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Personal Wealth Management

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Stocks continued their upward march in the first quarter, with large-caps gaining almost 6%, while mid and small-cap stocks posted gains approaching 8%. Overseas, returns were not as strong, though still good. Developed-market foreign stocks were up more than 3%, while emerging-market equities gained just under 2% for the quarter. Domestic high-quality, intermediate-term bonds didn't fare as well, barely gaining ground in the first quarter, while foreign bonds did a bit better, with developed-market government bonds gaining 0.7% and emerging-market bonds climbing by almost 3%.

Index Returns *Through 3/31/2011*

Index	QTD	YTD	Annualized Returns 1-Year	3-Year	5-Year
S&P 500	5.92%	5.92%	15.65%	2.36%	2.62%
Russell 1000	6.24%	6.24%	16.69%	2.98%	2.93%
Russell 2000	7.94%	7.94%	25.79%	8.57%	3.35%
MSCI EAFE	3.37%	3.37%	10.42%	-3.02%	1.30%
Barclay Capital US Aggregate Bond	0.42%	0.42%	5.12%	5.30%	6.03%
Barclay Capital Municipals	0.51%	0.51%	1.63%	4.47%	4.14%
Dow Jones AIG Commodity	4.45%	4.45%	28.49%	-5.20%	2.57%
HFRI Fund of Funds Composite Index	0.82%	0.82%	5.08%	-0.83%	1.60%

Stock Returns—Why We Remain Cautious

Stocks are the primary asset class for taking on risk. So when expected returns from stocks are not attractive to us, our positioning is likely to be cautious—as it is today. To understand the potential upside for stocks it's important to evaluate each of the factors that drives returns and how they might behave over our investment horizon. There are three key variables we assess: dividends, earnings growth, and changes in the price/earnings ratio.

Dividends are the easiest to analyze. Today's dividend yield is very low, so low that even strong growth in dividends paid will not make the dividend-yield a huge contributor to returns over the next five years. As we write this the S&P 500 currently yields about 1.8%. Compare this to the 25-year average of 2.3% and the 50-year average of 3.1%. Bull markets in the past have always begun with higher-than-average dividend yields. Since 1926, the only time the dividend yield was lower than it is now was during the period of elevated stock valuations during the late 1990s and early 2000s. It's easier to capture strong returns over multiyear periods when more of the return comes from dividends.

Earnings growth is more challenging to assess and forecast. Over the very long-term, the rate of GDP growth and earnings growth has been similar, though there are shorter periods when the relationship has not held. Earnings are much more volatile than GDP and earnings volatility has increased over time. Various factors have increased earnings volatility, including rising debt levels in the economy and in the corporate sector, as well as accounting changes and perhaps most important, a greatly increased tendency for corporations to take write-offs. (Note that these are reported or "GAAP" earnings, as opposed to so-called "operating" earnings, which exclude write-offs.)

Earnings have rebounded powerfully since the very deep trough in 2009. This rebound has been driven by cost cutting and government stimulus (neither of which will be sustained) and

Currently, we are positioned somewhat conservatively with our portfolio allocations.

Our longer-term analysis suggests that stock returns are likely to be mediocre.

Likely returns from bonds are even lower than stocks.

As a result, we are under-weighted to stocks and bonds in favor of fixed-income and alternative strategies that offer competitive returns at less risk.

With muni bonds, the over-all market is currently pricing in a default level that we believe is much too pessimistic.

Things could turn out more positive than we expect, but even if they do the underlying problem of too much debt can't be fixed without hurting economic growth.

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emerging markets' growth, which we believe is likely to be sustained (though inflation in emerging markets presents a serious risk). Despite the sharp rebound in earnings, growth is likely to be subpar as the rest of the cycle unfolds. Subpar economic growth is consistent with historical outcomes in the aftermath of a financial crisis. This history dovetails with a key assumption influencing our analysis—that the excessive private and public debt cloud hanging over the economy will result in continued deleveraging and therefore a lower level of consumption than would otherwise be the case. Private debt has declined from its peak but remains historically high while public debt has spiked higher and will continue to increase given growing entitlement costs as baby boomers age.

