

# the Clarity October 2009 report

**D**uring the third quarter of 2009 the capital markets performed strongly. Pick an asset class and chances are it was up substantially. While last year virtually all assets experienced dramatic declines, the third quarter of 2009 saw the opposite – everything, it seems, gained in unison. Domestically, the Russell 3000 gained 16.3%, with medium capitalization and value stocks leading the way. Aided by the depreciating dollar, international stocks rose 19.5% in dollar terms but just 14.8% in local currencies. Global real estate was a standout, gaining 25.2%. Commodity indices rose slightly but several areas, including copper, sugar and natural gas all saw double-digit gains. Not to be left out, fixed income markets continued their climb as risk aversion waned. While the overall bond market gained ground, the least creditworthy drove the advance, with corporate high yield bonds gaining 14.8%. Municipal bonds rose 7.1% during the quarter; their yields are now at 40-year lows, according to the Wall Street Journal.

The last two calendar quarters have been some of the strongest for the S&P 500 in over a decade. At the end of September the S&P 500 had risen for seven straight months, the longest streak since mid 2006 to early 2007. (Over the past two decades, the longest positive streak has been eight months, which happened only three times in this period – 1995, 1996 and 2006-7.) When nearly all asset classes rise simultaneously – even though it is in the right direction – we become skeptical of its sustainability.†

## What Do We Know?

“Except in construction activity, the current depression seems to be following much the same course as that of 1920-21, as respects to the length and severity of decline and the inception of recovery; and we conclude that improvement in business volumes, the first step in business recovery, is already underway.”

— *Harvard Economic Service, June 30, 1931*

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

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“At this point, the available data on the housing market, together with ongoing support for housing demand from factors such as strong job creation and still-low mortgage rates, suggest that this sector will most likely experience a gradual cooling rather than a sharp slowdown.”

— Ben Bernanke, April 27, 2006

“The recession is very likely over at this point...”

— Ben Bernanke, September 15, 2009

Our nation’s financial leaders frequently make predictions and when they do we pay attention because the media often attributes market movements to their words. But the reality is that, though they predict repeatedly, their accuracy has been quite poor over time. In this way, they are like weather forecasters. Yesterday they told us it will be clear and sunny, but it rained. Today they offer their prediction that the clouds will clear and the sun will come out and we believe them again. Why?

The quotes above illustrate one main point: at any given time, no one – not even our financial leaders – know for certain what the economy and the markets are going to do. Economic predictions are like throwing darts blindfolded: a person may get lucky and hit a bull’s eye if he throws enough of them. Also, hearing such confident predictions often leads us to believe that decision-makers know more about the economy than our forebears; this is simply not the case. Our financial leadership is just as inaccurate and overconfident now as they ever were, perhaps more so today as the economy becomes increasingly complex and interconnected globally. Occasionally, though, our decision-makers will admit to lacking foresight. Janet Yellen, San Francisco Federal Reserve Bank President recently said, “To provide more accommodation, the Fed has used unconventional policy tools. Collectively, these programs, which have provided us a slew of new acronyms, appear to be helping. But *we have little experience with them and the extent of their effectiveness is highly uncertain.*” (emphasis ours)

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Our economy may now be in real recovery or it may be experiencing a temporary, statistical bounce in the wake of massive government intervention. Regardless, there is no doubt that the drumbeat of positive economic news continues to grow louder alongside the assured statements of our nation’s leaders. Federal Reserve Chairman Ben Bernanke has said the economy is recovering. The Treasury Secretary Tim Geithner, who has been on a “worst has passed” tour the past couple months, expresses this same view.

To borrow from Warren Buffett, “Don’t ask the barber if you need a haircut.” That is, we cannot expect unfettered candor from these men because it is in their interest to make such

positive statements. (It’s hard to imagine a Treasury Secretary on national television screaming, “The sky is falling!”) Not all financial authorities are as sanguine as Bernanke and Geithner, though. Yellen, previously mentioned, has been more forthright (and realistic) with her assessment of the economic plight of the United States:

*I expect the recovery to be tepid. What’s more, the gradual expansion gathering steam will remain vulnerable to shocks. The financial system has improved but is not yet back to normal. It still holds hazards that could derail a fragile recovery. Even if the economy grows as I expect, things won’t feel very good for some time to come. In particular, the unemployment rate will remain elevated for a few more years, meaning hardship for millions of workers. Moreover, the slack in the economy, demonstrated by high unemployment and low utilization of industrial capacity, threatens to push inflation lower at a time when it is already below the level that, in the view of most members of the Federal Open Market Committee best promotes the Fed’s dual mandate for full employment and price stability. As a result, monetary policy makers will continue to face a difficult task in the years ahead...A sputtering financial system is not the only challenge before us. The chances are slim for a robust rebound in consumer spending, which represents around 70 percent of economic activity. Of course, consumers are getting a boost from the fiscal stimulus package. But this program is temporary.*

