

# the Clarity April 2009 report

**D**uring the first quarter of 2009 the stock market continued its decline with the broad market Russell 3000 Index falling 10.8%. Small cap stocks (Russell 2000) led the way down, losing 15.0%, while mid cap stocks (Russell Midcap) fared slightly better, losing “just” 9.0%. These numbers betray the full story; at the low points of early March, the broad market was down over 20% from the levels at which it began the year, followed by a strong rally to finish the quarter.

Conflicting data (some negative, some positive) may indicate that the economy is reaching a point of stabilization – we are now officially 15 months into a recession – but only time will tell. Meanwhile, stocks will probably continue to bounce around like a child who’s had too much candy.

## **When Will Stocks Come Back?**

After experiencing a rapid and deep contraction in stock prices with few clear signs of a quick turnaround and a daily drumbeat of bad economic news, investors may feel like they’re stumbling their way around a dark room trying to find a light switch. It’s natural to wonder how low stocks can go after we’ve seen them fall to levels that just a few years ago would have seemed crazy and that few thought possible. Having experienced material declines in account values, long-term investors are asking how long stocks will take to recover to their former (higher) levels. Often, we anchor our brains to these high points – peak stock prices – believing because stocks have been at those levels they belong and will return there. But it is important to keep perspective: stocks are just as likely to go up *too high* as they are to fall *too low*. While we think stocks today are priced *too low*, with the benefit of perfect hindsight it appears that the all-time high stock prices of October 2007 were not justified by stocks’ intrinsic values and were, therefore, *too high*.

The stock market, when it reached its 2007 highs, had been trending strongly upward since 2003, and hit new highs consistently from late 2006

*clar’i•ty*: n. The quality or state of being clear.

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(when it had surpassed its 2000 peak) through its zenith a year later. On October 9, 2007, the Dow Jones Industrial Average (DJIA) hit an all-time closing high of 14,164, and has not reached that level since. At the end of the first quarter, the DJIA stood at 7,609, a decline of 46.3% from the very top.

Investors rightfully question when we might see the stock market recover to the peak levels that now seem so distant, but the answer is illusive. So what does history tell us about what happens when stocks go through strong, upward-trending periods, hit a new high, then don't reach that high again for at least a year, as is currently the case? For insight on the above questions, we looked back at the Dow Jones Industrial Average from 1900 through the end of the first quarter 2009.

Peak	Recovery	Max Decline
6/17/1901	3/24/1905	-46.1%
1/19/1906	9/28/1916	-48.5%
11/21/1916	7/9/1919	-40.1%
11/3/1919	12/31/1924	-46.6%
9/3/1929	11/23/1954	-89.2%
4/6/1956	9/15/1958	-19.4%
1/5/1960	4/10/1961	-17.4%
12/13/1961	9/5/1963	-27.1%
2/9/1966	11/10/1972	-36.6%
1/11/1973	11/3/1982	-45.1%
11/29/1983	1/29/1985	-15.6%
8/25/1987	8/24/1989	-36.1%
1/17/2000	10/3/2006	-37.8%
<b>10/9/2007</b>	<b>??</b>	<b>-53.8%</b>
<b>Average</b>		<b>-38.9%</b>

The above chart shows the maximum decline from peak to trough (a.k.a., "The Bottom") in each of these periods. For all periods, the average fall to the nadir was 38.9%, but the declines ranged from as shallow as 15.6% (1983-1985) to very deep 89.2% (in the midst of the Great Depression). At the lows of early March 2009, the DJIA fell as low as 53.8% from its 2007 peak and stood 46.3% below it at the end of the first quarter. Of all the peak-trough periods presented above, covering 109 years, *this already ranks as the second-worst decline.*

These numbers can help investors to derive reasonable expectations of the future. Have we seen the

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worst of the declines? If history is any guide, these figures illustrate that while it could be several more years until the Dow gets back to the record levels of October 2007, the significant stock price declines we have experienced *already exceed* those from similar periods we've seen in the past 100+ years.†

## Client Portfolios are Not “The Dow”

The Dow Jones Industrial Average figures presented above are meant to provide some historical perspective. But they don't mean we investors should simply accept our fate, sit on our hands and wait for stocks to recover to their former highs. No, the Dow numbers presented above probably say more about the future expectations for a passive, indexed stock investment strategy than they do about actively managed portfolios allocated among different asset classes with disparate risk-return profiles. Large cap stocks, as represented by the DJIA, are only one piece of the total pie, but often receive a disproportionate amount of investors' attention.

