

Quarterly Market Review

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Perspective

The fourth quarter started the same way that the third quarter ended, with significant losses across the board. However, the equity and fixed income markets began to stabilize somewhat in November, and even managed to post slight gains in December. In a year of turmoil there were few if any winners, indeed only one diversified stock fund posted a gain for the year according to Morningstar, and that a scant 40 basis points. It is easy to talk about the credit crisis, the high correlation of returns across all asset classes between August and November and “once in a lifetime” or “three standard deviation events” to explain the year’s performance. Perhaps a more practical exercise is to look at the best and worst performing investment managers and see what can be learned going forward.

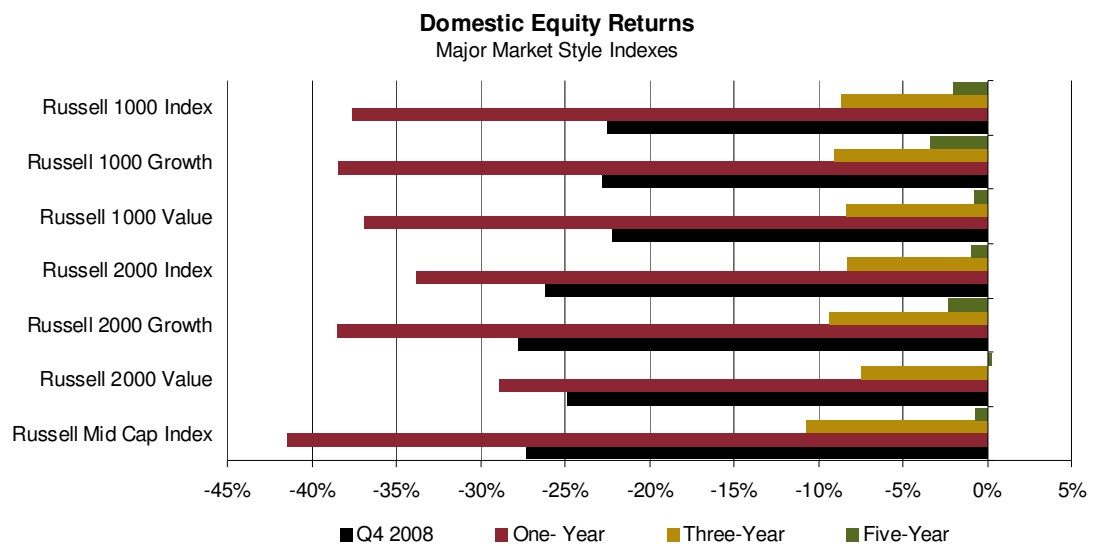
Surely one consequence of 2008 will be to stir the debate of active vs. passive investment management. One of the core arguments for active management is the ability to manage risk and avoid the catastrophic losses. Clearly this didn’t happen this year. Another facet of this debate is likely to be a much closer look at the conventional wisdom that active managers should remain fully invested (minus frictional cash reserves for operational issues). With all but the Treasury markets struggling for most of the year, not being fully invested was one of the best “active” decisions available to active managers. Yet very few managers took advantage of this tool. Advisors and investment committees are generally loathe having cash build up with individual managers, as it upsets their asset allocation goals for the total portfolio. However, those same consultants and committees almost never make the tactical decision to go to cash. Also, investors typically are reluctant to pay full management fees when a significant portion of the portfolio is merely sitting in cash. This attitude is clearly expressed to the individual portfolio managers and carried out to a large degree. Asset allocation has been proven through numerous studies to be the most influential decision in regards to performance outcomes, and advisors and investment committees spend a great deal of time setting their allocations to meet specific needs and risk tolerances. However, if these groups choose to use active management to execute the asset allocation, why take a simple but powerful tool out of the hands of the portfolio managers? There is not a simple answer to this question, and likely no one “best” answer in any case.

Domestic Equity Markets Overview

“No where to hide” was the common refrain during the last three months of the year. Indeed, the domestic indexes were down 20-27% with very little difference between the value and growth style indexes, though both small and mid cap stocks underperformed the large cap index by seven percent. Likewise, from a sector standpoint, not one sector in either the Russell 1000 or Russell 2000 had a positive return for either the final quarter of the year or for the year as a whole. Healthcare and Consumer Staples outperformed on a relative basis among the large cap stocks, though double digit losses in these “defensive” sectors was small comfort.

Whether looking at the small cap or the large cap indexes, market capitalization was a key factor. In both cases the larger, and usually more liquid names, performed better than their smaller counterparts. This was part of the broader flight to quality during a time when risk was dramatically re-priced. As part of the broader flight to quality, equity securities ranked “C” by S&P, the bottom category, suffered much higher losses than those ranked “A”, regardless of market cap.

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International Markets Summary

The only relative "strength" overseas was in the Far East, which was down roughly 20% in local terms, but the weakening dollar kept the U.S. investors losses to 10%.

The international markets were down sharply in the final quarter as well, compounding their third quarter 20% losses with 20-25% losses in the fourth quarter, depending on the region. The only relative "strength" overseas was in the Far East, which was down roughly 20% in local terms, but the weakening dollar kept the U.S. investors losses to 10%. Japan, as the dominant country in that region, led the way, down just 9.0% for the quarter. The European suffered the worst losses during the quarter including Austria (-43.2%), Greece (-41.0%) and Norway (-40.6%). There may be some light at the end of the tunnel however, as most of the market enjoyed a sharp rally in the final month of the quarter, only the U.K. and Ireland had negative dollar based returns. Spain was up 13% in the final month alone. This sharp rally has continued through the first week of the new year.

