WealthHealth
Personal Wealth Management

2008 Mid Year Review & Outlook

5 Becker Farm Road
Roseland, NJ 07068

Tel: 973.535.9577
Fax: 973.535.9777

www.wealthhealthllc.com
info@wealthhealthllc.com

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 selloff resumed with a vengeance in June, with large-cap stocks (as measured by the S&P 500) dropping 8.4% for the month and almost 3% in the second quarter. The phrase "June gloom" is used by our Southern California residents to describe the cold and fog that persists this time of year, and it could also be used to describe investors' moods as the quarter came to an end. The S&P 500 is now down 12% for the first half of this year, and is about 18% below its October 2007 high. The market offered few places to hide. Mid- and smaller-cap stocks fared better than large in the second quarter, but still got slammed in June and now have high single-digit losses for the first half of 2008. The MSCI EAFE also had a rough month, losing more than 8% in June and 2.25% in the second quarter. Foreign stocks are now down almost 11% through the first half of 2008. REITs were hit hard, dropping almost 11% for the month, putting them in the red for the first half and closer to valuation levels we'd view as attractive relative to stocks.

Stocks were sharply lower in June amid renewed concerns that fallout from the housing crisis and credit crunch will drag down the economy.

Meanwhile, inflationary pressures from higher gas and food prices make it more difficult for the Fed to balance the goals of boosting the economy while keeping inflation in check.

Stock valuations are more attractive, but not yet compelling. Our return outlook for stocks from current levels is in the mid-to-high single digit range over the next five years. Our return expectation for bonds is lower—in the low-to-mid single digit range.

We are nevertheless getting closer to seeing tactical opportunities in stocks, REITs, and high-yield bonds, and will continue to watch valuations closely.

Index Returns *Through 06/30/2008*

			Annualized Returns		
Index	**Quarter-To-Date**	**Year-To-Date**	**1-Year**	**2-Year**	**3-Year**
S&P 500	-2.73%	-11.91%	-13.12%	2.35%	4.40%
Russell 1000	-1.89%	-11.20%	-12.36%	2.73%	4.81%
Russell 2000	0.58%	-9.37%	-16.19%	1.22%	3.79%
MSCI EAFE	-2.25%	-10.96%	-10.61%	6.54%	12.83%
Lehman Brothers Aggregate	-1.02%	1.13%	7.13%	6.61%	4.08%
Lehman Brothers Municipals	0.64%	0.02%	3.24%	3.96%	2.93%
Dow Jones AIG Commodity	16.08%	27.22%	41.56%	20.70%	19.83%
CSFB/Tremont Hedge Fund	2.58%	0.52%	4.09%	10.09%	11.00%

Domestic high-quality bonds were flat in June, and down just over 1% for the second quarter. Though not a good return in a normal environment, bonds nevertheless provided balanced investors with a margin of protection from stock-market losses, which is part of their role. The Lehman Brothers Aggregate Bond Index, our proxy for the bond market, is up 1.13% through the first half of the year. The short-term emerging-markets local-currency bond benchmark gained almost 1% for the month and almost 4% for the second quarter, bringing its year-to-date gain to 8.7%.

What is Driving Stocks Lower Again?

As always happens in an environment of fear, we are being asked (and asking ourselves) a lot of questions. What is going on, and how bad could it get? Is there anything we should be doing about it in our portfolios? This environment is in many ways unique and presents its own set of challenges, which we'll address more specifically in a moment. But more generally, we want to start by saying that we've been through a few difficult investment

5 Becker Farm Road
Roseland, NJ 07068

Tel: 973.535.9577
Fax: 973.535.9777

www.wealthhealthllc.com
info@wealthhealthllc.com

environments over the years, and while each of these periods presented its own particular challenges, one thing that is common to them all is that a sense of accelerating bad news, escalating risk, fear, and panic were almost always present.