We at Clarity Asset Management actively manage asset allocations and the mutual funds within each asset class. We view each mutual fund as a tool to gain exposure to a certain

New All-Time High		Surpassed Initial High		
Date	DJIA Level	Date	DJIA Level	Years
6/17/1901	78	3/24/1905	79	3.8
1/19/1906	103	9/28/1916	103	10.7
11/21/1916	110	7/9/1919	110	2.6
11/3/1919	120	12/31/1924	121	5.2
9/3/1929	381	11/23/1954	383	25.2
4/6/1956	521	9/15/1958	523	2.4
1/5/1960	685	4/10/1961	692	1.3
12/13/1961	735	9/5/1963	738	1.7
2/9/1966	995	11/10/1972	995	6.8
1/11/1973	1052	11/3/1982	1065	9.8
11/29/1983	1287	1/29/1985	1293	1.2
8/25/1987	2722	8/24/1989	2735	2.0
1/17/2000	11723	10/3/2006	11727	6.7
10/9/2007	14164	??	??	1.5
<b>Average</b>				<b>6.1</b>
<b>Average (ex-1929)</b>				<b>4.5</b>

The above chart shows each of the periods when it took a year or more to get back to or surpass the high, including when the new all-time high was reached, the date it was subsequently reached or exceeded, and the time between each date.

Prior to the current period, there have been 13 similar instances since 1900. As shown, among all of these instances, the average time to get *back to even with the high* is just over 6 years. This average obfuscates the wide variation in these numbers, however. As shown on the chart, it has taken as short as 1.2 years to reach new highs (1983-85) and as long as 25 years, which occurred during the period that included both the Great Depression and World War II. During the period that included World War I, it took 10.7 years. Excluding the Great Depression period, a clear outlier, the average is about 4.5 years. (Note that these numbers do not include reinvested dividends.) The lesson? Given that the DJIA peaked only 1.5 years ago, we may have a while to go before we see the October 2007 highs again. There may be some good news, however, illustrated by the following chart.

piece of the investable universe, and all of the mutual funds we utilize are managed actively. In the current environment, we believe allocating to flexible, active managers is more important than ever, because the opportunities to add value relative to passive investments appear to be much greater than has been the case in years prior.

There are a few important points to keep in mind with respect to our management philosophy. First, our portfolios are not structured like the Dow Jones Industrial Average, so they may or may not move in similar ways. The Dow is a (mostly) static collection of just 30 stocks, whereas our portfolios are allocated into several different asset classes, including domestic stocks, foreign stocks, global real estate, convertibles, investment grade and high-yield corporate bonds, government bonds, mortgage-backed securities, etc. We change funds and allocation mixes when we believe such actions are warranted by market or fund-specific conditions. Second, each mutual fund we own is actively managed. We believe the manager(s) of each fund has (have) the ability to add value within a particular asset class. We view the process as allocating capital to investment managers, not simply buying mutual funds. (It just happens the most cost-efficient vehicle for this type of management is the mutual fund.) The managers we use do not operate passive buy-and-hold strategies. While we typically “buy and hold” funds for longer periods in client portfolios, the underlying managers are not sitting on their hands. We expect each to be actively pursuing the best risk-adjusted opportunities, a strategy that should lead to satisfactory results over time.

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We think it’s more likely than not that we are in a period where intermediate-term index fund returns may be pressured relative to a carefully selected portfolio of value-conscious active managers. Our portfolios are structured differently than the broad market, we have active managers operating each fund, and we believe owning a collection of funds with exposure to disparate asset classes can offer higher risk-adjusted returns than a portfolio of large cap stocks alone (such as the DJIA).