In addition, profit margins are far above their average level of the past 30 years and tend not to stay elevated for long. This suggests that revenue growth will have to be exceptionally strong relative to expense growth in order to drive continued earnings growth. That would be a particularly impressive achievement in the face of the debt-related demand headwinds we foresee. Increased regulation and the likelihood of higher taxes also could challenge growth. So could unexpected economic events—such as growing instability in the Middle East (which triggered a rise in the price of oil) and Japan's tragic natural disaster, which will have a temporary impact on the global supply chain and Japan's growth rate.

Still, there are some offsetting positives. The most significant is the growth in the developing world, which is benefiting many U.S. companies. Our S&P 500 earnings assumptions factor in a material emerging markets impact, but it is not enough to fully offset the other macro headwinds.

Changes in the P/E multiple (the price that stocks sell at relative to their earnings) can be affected by a number of factors, including: expectations for growth, the level of interest and inflation rates, and investor sentiment. One issue we keep in mind is that investors don't like extremes of either high inflation or deflation.

Inflation vs. Deflation

We believe the deflationary scenario is not likely. The economy has been improving and the developing world is growing at a healthy clip and is now big enough to have a material impact on global growth. However, the deflationary scenario is not so improbable to justify dismissing it. At the other end, we also don't view a return to normal as highly probable given the continued stress points in the economy including high public and private debt levels throughout most of the developed world, weakness in the labor market, and the threat of further declines in housing prices. Additionally there are the global risks of spiking oil prices, food and commodity-driven inflation in emerging markets, and now supply chain disruptions from Japan. It is true that the U.S. economy has clearly improved. This contributes to our view that continued subpar growth, not imminent recession, is the most likely scenario. However this recovery is unusually weak despite the fact that the downturn was so sharp (which normally results in an equally sharp rebound) and the fact that there has been massive fiscal and monetary stimulus.

The stimulus and quantitative easing are scheduled to wind down in coming months; it is not clear that the private sector is ready to take the baton and accelerate into a normal recovery mode. Consumer confidence is improved from its lowest levels but remains weak overall. Business confidence is back to normal levels, however, CEOs remain concerned about consumer demand. The labor market looks set to improve, but the improvement so far is at a rate that is not contributing enough to job growth (all measures of unemployment are historically quite bad—for example the U6 rate which measures the unemployed, underemployed, and "discouraged" workers is at an extremely high 16%).

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In our view, the European equity markets remain similar to those in the United States with respect to overall fundamentals and return potential. Europe continues to struggle with its own debt crisis and economic challenges. The single currency greatly complicates policy management for a group of countries with entirely different economic fundamentals—a powerful Germany at one extreme and debt-plagued Greece, Ireland, and Portugal at the other.

On the downside, we could be underestimating the odds of a deflationary scenario. If heavily indebted households and governments retrench, the resulting drop in aggregate demand for goods and services could send prices dramatically lower. Such bouts of deflation can be self-reinforcing.

Policy risk in the United States and around the world is also a major inflationary concern. How high might interest rates rise and what will happen to financial markets when the Fed stops buying U.S. Treasuries at the end of QE2 in June? It has purchased 70% of the new Treasury supply since last summer and PIMCO estimates that rates would be 1.5 percentage points higher without Fed buying. How will politicians address the deficit? The issue must be dealt with, but it is highly politicized and must be handled with intelligent policies and at the right pace. What is "right" is debatable but the increasing willingness of some politicians to consider tax and entitlement reform offers a little hope, though it's difficult for us to have much confidence in the outcome of political debates these days. Despite these very real concerns we continue to believe that the strength and growing influence of the developing world and the resiliency and resources of the United States make the deflationary outcome a relatively low probability.