Where do we believe we go from here? As Yellen said, we are probably in for a long slog. The economy will reach (has reached?) what will technically be the recession’s end but unemployment will remain stubbornly high for some time. Analyst John Mauldin has estimated that in order to return to 5% unemployment by 2014 (from nearly 10% now), the U.S. will need to create 15 million jobs, or an average of 250,000 per month, over the next five years. Given that job losses persist and that not one year in the past decade has seen average monthly job creation at that rate, it seems to be a low probability outcome.

## The Capital Markets, Fairly Valued

The capital markets and the economy are related, but exhibit disparate behavior. Case in point: the U.S. economy has not been performing well since March, but that hasn’t stopped the stock market from rallying nearly 60% from the lows. The rally has not been limited to stocks. Indeed, risk aversion has meaningfully subsided across the capital markets; the least creditworthy stocks and bonds have led the charge higher. High yield bonds are up nearly 50% this year, more than double the S&P 500. These risky bonds now yield less than 8%, close to where very low risk (AA) bond yields peaked early this year. Triple-C bonds, which are “currently vulnerable and dependent on economic conditions to meet [their] commitments,” are up over 90% this year. It appears to us that

from current capital market valuations, further (durable) price appreciation will require fundamental economic improvement.

We never know where the markets will move next, but we can make reasonable estimates of their intrinsic value. According to our estimates, the S&P 500 trades at 16 times normal earnings and near the high end of its value range. Using cyclically adjusted earnings for the S&P 500, stocks trade at closer to 20 times earnings. (The price-earnings ratio for the market has averaged roughly 15 over very long periods.) Another measure of market valuation based on the replacement value of assets is at about 0.80, just slightly above the long-term average of roughly 0.75. One metric taken alone may not indicate much, but several arrows pointing in the same direction demand more attention. And on many different measures, the domestic stock market in aggregate is no longer cheap but fairly valued, in our opinion.

How are we investing in this environment where the future is so uncertain and market valuations appear full?

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We try to prepare for multiple eventualities with a keen eye on the risk and return profiles available in the capital markets. Ultimately, investors should be rewarded for providing capital to those who use it. But contrary to popular belief, risk and return do not always follow a linear relationship; that is, high risk does not necessarily equate to a high return. Today, the capital markets appear much riskier than just a few months ago (at lower prices) and implied long-term future capital market returns appear to be merely average from today's levels.

While we expect average long-term returns from the market in aggregate, our management approach has always involved individual security selection where we believe superior risk-adjusted returns are possible. The mutual fund managers we use and the equity accounts we manage are invested in carefully selected portfolios of stocks, bonds and/or cash. We, and the managers we utilize, focus on the risks inherent in the returns being sought and are willing to hold cash where adequate compensation for risk is lacking.

## Portfolio Repositioning

Amidst all of the uncertainty inherent in the economy and markets, we must appreciate that current conditions are nonetheless quite favorable. The S&P 500 has risen for seven straight months and volatility is back at low levels not seen for over a year. Fairly valued capital markets (in aggregate) indicate buyers and sellers are transacting at prices that more adequately reflect the value of assets. The benign conditions of the past couple months have been ideal for repositioning portfolios and in early August we implemented several

changes to our client accounts. We restructured asset allocations and the funds we use cognizant that the market cannot continue climbing indefinitely without some short-term setbacks. Our overriding goal is to reduce downside risk while maintaining exposure to the potential upside.

We've sought to allocate to funds whose managers exhibit broader flexibility in managing their portfolios. For example, the fund we use that primarily owns large cap stocks tends to hold excess cash in the portfolio when its manager isn't finding securities trading at proper valuations. We have also allocated more to funds whose managers invest in multiple assets, such as stocks, convertible securities and bonds. With stocks and bonds discounting similar long-term returns from here, the manager of a multi-asset fund can allocate capital to the areas generating the most attractive risk-adjusted returns unconstrained by asset class. Some of the funds we've added also utilize hedging techniques for downside protection.

## Snapshot: The Crash of 1929

After falling 48% in the crash of 1929, the stock market experienced several intervening rallies before ultimately finding its bottom in 1932. The Dow Jones Industrial Average rose 48% from November 1929 through April 1930 before falling another 47% over the next eight months. It then rallied 23% from December 1930 through February 1931, fell 56% through October, rose 3% over the next five months, then fell another 54% from March through July of 1932, when it reached its final nadir 89% below its high. Too, the real economy temporarily strengthened (from December of 1930 through the middle of 1931) before declining even deeper afterwards and not bottoming until 1933. While the structure of the markets and economy were very different than today during this period, this illustrates how short-term market rallies (and economic improvement) can occur within the context of secular declines.