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If the reversals in the second half of the year for the domestic and international developed markets were sharp, then they were catastrophic in the emerging markets. As part of the global flight to quality, the emerging markets were punished during the final half of the year. In Latin America, Argentina was up 44% at mid year, but was down more than 40% in the final quarter to finish the year down more than 54%. The BRIC group of countries, the focus of growth last year in the emerging markets, were all down more than 50% for the year, with Russia down more than 70%. Though not quite as universal as in the developed markets, the emerging markets did enjoy a significant rally in the final month of the year.

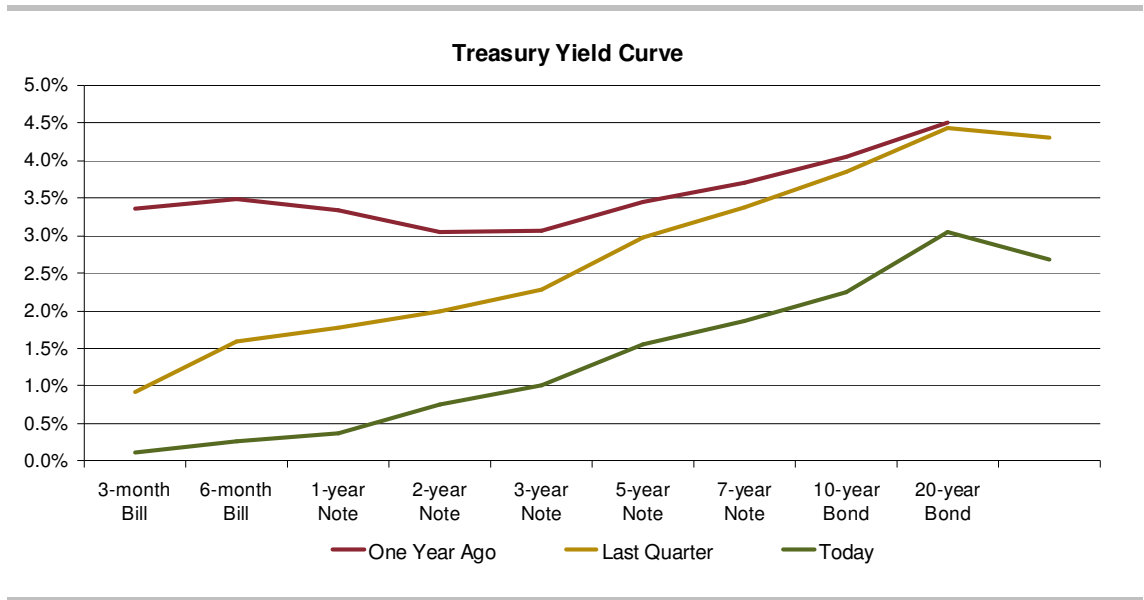
Fixed Income Summary

It is not surprising then that Treasuries dominated the return of the Aggregate Index, up 8.75% and the long Treasury (20+ years) up 27.29%.

The domestic fixed income markets rebounded sharply in the fourth quarter, with the Barclay's Aggregate Index up 4.6%, accounting for all but 70 basis points of the total return for the year. This was jumpstarted by a sharp cut in the Fed Funds rate in October, followed by another in December. The Treasury yield curve responded falling 80-160 basis points from the short to the long end of the curve. It is not surprising then that Treasuries dominated the return of the Aggregate Index, gaining 8.8% with the long Treasury index (20+ years) up 27.3%. Corporate bonds were up 4.0% and the MBS Index was up 4.3% for the quarter. Of the investment grade sectors, only BBB-rated corporate bonds had a negative return for the quarter. These gains did not extend to the non-investment grade sectors however, as the U.S. High Yield Index was down 17.9% during the quarter, and down 26.2% for the year.

The municipal market remained mixed during the final quarter, with reasonable returns in the short and intermediate maturities, but mounting losses in the longer maturities. For the final quarter, the Barclay's Municipal Index, covering all maturities was up 0.7%, but posted a loss of 2.5% for the year. The most

popular part of the curve for the average investor, as represented by the 1-10 Year Index, was up 3.0% for the quarter and 4.2% for the year. In addition to maturity, investors paid a great deal of attention to credit quality as the top tiers (AAA and AA) sharply outperformed the lower tiers.



Outlook

We will only be able to look back several years from now to see if the fourth quarter of 2008 represented the bottom of this bear market, or simply a pause in the decline. But for those investors with suitable long-term horizons, the current market uncertainty also presents many opportunities.

After the losses of the third and first part of the fourth quarter, it is understandable to see bleak forecasts for 2009. And fundamentally there are many reasons to see these forecasts as accurate, with escalating unemployment, weak or negative GDP growth, economy wide aversion to risk and a spiraling government budget deficit that is likely to grow over the next several years, with negative consequences for both the strength of the dollar and inflation. However, just as a strong April and May disguised the very weak returns of June, the stomach churning drop in October masks a broader rally in December that continues through the first week of the new year. We will only be able to look back several years from now to see if the fourth quarter of 2008 represented the bottom of this bear market, or simply a pause in the decline. But for those investors with suitable long-term horizons, the current market uncertainty also presents many opportunities.