WealthHealth
Personal Wealth Management

5 Becker Farm Road
Roseland, NJ 07068

Tel: 973.535.9577
Fax: 973.535.9777

www.wealthhealthllc.com
info@wealthhealthllc.com

2008 Investment Review & 2009 Outlook

Solid returns for stocks and bonds in December provided little relief in a year that will go in the books as the worst in decades for financial assets. While equity returns varied widely in the month, fourth-quarter and full-year returns were comparably dismal for most equity asset classes. The S&P 500 Index gained 1.1% in December, but lost about 22% and 37% for the fourth quarter and calendar year, respectively. Smaller-caps closed the year with a strong 5.8% December gain for the Russell 2000, but losses for the quarter were 26% and for the full year the index was down 33.8%. Aided by dollar weakness, foreign stocks saw very strong gains in December, with the MSCI EAFE Index gaining 6.01%. The 20% fourth-quarter loss was not as bad as U.S. stocks, but for the full year the MSCI EAFE was down 44%, about seven percentage points worse than domestic equities. Domestic bonds had a good showing in December, with the Lehman Aggregate Bond Index gaining 3.7%, which was enough for a very solid 4.6% gain in the fourth quarter and a 5.2% gain for the year. Among other asset classes, returns varied widely. The Merrill Lynch High Yield Master Index rebounded strongly in December after reaching record-level yields, with a 7.6% gain, and REITs, which have also been plagued by concerns about access to credit, shot up 17.4% for the month. However, both finished the year with big losses: high yield lost 26% and REITs fell 37% in 2008. The commodity asset class was the only loser among those we follow, with a 4.5% loss in December. This asset class, which in many environments behaves quite differently from equities and is therefore valued as a diversifier, saw a full-year loss of 35.6%, almost the same as that of stocks. But in a grim year where almost nothing unfolded according to expectations, and there was no place to hide short of stuffing cash in a mattress, that is little surprise.

Index Returns *Through 12/31/2008*

Index	Quarter-To-Date	Year-To-Date	Annualized Returns: 2-Year	3-Year	5-Year
S&P 500	-21.94%	-37.00%	-18.48%	-8.36%	-2.19%
Russell 1000	-22.48%	-37.60%	-18.76%	-8.66%	-2.04%
Russell 2000	-26.12%	-33.79%	-19.27%	-8.29%	-0.93%
MSCI EAFE	-19.95%	-43.38%	-20.66%	-7.35%	1.66%
Lehman Brothers Aggregate	4.57%	5.24%	6.10%	5.51%	4.65%
Lehman Brothers Municipals	0.75%	-2.47%	0.41%	1.87%	2.71%
Dow Jones AIG Commodity	-30.04%	-35.65%	-13.52%	-8.60%	0.23%
CSFB/Tremont Hedge Fund	-10.22%	-19.07%	-4.56%	1.23%	4.12%

For investors 2008 was a once-in-a-lifetime train wreck. The year was arguably the most painful in modern investment history. Almost every asset class was in the red for the year, with many deeply underwater, giving investors almost no place to hide. Government bonds were one of the few exceptions.

As the year progressed we became more troubled about the continuing credit crisis and the possibility that it could trigger a recession which could be followed by a multi-year period of sub-par growth. By mid-September, with major financial institutions falling like dominos and the money markets, freezing up, it became clear that we had to adjust our thinking in light of

2008 was as bad an investment year as most of us will likely experience in our lifetime. Stocks had their worst calendar year since 1931.

Many metrics suggest that stocks should at least provide satisfactory returns going forward and possibly something better. But the near term is much less clear. While it may be probable that we have seen the market bottom, we can't be sure.

We believe investment grade and high-yield bonds offer compelling return potential over coming years and have a significant tactical weighting in our portfolios.

The possibility of a lengthy recession exists, but with a great deal of negativity already priced in, the longer-term return outlook is decent. We believe we will continue to see numerous opportunities created in this highly dislocated environment.

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both the severe market declines and challenges facing the global economy that went beyond what most investors have experienced in their lifetimes.

Encouraging Signs

Historical comparisons are sometimes helpful. There have been two extreme economic and investment environments in the last 80 years—the 1930s, and the 1970s/early 1980s. In both periods, investor confidence was crushed after lengthy periods during which returns were dismal and because of a continuation of negative headlines. But as it turned out, both periods presented a great opportunity for long-term investors to buy stocks. This may be a similar time. These experiences reflect the tension that investors face—when risk seems greatest it is usually a good time to invest and when risk is an afterthought investors are likely to be disappointed with their returns going forward.

Historical Evidence: Trailing Risk Premiums

There are many ways to consider historical stock-market performance. One is to focus on the risk premium. This compares stock market returns to the returns an investor could have achieved if the money had instead been invested in a risk-free asset. Since we date this secular bear market at about nine years old, we looked at the stock market risk premium over the past nine years (using month-end returns). To do this we compared the S&P 500 returns to returns from three-month Treasury Bills. We then compared the returns to other periods going back to the Great Depression.

The takeaway is that by underperforming T-Bills by 59% over the last nine years (as of 12/31), the risk premium was one of the worst on record—matching the worst nine years during the Great Depression but not quite as bad as the worst periods that encompassed portions of the inflationary 1970s. On a forward-looking basis, what is very encouraging is that the long-term returns were quite good following similarly horrible nine-year periods for risk premiums. Furthermore, the end of these nine-year periods fell close to the bear market bottom.