Implementing these changes in March during the market lows would have been less prudent because at those levels the market was roughly one-third undervalued by our estimation. Since late July, the S&P 500 Index has traded right around our calculation of fair value and we believe these adjustments move client portfolios to a more flexible and risk-aware stance at a time when the marginal investor is moving further out on the risk spectrum. In our view, the opportunity cost of holding cash and bonds (versus stocks) is much lower than it was just a few months ago. And given the continuing economic issues – unemployment, capacity underutilization, falling tax revenues, deleveraging and rising savings rates, lower growth and higher capital costs going forward – some skepticism in the form of limited hedging appears reasonable.

## Tax Losses as an Asset

During the quarter, as mentioned above, we executed a substantial repositioning of client portfolios. We posted comments regarding these changes on the website in early August

to inform clients of the large amounts of trades they might see in their accounts as a result of these actions. We executed trades in accounts regardless of tax status and many of the sales occurred below the securities' cost basis, resulting in capital losses for tax purposes. Concurrently, we want to highlight how we view realizing tax losses as part of a portfolio rebalancing.

When we rebalance portfolios our goal is to reduce risk while enhancing potential returns. Therefore, rebalancing means selling assets with a less favorable risk-return profile on a look-forward basis while purchasing assets we view as superior on this measure. We expect these shifts to be advantageous regardless of whether or not taxes apply. In all accounts, independent of tax status, the added value is the potentially superior risk-adjusted returns based on the relative performance of the purchased and sold investments. Rebalancing with losses in taxable accounts, however, provides an added bonus to future after-tax returns.

As most clients are aware, losses can be used to offset gains for tax purposes. Excess losses, or those not offset by gains in the current year, can be carried forward and used in the future. In this way, they are assets because they shield a certain amount of taxes in the years they are used to offset gains.

And their value rises with the tax rate. With capital gains tax rates likely rising in 2011, these losses will become even

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more valuable. For example, \$20,000 of excess capital losses when capital gains rates are at 15% is worth \$3,000 in taxes shielded. If (when) rates go to 20%, this tax shield becomes worth \$4,000. Note that one pays nothing for this asset – it comes as a result of a portfolio rebalancing – but that by taking losses today to shield gains tomorrow this asset actually can appreciate when tax rates rise. In this way, tax loss assets enhance future after-tax returns should the new investments supply future gains, the taxes on which can be offset with past losses.†

## Reflecting on Personal Risk Tolerance

We invest each client portfolio according to its investment objective, with risk tolerance as the chief consideration. Only clients can determine their overall tolerance for risk; therefore, when we invest accounts we are working within the parameters set by our clients. With markets trading at reasonable valuations after a powerful rally, now is an ideal time for clients to reflect on their own tolerance for risk. In the face of severe market declines a few months ago, we advised clients not to panic and to think long-term, especially with the portion of their portfolio invested in stocks. Clients who were fearful but resisted going into panic mode should give themselves a pat on the back because they didn't let fear influence rational decision-making. As a result, they can now make more rational decisions from a much higher market level.

In reflecting on their own risk tolerance, clients can ask themselves some basic questions. Before this recent rally, did you think you might have been taking too much risk? Did the volatility and paper losses cause you sleepless nights? Did you think it might have been nice to hold a little more cash should the short-term need arise? Needless to say, the past year has provided investors with a real world test of their perceived risk tolerance. Some clients handled their portfolio declines as they expected, which is excellent because it likely means they're comfortable with the level of volatility risk they're taking. But for clients who, in the darker days of February and early March wished

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they had been more conservative but (wisely) resisted the urge to “go to cash,” now may be a good time to discuss these concerns with us. We prefer any risk-level adjustments to be made proactively in a calm environment, rather than as a reaction to the often manic depressive behavior of Mr. Market.

†Calculated by Clarity Asset Management, Inc.

*The S&P 500 Index and Russell 3000 Index are market-value-weighted indices and the Dow Jones Industrial Average is a price-weighted average; each consists of stocks chosen for market size, liquidity, and industry group representation. Numbers do not reflect fees, brokerage commissions or other expenses of investing. International stock data reflects the net total returns of the MSCI EAFE Index. Global real estate reflects the performance of the FTSE EPRA/NAREIT Global Real Estate Index. Commodity information sourced from the Wall Street Journal. High yield and municipal bond information sourced from Morningstar. Other bond market information sourced from Barclays Capital. Snapshot: Crash of 1929 data derived from the book Anatomy of the Bear by Russell Napier.*

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