Argent Wealth Management

QUARTERLY
Investment Outlook

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Second Quarter 2009 Investment Outlook

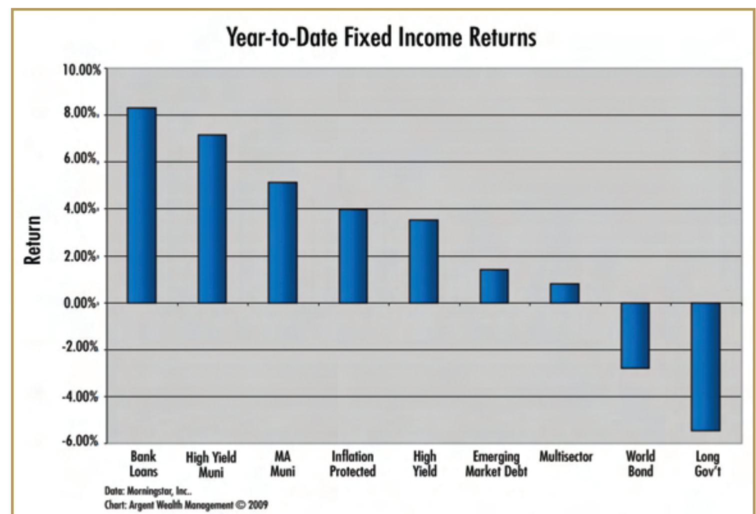
First Quarter 2009 Review: And This Feels Better?

On the surface, the first quarter of 2009 felt like an extension of last year's brutal bear market. Global equity markets continued to fall, a descent only modestly mitigated by a sharp rally in March. Conditions and future prospects for the economy remained bleak. U.S. unemployment rose to a 26-year high while corporate profits continued to plunge.

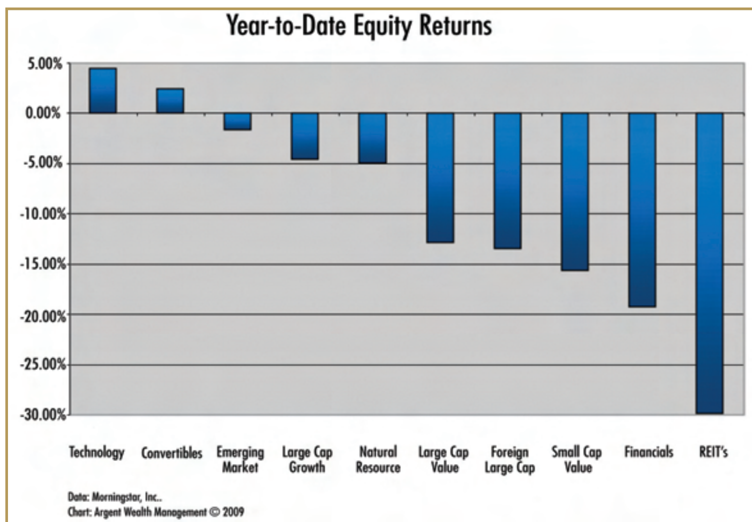
Yet beneath the surface, the behavior of financial markets in the first quarter differed markedly from the synchronized meltdown of second half 2008. All asset classes did not move in brutal downward lockstep. In fact, despite another generally dismal quarter for equity markets, many parts of the fixed-income markets posted respectable gains. Gratifyingly, several of those that did so were market segments we favored.

What has changed? Crucially, markets are starting to discriminate among assets on the basis of relative value. No longer are prices of most assets relentlessly sinking with no regard to fundamental value, amid forced sales by stressed investors. While liquidations by highly leveraged investors such as hedge funds and commercial banks certainly did not cease in the quarter, they abated considerably.

Leading the pack over the quarter were senior secured loans, municipal bonds, and high-yield corporate debt. In our previous *Outlook*, we noted that these areas had become extraordinarily attractive as a consequence of the severe de-leveraging of the financial system in the wake of the Lehman Brothers bankruptcy filing. We believe they still represent excellent value, even after their recent gains.



The only major segment of the U.S. fixed-income markets to record losses were Treasuries. Yields of the highest-grade securities began the quarter at incredibly low levels as investors flooded into areas of perceived safety. As the rush subsided, yields on these instruments began to normalize to higher levels. They would likely have risen much more sharply (and their prices fallen more steeply) had the Fed not decided to become an aggressive buyer of Treasuries. But while the Fed may have succeeded in capping Treasury yields during the quarter, they can't manipulate the market forever. A massive and exploding deficit must be financed. It's hard to imagine that financing on such a gigantic scale can be accomplished without an eventual rise in government bond yields.



