

# the Clarity July 2009 report

**D**uring the second quarter of 2009, capital markets showed us that asset prices can still go *up*. The S&P 500 Index rose 16% during the quarter – the strongest quarterly rally since the fourth quarter of 1998 – and has risen 38% from its March lows. Meanwhile, consumer confidence has rebounded from record low levels and once-rampant fear appears to be subsiding. Indeed, the CBOE volatility index, often called the “fear index,” is now trading back near its low levels prior to Lehman Brothers’ collapse in September when we were hit with what Warren Buffett called, “Economic Pearl Harbor.”

Coming off the best quarterly performance for the broad market in over a decade, the winds of popular sentiment appear to be blowing in one general direction, pronouncing that the economy has stabilized and so-called “green shoots” are beginning to emerge amidst the economic wreckage. But is this true? Has the economy actually bottomed? Many of the talking heads on cable and network news seem to think so and it is certainly possible after the precipitous declines we’ve seen over the past few months. But the fact is the data to confirm that things have stabilized won’t be available until months afterwards. (For example, the recession began in December 2007 but wasn’t declared official until nearly a year later.) While we’re not sure when, we do know that the economy will stabilize *at some point*. Yet we think it will be several years before we see a return to the “peak” levels of economic activity we last saw in 2006-2007.

We reiterate the point here that the capital markets and the economy are intertwined but distinct. Stock prices sometimes correctly reflect economic fundamentals; at other times, they do not. Just because economic activity might be rebounding does not necessarily mean asset prices will rise. And while stocks tend to portend movements in economic activity, they are not perfect predictors. So if prices are going up, it doesn’t necessarily mean the economy is recovering. Nevertheless, asset prices worldwide have risen substantially from their winter doldrums. Corporate bond prices hit a bottom in December of 2008 while stocks reached their nadir three months later. Both are up substantially from those lows.

*clar'·i·ty*: n. The quality or state of being clear.

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## The Future Is Always Uncertain

Despite the significant rebound and the feeling that everything might be getting back to normal, the broad market S&P 500 is still 40% below its October 2007 highs. Stock prices have rebounded significantly, but prices are right about where they began 2009. As we laid out at the beginning of the year, our economy is unlikely to be the same coming out of this crisis. Going forward, it will be difficult for consumers to resume their spendthrift ways. Rather, we'll probably continue to see higher savings rates and years of deleveraging as consumers align their household cost structures to perceived future income levels. (In fact, the national savings rate has already climbed to nearly 7% from 0% just a couple years ago.) Accordingly, the source of 70% of our economic activity – consumer spending – will probably be much less robust and become a smaller part of the economy. Capacity utilization is likely to be sub-optimal for some time, which implies higher structural unemployment and lower future wage growth. If the government continues its profligate spending without commensurate cuts in entitlements, it will be difficult to avoid higher domestic taxes down the road. Rising national debt levels and no sign of a slow-down in spending indicate an increased tax burden on consumers, investors and entrepreneurs.

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The various feedback loops created by all of these elements are likely to translate into slower economic growth than we have been used to in the recent past. As businesses (like consumers) deleverage and adjust their capital structures for a more uncertain economic environment, corporate returns on equity will probably be driven lower; meanwhile, risk-aware investors are already demanding higher returns, which has increased the corporate cost of capital. This combination may bring stocks' justified price-earnings (P/E) multiples down from the high levels to which we've become accustomed.

Governments, businesses and consumers do not become aware of all these realities overnight. They take time to work their way into the collective consciousness. It took years for Americans to go from saving 8-10% of their income (1950s through early 1990s) to 0% (2006), and to double their household debt as a percentage of personal income. The same goes for businesses and governments (which are run by consumers), who largely didn't have rainy-day contingency plans going into this crisis. We think this is bound to change the collective mindset as we move forward. The result will be a more resilient economy but one that is less optimized should boundless growth and low volatility return. Bill Gross, a well-respected bond fund manager, has called this lower level of future economic growth the “New Normal.”

