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First Quarter Overview
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The
Quarterly Report

Stocks saw their best one-month gain in March in more than six years, but while it was a welcome respite from the battering in January and February, the first quarter still ended with a double-digit loss for equities. The list of issues affecting today's investment landscape is dizzying and at the top is the dismal state of the global economy. The fundamental problem is that over the past several economic cycles U.S. households and the financial sector took on increasing amounts of debt relative to their assets and income in order to fund consumption and investment. This trend was self-reinforcing as purchases with borrowed money drove up asset prices (such as homes) and profits, which supported even more borrowing. Ultimately the upward spiral was unsustainable, and now forced deleveraging has created a self-reinforcing adverse feedback loop of falling asset prices and lower spending and profits.

Certainty and Uncertainty While we freely admit to being uncertain about a lot of things in this environment, we are confident that the current administration and the Federal Reserve are very aware of the severity of the economic challenges we are facing. We are also confident that they will try to do everything they can to break the downward momentum. Last December, for example, the Federal Reserve cut the Fed Funds interest rate to zero for the first time ever. It subsequently took additional unprecedented steps to inject more liquidity into the economy and loosen up the sclerotic credit markets, by announcing that it would buy up to \$300 billion of longer-term Treasury bonds and \$1.25 trillion of agency mortgage-backed securities. Most recently, the Treasury announced the details of its plan for a public-private fund to purchase up to \$1 trillion of "toxic mortgage assets" from bank balance sheets with the goal of getting the lending markets to start functioning normally again.

While we think that the policies and programs recently announced are likely to help move the economy towards recovery, they will not solve the serious problems we are facing and we expect more government actions in the months ahead. But in our opinion, no matter what policies are introduced, the impact of consumer and financial system deleveraging will almost certainly be a significant drag on economic growth over the next several years as saving and paying down debt replaces borrowing and spending. We also believe that no matter what the short-term outcome, there will be a price to pay down the road for the current policy actions—potentially in the form of a weaker dollar, higher inflation, higher interest and tax rates and, consequently, subpar economic growth and corporate profits.

So there is a huge amount of uncertainty as to how this all plays out. It is important to remember that while uncertainty is uncomfortable, it is always an aspect of investing and it is what creates great long-term opportunities. (If there was perfect certainty about the future, one would never be able to buy an undervalued asset.) So how do we make investment decisions in this environment? We use the same framework we have always used: assessing the potential risks and longer-term return opportunities in various scenarios across a variety of asset classes.

Extending Our Time Horizon As we extend our investment time horizon out towards 10 years, our expectations for equity returns move toward the more optimistic end of our range, in the upper-single-digit to lower-double-digit return range. We want to emphasize that there will be a recovery in earnings at some point and we believe investors with a very long time horizon (greater than five years) should do at least okay owning equities at current prices and likely better than bonds. But the path from here to there is likely to be bumpy and there will probably be some big dips along the way. If so, we will look to opportunistically add to our equity exposure at lower valuations in order to generate higher long-term returns.

Active Equity Managers May Add Significant Value in this Environment While our current return expectations for the overall market are muted, we continue to hear from the majority of our equity managers that they are finding tremendous, once-in-a-generation opportunities right now. While they don't claim to know exactly when the market will reflect what they believe is the true underlying business value for these

"Perhaps in a similar fashion, people who are in their own personal crises—a pink slip, a foreclosure—can be reminded that no matter how dire the circumstance, or how little time you have to deal with it, further action is always possible. There's always a way out of even the tightest spot. You can survive."

~ Capt. Chesley B. Sullenberger III ~ (Sullenberger and his crew saved all 155 lives aboard US Airways Flight 1549 in New York)

companies, they are highly confident that it will happen over the next several (typically, three to five) years and their shareholders will be well rewarded.

Shorter-Term Risk Remains We continue to stress that there remains significant short-term downside risk in the stock market. As we write this the market is in the midst of a 20%+ rally from March 9th. We know that rallies of 20% or more within longer-term bear markets are the historical norm, not the exception. Prudent investors should be prepared for the possibility that the S&P 500 index could decline 25% to 30% from its current level (in the vicinity of 800). To be clear: we are not predicting the market will drop 30%, and the prior low could prove to be the bottom. But we think it is within the realm of reasonable worst-case outcomes, given the severity of the current economic crisis, the uncertainty as to its resolution and, importantly, the potential for market psychology (fear) to overshoot on the downside. That is, irrational pessimism can take hold and push the stock market to ridiculously low levels just as irrational exuberance pumped up stock prices to unsustainable heights during the tech bubble or other similar manias. Of course, our portfolios are not invested 100% in equities, so even in this scenario of a 30% stock market decline, the total portfolio loss would almost certainly be less.

Given the pain investors have already suffered, their capacity to absorb further losses is probably lower now than at any other point in their investment lifetimes. Therefore it is important that investors make an honest assessment as to whether they have the financial and emotional ability to withstand short-term declines of the magnitude we describe. We want to emphasize that we do not believe these would be permanent losses of capital. And we would expect strong stock market returns starting from those depressed levels looking out over the next five years. We also would probably be making tactical moves to take advantage of the compelling longer-term returns. But none of these factors will make those losses less painful should they occur, and won't change the fact that investors who throw in the towel and sell equities will be locking in their losses and hampering their ability to benefit from the rebound. For someone who believes they would not be able to make it through another bad stretch of stock market declines without bailing out, it makes sense to become more conservative now.

On the other hand, we recognize that becoming more conservative can also be a painful decision for someone who has already suffered sizable declines. What if the worst-case scenario does not play out and instead the market moves higher? An investor may feel great regret that they did not stick with the more aggressive portfolio, which will have outperformed their more-conservative portfolio in this scenario. The emotions triggered by each of these scenarios—anger, regret, fear, greed—can lead to poor investment decisions. Therefore, it is very important for clients to think in advance about how they are likely to react to the various potential outcomes and to invest accordingly. Part of our job is to help clients work through that decision so that their true risk tolerance and investment time horizon matches that of the portfolio they are in.

Shorter-Term Uncertainty Creates Longer-Term Opportunity Investor psychology is a powerful force that can overwhelm rationality. We've seen this throughout history on both the upside and downside. Markets can and do overshoot what a rational analysis would suggest is fair value. While this can cause discomfort in the short term, it can also create terrific investment opportunities for those able to identify and willing to take advantage of such mispricings. Our discipline continues to stress that we don't try to time short-term market moves, but instead base our tactical decisions on a longer-term investment horizon.

We Are Taking Nothing for Granted We have talked a lot about the risks and uncertainty in the economy and the financial markets. At the same time, we want to emphasize that we are resolutely focused on meeting these challenges with process and discipline. In addition to analytical expertise, conviction, and patience, we think our ability to navigate this environment and make effective long-term decisions requires that we think creatively, expand our knowledge base, continually challenge our analysis and assumptions, seek new data, and discuss our views with other experts in the field, in particular those whose analysis or opinion may differ from ours. We want to think carefully about how we could be wrong, particularly in terms of assessing the downside risk. We also need to have the intellectual honesty and humility to change our view or admit a mistake if we find that the original reasons for our investment thesis no longer hold true as a result of new developments. These qualities have been critical to our past success and, we believe, bode well for our ability to continue to add value for our clients in the future. We hope we are positively surprised and that a sustainable recovery takes hold more quickly than we expect and that our optimistic scenario plays out. But we are not managing our portfolios based on that hope. Instead, as always, we strive to analyze the situation rationally and in depth, weighing the potential risks, rewards, and outcomes in order to make the best investment decisions we can on our clients' behalf. ~ RWT ~

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