The Federal Reserve's unprecedented actions to shore up credit markets a few months back led many to hope that we were past the worst of the financial crisis and that the stock market had hit bottom. While the Fed's actions may have significantly reduced the risk of a full-scale 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 (which of course is a major driver of the economy). Add in the impacts of high levels of household debt (which suggests the need to retrench rather than spend), higher gas and food prices, a weakening labor market, and, by one measure, consumer confidence at a 28-year low, and it seems increasingly likely that consumer spending will continue to deteriorate.

The damaging combination of a slowing economy and higher inflation (the widely feared "stagflation") has also led to questions about the ability of the Fed to support economic growth and employment without stoking fears that it has gone soft on inflation. What it all means is that risks to the economy remain high, and the financial markets are now more fully discounting this risk, which is an unemotional way of describing the battering taken by stocks in recent weeks.

As always, there are positives as well. Outside the financial sector, corporate balance sheets remain generally healthy and earnings have been okay. One source of strength has been exports, which so far have managed to offset much of the impact of the housing decline on GDP. But this could diminish if our slowing economy means we also export economic weakness to the rest of the globe, and there are signs that this is happening.

Though we have seen several market crises over the years, we also recognize that history never repeats itself exactly, and almost anything can happen from here. One possibility is that things in the stock market could 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 our investment discipline help us avoid becoming panicked by short-term concerns and paralyzed by longer-term uncertainty.

Our experience in past market cycles and our analysis of the current market environment, lead us to two important conclusions. First, we do not believe it is time to get more defensive and reduce equity exposure. It is easy to put too much weight on negative scenarios when bad news dominates the daily headlines, but we currently view stocks as priced to outperform bonds and cash in most scenarios over the next five years. Second, big market downturns invariably present opportunities, and without them, we would not have had the chance to identify some of the tactical allocations that have added value to our portfolios over the years. Our investment discipline and focus on what is knowable help us identify those asset classes where investor panic has led to excessive undervaluation, and we currently note three asset classes (U.S. equities, REITs, and high-yield bonds) where valuations have become more attractive and that we are monitoring closely.

5 Becker Farm Road
Roseland, NJ 07068

Tel: 973.535.9577
Fax: 973.535.9777

www.wealthhealthllc.com
info@wealthhealthllc.com

Setting Return Expectations

The annualized return for the S&P 500 over the past 10 years is just under 3% -- more than 70 basis points below that of risk-free Treasury bills! In the decade prior, stocks returned a whopping 18.6%. It would be nice if this history meant that, having come through a decade of above-average returns and a decade of below-average returns, we could now start from scratch and simply expect "average" returns of 10% to 12% a year on equities. Unfortunately, though, the market is forward looking and doesn't care where it's been. As we look forward to the next five years, our general expectation is for a low-return environment overall—for both stocks and bonds. We note, however, that the market's selloff in June has brought equity prices down far enough to make our potential return range on equities higher than it was just a few weeks earlier.

While recent declines have brought stocks closer to fat-pitch territory relative to bonds, as mentioned, our overall expectation is that we'll see a fairly low-return environment in coming years for stocks and bonds. As such, like the additions of commodities, emerging market local currency bonds, structured notes, and publicly traded long/short funds, we continue to evaluate alternative investments that we believe can add value to our portfolios. Relatively speaking, the "alternative" asset class is still young and not always well defined, but through our research, we have found several alternative investments to be potential sources of added value, especially in an environment where opportunities may be limited.

We suspect this will continue, at least for a while, to be one of the most challenging investment environments we've faced. We also know that many of the managers we respect tell us they are buying shares of high-quality companies at bargain-basement prices. Consequently, even though the overall market does not look compelling to us from a top-down valuation perspective, the current economic and market turmoil appears to be creating significant opportunities for bottom-up individual stock selection.

Indeed, it is often when the overall trend is negative that disciplined investors can build a portfolio for long-term outperformance by carefully taking advantage of the opportunities created by these dislocations. This requires patience as well as the ability to favor long-term analysis over short-term fear, which is what distinguishes successful investors.

Certain material in this work is proprietary to and copyrighted by Litman/Gregory Analytics and is used by Wealth Health LLC with permission. Reproduction or distribution of this material is prohibited and all rights are reserved.