All of that said, we are incredibly optimistic about the long-term strength of our economy and the capital markets. Ours is one of the most dynamic, resilient and innovative economies in the entire world. Disruptive, unforeseen technologies will be developed that change the way we live and work, propelling us to still-higher levels of economic prosperity in the future. These technological advances will make our society more productive, increase the longevity and health of our citizens and continue to increase our standard of living. While we have near-term concerns that give us pause, we believe the future of the U.S. – and the world – is bright.

## Starting Valuations and Future Returns

As U.S. investors, we have been used to stocks trending steadily upward over time – particularly, the last 25 years through 2007 – and it's important to consider why they behaved as they have. As most investors know, stocks trended upward from the early 1980s through mid-2007, amidst a secular decline in interest rates. This is the stock market of which most people alive today are aware. Over this same period, our country saw interest rates come down from nearly 20% to essentially 0% today. As interest rates and the market's expectation for future inflation fell over time, stocks' earnings multiples rose from 8 to nearly 20, a roughly 4% annual return solely from multiple expansion. (Lower interest rates make assets more valuable, increasing prices; higher rates do the opposite.) Those same tailwinds simply don't exist for stocks today, with interest rates at zero. With higher inflation a near-certainty given recent Federal Reserve and government actions, higher interest rates appear inevitable at some point in the future.

We note that it is not unprecedented for markets to trade in a range following decades of trending upward. For example, the U.S. stock market from the early 1940s through the late 1960s saw a steadily trending market marked by rising P/E multiples and robust corporate earnings growth (not unlike the last 25 years). From the late 1960s, the market traded in a range but went nowhere until the early 1980s, when low valuations paved the way (by 1982) for another strongly upward-trending market. (Corporate earnings grew over this period, but inflation and interest rates rose while stocks stagnated.) The starting level of valuations plays a major role in long-term stock returns and, judged from this perspective, we clearly lack such tailwinds from where we stand today. Despite the possible headwinds we believe active managers, in contrast to passive indexed strategies, can add value in an environment where stocks aren't exhibiting definite trends.

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## Portfolio Management in the Current Environment

Volatility and turbulence in financial markets tend to cluster in time and it is therefore difficult for us to sound the “all clear” at this point. We remain convinced that the economy has recalibrated and we are in a different environment, as previously stated, but our investment philosophy has not changed. We are long-term investors who believe that investing across a range of asset classes using actively managed strategies on a diversified and disciplined basis offers the best prospect of meeting long-term investment objectives. We don’t expect to suddenly be able to time the market after being unable to do it before, nor will we try. But we will make adjustments in the implementation of our strategies to meet client goals. We believe active managers are especially important during periods where stocks do not trend strongly upward and so we continue to focus on investing client assets with mutual fund managers who are focused on stocks’ intrinsic values in their buy and sell decisions. Allocating client portfolios to opportunistic, active managers – managers focused on valuing assets, not timing the market – is, in our opinion, the best way to capitalize on the dislocations caused by the current environment.

### High Yield Bond Sales

During the quarter, we made one notable change to client portfolios. We sold about half of our positions in high-yield bonds, both corporate and municipals. Each has had a banner year; at the time of sale, high yield corporates were up over 20% for the

year while municipals had advanced about 15%. This strong performance has

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brought yields in these asset classes down to levels where our credit risk concerns became more pronounced. We are also concerned about duration risk – or sensitivity to interest rate movements. Long duration bonds, such as high-yield municipals, are not likely to perform well should interest rates rise significantly.