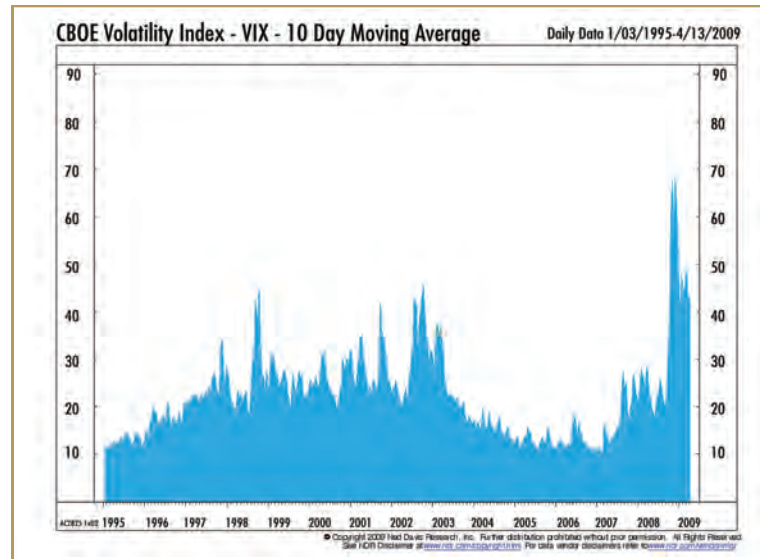
While equity returns were generally negative for the quarter, the dispersion of returns across market segments was unusually wide. Top-performing areas included technology, convertibles, emerging markets, and natural resources. All these segments benefited from attractive relative valuation and renewed risk appetites by investors.

The worst-performing equity sectors were the overlapping categories of financials and value-oriented stocks, both in the United States and abroad. The common theme was the continued meltdown of financial shares as loan losses kept mounting and governments debated nationalizing the most distressed institutions. On average, financial stocks plunged a whopping 20% for the quarter, so it took little active exposure to this sector to put a serious dent in performance.

New Realities for Investing

Unquestionably, today's investment environment is the most challenging that most of us have ever confronted. Money-market yields are approaching zero, making it impossible to get real capital appreciation without taking risk. Yields on Treasury bonds are also unappealingly low. Equity markets seem cheap by some metrics, but not by others, and are fraught with volatility and uncertainty about future corporate profits. In fixed income, corporate bonds and senior secured loans sport exceptionally attractive valuations, but are dogged by rising defaults. Even the seemingly sacrosanct municipal-bond market faces challenges as the finances of many state and local governments deteriorate.

Perhaps the most troubling aspect of the new reality is greatly heightened volatility. As shown below in a chart of the VIX index, an excellent barometer of investor anxiety and market unsteadiness, the days of comfortably stable markets are long gone. We firmly believe that high volatility will linger for quite some time.



A key contributor to heightened volatility is uncertainty about the future path of global economic growth. Economies around the world are enmeshed in a giant tug-of-war between massive deleveraging of the financial system on one side, and powerful policy stimulus aimed at restoring economic health on the other. How this battle is resolved is far from certain.

If the unprecedented and coordinated stimulus measures taken by central governments succeed in fostering economic recovery, then re-inflation leading to significant inflation is likely to result. If these actions fail, then a more severe recession, even depression, is possible, accompanied by deflation. Unfortunately, the path leading to strong and stable growth and low inflation (a 1990s replay) is the least likely of all economic scenarios.

This "bimodality" of economic and market outcomes requires a different approach to investing. If an economic recovery unfolds with high inflation, then hard assets such as commodities will emerge as market leaders. Both equities and investment-grade bonds could fare poorly in this scenario. If, on the other hand, a deep economic contraction and deflation materialize, an entirely different set of assets

will lead markets. The highest-grade bonds, such as U.S. Treasuries and top-rated municipals, would likely garner attractive returns even as inflation-friendly assets such as commodities suffer.

This outlook means a revised set of rules for successful investing.

A Broader Range of Assets

The first and most important of the new rules is to be invested in a greater variety of financial assets than the traditional categories of equities, bonds and cash. In either inflationary or deflationary environments, asset classes outside these groups are the likeliest to outperform.