## Dow Point Moves in Perspective

As much as we like to discourage investors from watching the day-to-day movements of the stock market, we realize it still occurs. While our client portfolios are structured very differently than the Dow Jones Industrial Average, we know it is one of the most followed market indicators, driven by its pervasive media presence. Accordingly, we want to address one major misconception we see in media citations of the DJIA – the use of “points” in figuring how much “the market” moved. For instance, one might hear on the news, “The

Dow gained 500 points today.” A person observing this today might think that’s good news, and they would be right. But someone hearing this same phrase in the mid-1970s might book a flight to Fiji, since gaining that many points would have meant being up 50% in a single day. Similarly, a 508-point decline on Black Monday in October 1987 caused widespread panic because it represented a decline of 22.6% in one day. Today, Black Monday’s decline is only the 11<sup>th</sup> largest point loss of all-time (but still the largest single-day percentage loss), and a 500-point move at current Dow levels is “only” about 6%. Twenty years from now, when we believe the Dow will be materially higher, a 500-point move will be even less meaningful in percentage terms.

**“Today, Black Monday’s decline is only the 11th largest point loss, but is still the largest in percentage terms.”**

Furthermore, the media, when referring to the DJIA, often talk about “all-time” biggest point moves. After all, point moves grab headlines. But to get a true idea of how much “the market” moves, one must consider the percentage. To put the difference between them in perspective, since the beginning of 2008, we’ve seen 13 of the top 20 biggest DJIA *point* losses of all-time; in contrast, only 4 of the top 20 *percentage* declines have occurred during this period. Similarly, over this same timeframe we’ve seen 14 of the 20 all-time largest *point* gains, but only 3 in the top 20 on a *percentage* basis. This illustrates the importance of keeping “point moves” in perspective. We believe it is important to look at percentages, not just the absolute value of the point move.†

(For a far better indicator of the overall domestic stock market, we believe the S&P 500 Index is the best among those widely disseminated. The Russell 3000 and Wilshire 5000 indices are even more complete, but are not often cited in the mainstream media.)

## Mutual Fund Changes

During the quarter, we made a couple changes to our fund lineup. These changes were driven primarily by our desire for managers with more portfolio management flexibility, and that have shown the ability and willingness to pay strict attention to value in their actions. For example, some mutual fund managers will always invest close to 100% of their portfolios in their mandated segment. A small cap manager may be fully invested in small cap stocks regardless of whether or not some of those stocks are overvalued. In the current environment, we don’t necessarily want our managers to remain fully invested at all times.

When one invests in individual stocks, he or she should attempt to estimate the value of each stock and buy it below that value, while selling it when the price is close to or

above the value estimate. Similarly, we try to find managers that we believe will operate their mutual fund's portfolio with the same logic. This means that they may hold more cash in their portfolio at times, not as an attempt to time the market, but due to a lack of acceptable prospects. If the manager can't find stocks meeting the fund's investment criteria, he/she may hold cash and short-term bonds, waiting to pounce on opportunities as they arise. We believe that this method of investing, properly executed, better manages downside risk while increasing opportunities for future appreciation.

Our brains sometimes trick us into believing we could have foreseen market movements clearly enough to take action beforehand. But despite claims to the contrary, there is no way to divine short-term market swings before they occur. This is why we spend no time trying to figure out which direction markets are headed in the next week or month. Our focus has always been and will continue to be with helping clients accomplish their financial goals by developing, selecting and monitoring a proper allocation of funds that provides a high probability of reaching those goals over the long-term.

## Latest Market Comments on the Website

We want to again remind clients that we are periodically updating the "Latest Market Comments" section on our website, [www.investmentclarity.com](http://www.investmentclarity.com). We've been pleased to see that several clients are utilizing this section of the site. Please continue to check in from time to time for our thoughts and commentary about market conditions. Although we don't recommend watching the market on a daily basis, it sometimes helps to have a source that can act as a filter for the deluge of available information.

†All numbers calculated by Clarity Asset Management, Inc. using data obtained from Dow Jones & Company.

*The Dow Jones Industrial Average ("DJIA") is a price-weighted index consisting of 30 established U.S. companies that are leaders in their industries and does not include the reinvestment of dividends. The DJIA is an unmanaged composite and investors cannot directly invest. The Russell 3000, Russell Midcap and Russell 2000 are market-value-weighted indices consisting of a group of stocks chosen for market size, liquidity, and industry group representation and do not include the reinvestment of dividends or interest. Each Index represents an unmanaged composite and investors cannot directly invest in an index. The Wilshire 5000 Total Market Index is a capitalization-weighted index measuring the performance of all U.S. equity securities with readily available price data. Over 5,000 capitalization weighted security returns are used to adjust the index. Numbers do not reflect fees, brokerage commissions or other expenses of investing.*

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