As the prices of these assets rose, spreads (interest rates relative to Treasuries) narrowed, reflecting less risk aversion and more eager buyers. At one point a few months ago, the high yield market had a yield of 22.5%; today, it is closer to 13%. But while spreads have compressed, the fundamental pressures have not abated; there remain considerable challenges in the form of higher future corporate defaults and lower recovery rates on defaulted bonds. Some of the rise could also be related to technical factors. High yield bond funds have received large inflows in the past few months and not enough new supply has been issued to soak up this new money. Therefore, fund managers have bid up the prices of secondary

market bonds. In short, all things considered, the risk-reward tradeoff in high-yield bonds does not look as favorable from current levels.

High yield municipals have also rallied significantly since the beginning of the year. Intermediate municipal bond yields have come down from roughly 6.2% to just 4.5% at the time of our sale. As mentioned, the primary goal with the sale of high yield municipals was to reduce the duration exposure, since the fund owned very long-term bonds and the portfolio duration was above-average. We think keeping shorter portfolio duration is prudent given the likely upward pressures on future interest rates, described previously. Many of the holdings in the high yield municipal funds we utilize are project-specific bonds and other revenue bonds, which, like high-yield corporate bonds, are likely to face more pressure going forward than will bonds backed by the taxing authority of the governments they represent (general obligations).

Please note that the proceeds from these sales are being held in money market funds, which we view as short-duration, low-credit-risk, fixed income. So if your account is holding an above-average amount of money market funds, this is the reason.

### Rebalancing in a Volatile Market

As we’ve highlighted multiple times, we rebalance accounts on a quarterly basis, if necessary. Client accounts are diversified among asset classes according to percentages that we believe are consistent with long-term investment objectives. We seek to maintain this balance of assets over time. As markets fluctuate and asset percentage allocations dynamically change, we need to restore the balance. Therefore, we trade accounts when necessary to bring accounts back into alignment with investment objectives. Within a disciplined rebalancing framework, more volatile financial markets typically mean more frequent trading. This is because some assets rise while others fall, and some go up or down more than others. For example, as we rebalanced accounts in January through March we were selling bonds and buying stocks; as stocks and high-yield bonds have rebounded in the past few

months, we have been selling these asset classes to allocate to those that have not performed as well on a relative basis.

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To illustrate how the rebalancing process can add value in a volatile market, assume an investor starts with \$100,000, allocated 60% to stocks and 40% to bonds. Over the next quarter, stocks fall 20% and bonds gain 2%. This leaves the investor with \$48,000 (54%) in stocks and \$40,800 (46%)

in bonds, a total of \$88,800. Market movements have caused the portfolio to drift away from its target allocation, so the portfolio is rebalanced back to 60%-40%. This means selling \$5,280 worth of bonds and buying the same amount in stocks, leaving the portfolio with \$53,280 (60%) in stocks and \$35,520 (40%) in bonds. Assume then that in the subsequent quarter, stocks rise by 20% while bonds gain 2%. At the end of the quarter, the investor is left with a total of \$100,166, versus just \$99,216 had the portfolio not been rebalanced. The process works similarly if the quarters were reversed (with stocks up 20%, then down 20%), since rebalancing would lead to selling a portion of the stocks and buying that amount of bonds. To the extent that markets remain volatile and range-bound with no definite trend, we believe this approach should add value – compared to a simple buy and hold strategy – over time. †

## Going Paperless

Clarity has always made quarterly statements available online, but prior to now has not provided clients with a choice to opt-out of a paper statement. We are now offering clients the option of forgoing a printed-paper statement each quarter in exchange for receiving it online. If you would like to receive your quarterly statements electronically and discontinue the paper statement, please contact us. We will set you up with a login to our website and you will receive an email notifying you when the statement is available each quarter. The service allows you not only to save paper, but also to receive your statement faster than “snail mail.” Please contact us with any questions.

†All numbers calculated by Clarity Asset Management, Inc.

*The S&P 500 Index (“S&P 500”) is a market-value-weighted index consisting of 500 stocks chosen for market size, liquidity, and industry group representation and includes the reinvestment of dividends. Numbers do not reflect fees, brokerage commissions or other expenses of investing.*

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