The more probable path is one of economic recovery coupled with inflation. This outcome could mean prolonged and substantial weakness in the U.S. dollar. Among countries, policymakers in the United States have been relatively aggressive and proactive in stimulating the domestic economy, both fiscally (the U.S. government budget deficit will be much larger as a percent of GDP than in many other countries) and in monetary terms (the Fed is printing lots of new dollars to purchase Treasury securities). These measures may wind up cheapening the U.S. currency as inflation resurges.

For dollar-based investors, high inflation coupled with dollar weakness would boost commodities such as oil, gas, and metals which typically do well in inflationary times; non-U.S. assets and currencies also would fare well as the dollar weakens. Two other likely winners: emerging markets, with doubly favorable exposures to commodities (in the case of many countries) and non-U.S. currencies, and smaller-capitalization equities positioned to prosper on global expansion.

The deflationary scenario would produce an entirely different set of winners. U.S. Treasuries and the highest-grade municipal bonds would likely post excellent returns, particularly on an inflation-adjusted basis. Debt of any kind would be deadly; economic contraction would make it more difficult to generate operating cash flow to service debt, as the real costs of debt payments would rise.

Any advisor who claims to know with certainty which of these two outcomes will emerge is naive at best and fraudulent at worst. With a multitude of governmental actions and market responses unfolding simultaneously across the globe, there are simply too many moving parts to forecast the future with any degree of certainty.

Given this uncertainty, portfolios must be recast to include a broader range of assets than the traditional equities, bonds and cash. Some of these non-traditional assets, such as commodities and foreign currencies, can be viewed as "insurance policies" protecting a portfolio from extreme outcomes, even those that seem unlikely. Weightings within this broadened set of assets can be recalibrated as a higher degree of certainty is established.

Opportunistic Investing

A second new rule is that investors will need to become much more opportunistic. Higher volatility and greater uncertainty about the economic outlook will result in greater financial-market dislocations—for example, a security or sector becoming exceptionally cheap or expensive. Investors who respond nimbly to these opportunities will be handsomely rewarded.

In turbulent times, the relative attractiveness of different asset classes can shift quickly. An asset class that seems exceptionally attractive may come a cropper mere weeks or months later. Investors will need to adjust more quickly than in the past to be successful.

To be clear, we are not advocating market timing—a wholesale movement from long-term assets such as equities to cash and then back in anticipation of broad market movements. We continue to believe that this approach will prove frustrating. Rather, we advocate adjusting a portfolio's mix of assets more rapidly and opportunistically than in the past.

Manager Selection

In the new higher-volatility environment, skilled active managers are more valuable than ever. Greater market instability, and the commensurately greater dispersion of returns among asset classes, sectors, and securities, amplifies the impact of both good and poor investment decisions. Managers with demonstrated skill and high conviction will be able to add much more value than in steadier markets.

That is why we now favor managers with flexible investment mandates across capitalization, style, region, and sector. Such flexibility will be more valuable than in steadier, gradually rising markets. As individual stocks and bonds fluctuate more wildly, managers with the acumen to identify opportunity will meet with greater success. The opposite approach is to use managers with narrowly defined investment mandates such as U.S. large-capitalization core equities. Managers who constrain their investment universe to a small list of securities will miss much more attractively priced securities that fall just outside their parameters.

Insurance Protection

An unfortunate reality of the approach outlined in this report is that no portfolio, no matter how rationally and skillfully constructed, can do well at all times across all its components. Inevitably, some allocations may at best disappoint, and at worst incur sharp losses.

In a high-inflation environment, commodities and other risk assets will be rewarding, while the high-grade bond "deflation insurance" will be costly. In deflationary conditions, the very same high-grade bonds will save the portfolio from disaster, and commodities and "risk assets" such as emerging market and small-capitalization equities will disappoint.

The key to success with this approach is to understand that the portfolio must be viewed as a whole. If the portfolio's winners produce richer payoffs and are more heavily weighted than losers, then the portfolio will have been successful in aggregate. It is tempting to anguish over losing positions and to consider purging them from the portfolio. However, such thinking defeats the whole purpose of having insurance policies that help protect a portfolio from substantial overall losses.

The opposite approach is an "all-or-none" portfolio. While such a portfolio (all cash, all equities, etc.) may produce spectacular returns if correct, it will result in disaster if incorrect. That is the antithesis of what we seek to achieve for our clients: to build wealth prudently over long periods of time while limiting downside risk.

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