At the other extreme we could be underestimating the risk that inflation might spike considerably higher, driven by rising commodity prices due to emerging-market demand, further disruptions of oil supply, and by government policy that is left with no choice but to inflate away the debt problem (the alternative is politically unpopular tax increases and spending cuts). Somewhat higher inflation in the near term is quite possible due to rising commodity-driven import prices and we believe higher inflation is probable over our five-year investment horizon. But with sizable slack in the economy and no sign of upward pressure on wages (which would seem critical in order to generate a 1970s-style wage-price inflationary spiral), sharply higher prices don't seem to be in the cards any time soon. (Aside from the inflation worry, rising commodity prices, if not passed through to the end consumer, imply a profit-margin squeeze to corporate earnings.) Never before have investors needed to consider the possibilities of both deflation and inflation to the degree they must now—this underscores the unusually high macro uncertainty.

On the upside, we may be overestimating the magnitude of the deleveraging to come, or underestimating the potential for households to leverage up one more time. Moreover, emerging markets might have even more global macro influence than we give them credit for, and may themselves leverage up more than we expect. We could also be underestimating the willingness of the financial markets to allow the United States to inflate away its debt problem. But overall, we believe the "return to normal and perhaps beyond" outcome is also unlikely, particularly the willingness and ability of U.S. households to support consumption by taking on more leverage in an environment where lending standards have tightened considerably.

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Alternatively, we may be underestimating the possibility of another low-interest-rate-triggered bubble, where investors are tempted to take more and more risk because of the skimpy yields available in the bond and money markets. Money market fund yields border on zero. The longer the economy can muddle through in a low-rate environment, perhaps the greater the potential for temporarily higher equity returns. This is by no means a far-fetched possibility—in our view it is already happening, with the stock market up over 20% since the Fed's announced the second round of quantitative easing last summer. (In fact, an explicit goal of QE2 was to cause equity prices to rise with the aim of generating a positive wealth effect that would stimulate real economy.) However, if this happens in a big way and without strong business fundamentals supporting the higher stock prices, we expect it to end badly as bubbles always do. Ultimately interest rates will rise, removing the justification for holding riskier assets at high prices. If rates don't rise it will mean that the deflation scenario is playing out, which obviously would be bad for stocks as well.

Margin of Safety

We've often said that we view investing as a marathon, not a sprint. We all are investors over a lifetime and any one year is a small slice of our investment timeline. Over our investing lives there will be periods when it pays to be conservative and others when it makes sense to be aggressive. Sometimes these periods will be short, others times they will last for years. Along the way there will be ups and downs within each of these periods. Our challenge is to ignore the ups and downs and focus on the potential returns we believe we can capture and weigh them against the risks.

Ultimately, what drives our risk-taking is the presence of a margin of safety, i.e., a significantly undervalued asset, such that even in a bad scenario it shouldn't have much downside. Today we believe there is an inadequate margin of safety in the stock market to overallocate to equities. Valuations are not attractive enough to compensate for the many serious concerns we've mentioned that could impact investment fundamentals. They also don't provide us with a margin of safety against risks we may not be anticipating. The Middle East uprisings and the horrific Japanese earthquake, tsunami, and nuclear disaster were entirely unexpected. Oil prices are higher than they would have been and, as we write this, it is not entirely clear what the short-term global economic impact of Japan's disaster will be. Regarding oil, up to this point the price spike is one the global economy can probably absorb though it will impact growth at the margin. But there is a price point that could endanger the recovery in developed countries and cause problems for many emerging markets. Saudi Arabia is critical. For the global economy it is good that it has not experienced widespread protests and that seems unlikely. It has the wealth to placate its population. But there is still a very unpredictable element to what is happening in that part of the world. And if there is a return to recession it could trigger very nasty problems given where we already are with respect to debt, deficits, and unemployment.

Even without worries about oil or the possibility of unexpected economic events, risky assets are not priced to offer enough reward given the above-average risks we see as the world seeks to deleverage after decades of expanding debt. In this environment, we remain positioned with below-average risk exposure, though we are not postured for a worst case. Reduced risk is for us, a common sense conclusion.

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