Worst Nine-Year Risk Premiums Since 1935

		Cumulative Return		Annualized Returns in Following Years			
Nine-Year Period Ending	Risk Premium	S&P 500	T-bills	Next Five	Next Seven	Next 10	Next 15
Dec-08	-59%	-28%	31%	?	?	?	?
Jul-82	-58%	52%	111%	29.7%	23.1%	19.2%	19.7%
Sep-74	-67%	-5%	62%	16.8%	14.4%	15.6%	17.2%
Mar-38	-56%	-46%	10%	13.0%	13.4%	11.9%	14.1%

* *S&P 500 return less the T-bill return.*

Valuation Evidence: Shiller P/E

There are many ways to assess valuations. Most now suggest that U.S. large cap stocks range from fairly valued to bargain priced. One metric we have added to our valuation tool box is the so-called Shiller P/E, named after Robert Shiller, the Yale professor. Shiller calculates his P/E based on an average of the last 10 years' earnings in order to smooth out short-term earnings volatility and also inflation-adjusts his earnings and stock price levels. The current Shiller P/E is 15x normalized earnings, which is lower than most of the post-WWII period except for the early 1970s through mid-1980s when inflation and interest rates were generally much higher. P/E's could go lower and stay in a low range for a period of years, but this level of P/E has generally been a good long-term entry point into the stock market.

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Dry Powder

There is a mountain of cash sitting on the sidelines. In fact, since the advent of money market funds more than 30 years ago, money market assets relative to total stock market capitalization has never been higher. Some of that cash is likely to find its way into stocks and bonds at some point, especially with returns on cash so low.

Cautionary Signs

All of this evidence as it relates to the long-term potential in stocks is encouraging, but the near term is much less clear. Policy makers have made it clear that they will do whatever it takes to support the economy, yet credit markets, though slightly improving, remain dysfunctional and the housing market remains highly stressed. And while a financial system collapse has been avoided, a newly realistic consumer, attempting to reduce debt and increase savings, could mean an economic retrenchment that lasts longer than the consensus expects. This could lead to an extended period of deflation, something that we are already getting a whiff of. In the near term, a significant deflation scare is not fully priced into the stock market.

Weighing the Evidence

Overall the evidence does not clearly suggest that stocks are at highly compelling valuation levels. It also doesn't make an ironclad case that the stock market bottomed in late November after the S&P 500 hit its lowest level since 1997. While it is quite possible, maybe even probable, that we have seen the bottom, we can't be sure. Forced selling by hedge funds and others may not be quite done and more individual investors could simply give up if the market heads back down towards its prior low. Despite the near-term caution, we think the weight of the evidence overwhelmingly suggests that investors are very unlikely to get hurt owning equities over the next five to 10 years and are likely to reap at least satisfactory returns. That is a justification for owning stocks with capital that is not needed in the near term. Moreover, periods of extreme dislocation usually create opportunities for significant value-added from active management. Based on our read of history as well as data that indicates extensive valuation discrepancies in the market currently, we believe that the next few years are likely to be good ones for active managers relative to their benchmarks. We believe the same holds generally true for foreign stocks. Because valuations there are not materially different from those of U.S. equities, we are neutrally weighted to foreign stocks at this time. We think it is likely at some point in the coming years that foreign stocks will see a currency tailwind to domestic investors as U.S. monetary and fiscal policy begins to take a toll on the dollar. This is something we are evaluating now.

Thus far this discussion has focused on stocks but they are not the only game in town. We have found opportunities in high yield bonds and REITs and believe there is good potential across the investment-grade bond market. We are also considering a re-entry point into emerging-market short-term local-currency bonds as a possible dollar hedge. We believe the dollar is likely to be a weak currency over the next several years with some risk of a sizable decline so we are in the midst of considering the best way to hedge this risk. This asset class is one option. However, we also are assessing the impact of the global recession on emerging countries (China's economy, for example, is rapidly slowing—much faster than was expected

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by most China watchers) and are not yet ready to make a play, especially with the value available in the domestic fixed-income market.

What the Future Might Look Like for Investors

We are prepared for volatile markets (though less volatile than this past fall) and the possibility that many equity-type asset classes will experience wide performance swings with occasional strong rallies and subsequent sell-offs. Rallies could last for months with sizable returns, followed by sharp pullbacks. We have already seen a stock market rally of 18%, followed by a 25% decline, and a 21% rebound within the last few months. Sizable ups and downs in equity markets could play out over a period of a few years even as some equity markets stay within an overall trading range or move only marginally higher before beginning a new bull market. We don't know if this is what the next few years will look like but we believe this to be a possible scenario because this is how other secular bear markets have petered out over time. This grinding process is one way to get at more bargain-priced markets as earnings start to recover faster than prices (this could happen even if earnings growth is sub-par). An environment like this could present us with multiple tactical plays as volatility moves asset classes into and out of undervalued territory. Those possible opportunities, along with potentially solid returns from our fixed-income investments could translate into an attractive investment environment as we wait for a new bull market. We know that 2009 and beyond will remain challenging but we believe we are well equipped to navigate treacherous waters.

We remain strongly committed to focusing everything we do on rewarding you for your confidence.

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