue to be very polarizing. The debt ceiling showdown earlier in the summer was the quarter's most dramatic example of politics contributing to general uncertainty. Despite an 11th hour agreement, the contentious process and lack of meaningful action seemed to drive down consumer confidence and were specifically cited as part of the reason for Standard & Poor's subsequent decision to downgrade the U.S. sovereign debt rating from AAA to AA. (The downgrade didn't reflect any new information about the debt challenges we face as a country and so we don't view the actual decision as a highly material development, despite the fact that it coincided with a sharp downturn in stocks immediately after the news.)

Overall, we continue to view policy mistakes, or simply inaction, as a major unknown and a potential risk factor. Too much austerity too soon could prove counterproductive (as was the case in 1937 when austerity measures tipped the country back into recession) and reduce tax receipts by a greater amount than spending cuts, thereby worsening the deficit problem. But, failure to address the deficit and debt in a meaningful way runs the risk of markets forcing the issue: investors demanding higher returns for taking on the risk of owning U.S. debt, forcing interest rates higher and further choking off growth, not to mention raising the cost of servicing our debt.

Meanwhile, with fiscal policy stalled by politics, monetary policy has been more aggressive with the Federal Reserve deploying a range of experimental tactics for boosting the economy. The quarter began with the end of QE2, the Fed's second bond-buying campaign, and it ended with Operation

Twist, by which the Fed will in effect exchange short-term debt on its balance sheet for long-term debt in an effort to reduce long-term interest rates and encourage lending and investing. The Fed has also made an unusually explicit commitment to keeping rates low until at least 2013. All of these efforts represent extraordinary measures intended to further the Fed's dual mandate of ensuring price stability (which today means fending off deflation and avoiding runaway inflation down the road), and fostering full employment.

Our view is that monetary policy is not likely to help the economy much in the long run. We continue to believe the problem isn't that we have overly tight monetary conditions, but that we have stalled liquidity as banks, corporations, and consumers hang onto their dollars rather than spending or lending them into the economy.

Debt Reduction Update

Despite the increasingly heated rhetoric of recent months, little progress has been made toward bringing down the government deficit and debt. The compromise agreement that enabled Congress to raise the debt ceiling promised some deficit reduction, mostly coming after the 2012 election. Nearer term, the budget reduction it effected is minimal and the plan puts off the inevitable decision to raise taxes, cut entitlements (Medicare in particular), or some combination of both, without which the deficit will reach unsustainable levels.

There has been some progress in bringing down the level of consumer debt relative to income, which is necessary for the economy to again grow at a healthy rate. But, government debt continues to grow. Ultimately, we think it could be close to a decade before overall household and government debt levels are reduced to a point where we can expect a more normal level of ongoing economic growth.

Debt and the Eurozone

European government debt problems are one of the other big-picture issues with potentially huge ramifications for the economy and financial markets. Investors grew increasingly concerned about Greece in recent months but also, more worryingly, about the larger economies of Italy, Spain, and even France, as well as European banks due to their exposure to European government debt. We share the view of most experts that Greece cannot repay its debt without some kind of restructuring, which is a deliberate euphemism for default. The question comes down to whether it is an orderly default, which can be managed in a way that avoids a damaging contagion effect that brings down other governments and/or banks, or a disorderly one, in which all bets are off.

As has been the case all along, we worry that markets may essentially force a resolution to Europe's debt issues by driving up bond yields (and therefore funding costs) to a level that would push the weaker eurozone nations (Greece, Portugal, Ireland) toward default and could also force Spain and Italy into a liquidity crisis and potential insolvency. We expect central banks to step in to provide liquidity but, even with support, this scenario (or a less severe version of it) would be a harsh economic shock at a time we can ill afford it.

At the overall portfolio level, possible shocks from the European debt problem are another of the reasons for our underweight to equities, though, within our equity allocation specifically, we have

maintained close-to-neutral exposure to developed international markets. While we are not tactically tilting the portfolios toward these markets, we recognize that active managers can use the declines of European stock and bond markets to take advantage of new opportunities (and a few have sought to do so). For us, the risks and unknowns are too high to warrant a tactical allocation at this time. Even after recent market declines that were greater in Europe than here at home, we don't (yet) find the valuations to be highly compelling.

China

We continue to lean toward the more pessimistic/skeptical opinion that China is experiencing unsustainable real estate growth which, once the balloon is pricked, would result in a sharper and quicker slowdown in economic growth than what investors are expecting. It is also the case that China, like emerging markets overall, is not immune to the slowdowns in the U.S. and Europe as these markets are key sources of demand for goods produced there. But our long-term positive view of emerging markets remains intact even as the nearer-term period may see slower growth. Recently, investors have seemed to recognize the potential for an economic slowdown and emerging-markets equities have taken a beating. In fact, toward quarter end, emerging-markets equities reached a point of sufficient attractiveness for us to add them to our portfolios (as mentioned earlier).

Investing is a Marathon Not a Sprint

As one investor we respect put it, "You need to be a marathon runner when investing. Investors should never judge their decisions based on a moment in time." Earlier this year when markets were shooting higher, some of our decisions and portfolio positions may have looked overly pessimistic or defensive. More recently, as markets tumbled and headlines blared about the possible collapse of the eurozone, perhaps our positioning looked overly optimistic or risky. But, in our opinion, that type of short-term thinking is what leads most investors to get whipsawed, chasing the market (or asset classes or fund managers) on the way up and then riding them down before jumping into the next hot asset class or manager. Conversely, we believe sticking with a process that has been successful over time, if not all the time, and using an appropriate time horizon to assess the success or failure of one's investment decisions is critical to winning the marathon of investing.

In our commentary last quarter we wrote, "In a recessionary, deflationary or 'flight-to-safety' scenario we assume these [absolute-return-oriented/unconstrained bond] funds will lag investment-grade bonds by several percentage points." Sure enough, that is what has played out over the past couple of months.

Over the past three months, Vanguard Total Bond Index is up 4%, while our absolute-return-oriented bond funds are roughly flat to negative 2%. That is significant underperformance, but it is within our range of expectations for these funds in this type of flight to quality or risk-off scenario, and it is also very short-term.

More specifically, we believe our actively managed bond funds can generate at least low- to mid-single-digit returns over the next five years, while managing interest rate, credit, and currency risk. This contrasts with the investment-grade bond index, which has very poor return potential and significant

interest rate risk. In other words, if rates rise meaningfully the investment-grade bond index will lose money—just the opposite of what has happened as a result of the recent sharp drop in interest rates.

Moreover, if we look back further than just the past few months we can see the value added from our fixed-income positioning. Over the trailing three years, our bond funds have either significantly outperformed the investment-grade bond benchmark or trailed modestly. And, as recently as the end of August all of these funds had beaten the investment-grade bond benchmark over the trailing three years.

A final note on risk and expectations: We think we do a very good job analyzing and weighting possible outcomes, but it's worth a reminder that no one knows for sure how things will play out. Intellectually honest investors know what can and cannot be analyzed with confidence and communicate this clearly, as we endeavor to do each quarter. As always, we remain focused on making the best long-term allocations based on thorough, careful analysis, taking risk and return into account.

– Litman Gregory Research Team (October 2011)

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