



**Light in the Gloom**  
*Keeping eyes open for encouraging signs*

By some measures the US stock market is discounting the end of the world. These are grey, gloomy days for investors, businesses and families, painted greyer still by 24/7 coverage of plunging markets, layoffs and disjointed responses from Washington. It's no wonder that most investors are looking for the exits or suffering in virtual paralysis.

Yes, these are grey days. But let's remember that it takes both black and white to make grey. There are important lights of hope burning now, easy to ignore amid this raging storm of pessimism.

**What's going right**

Sometimes good news really is good news, despite the endless drumbeat of economic decline and market collapse. Consider the short list of indicators below, which are positive today, and in another era would be considered resolutely positive:

- US Treasury bonds continue to perform well, reinforcing their reputation as the investment of choice in times of crisis.
- The municipal bond market is rallying, and righting its upside down yield situation from last year.
- Gold is up for the year – its purchase price is still 50% below its inflation adjusted high.
- The dollar is up – a strong currency is good for the US.
- Oil is cheap, and so is the price of money (interest rates), putting more dollars in the hands of savers, consumers and investors.
- Stocks become cheaper as prices go down; every price decline makes future purchases more appealing.
- The savings rate is rising for the first time in a decade, bolstering personal balance sheets.
- The home affordability index is surging, which bodes well for the next generation of first time homebuyers.
- \$4 trillion is sitting in money markets – almost half the value of all US stocks.
- There are currently \$13 trillion of US Treasury/Fed/FDIC initiatives in place to stabilize the markets and the economy (some would put this in the bad column, but consider the alternative right now).



### **What's going better**

For the statistically inclined, there's more good news:

- The TED spread has improved from crisis levels, indicating that the bank fix plan is partially working.
- LIBOR – same as above.
- CDS – credit default swaps have receded from highs, indicating the overall risks of bankruptcy are falling.
- Deflation – TIPS spreads have moved 125 basis points, returning from deflation to inflation. A little inflation is a good thing.
- US companies have borrowed \$360 billion since the start of the year. They can borrow, and they have – capitalism is alive!

We share these bright spots not to predict a bottom, nor as a signal to buy. Trying to predict future market direction is, in our view, pointless folly. Instead, we share these bright spots as a reminder that there are always positive and negative indicators. There were negative indicators three years ago – largely ignored – when the market only knew how to go up. And there are positive indicators today – largely ignored – amid the daily fare of market despair.

We share these bright spots mainly for moral support, hoping that a perspective that balances good and bad will help investors avoid decisions driven by fears – whether their own or those of doomsday friends, relatives or media commentators.

### **Time to face forward**

In last month's article on efficient markets, we discussed that investors cannot systematically improve their returns by acting on any available information – not earnings reports, not recent trends in stock prices, not interest rates, not bailout plans, not pundit opinions. The efficient market hypothesis tells us that all known information is incorporated into stock prices too quickly to act on it.

If you believe this theory like we do, then you believe that everything that has happened up to this very minute is already reflected in security prices. That makes this square one. Looking back serves no purpose. The question is not whether owning GE, AIG or the S&P over the last year was a good idea or not. Those ships have sailed.

### **The New Reality Portfolio**

The question is what kind of portfolio we should hold that will protect us from the worst and include us when the market finds its way forward again. In our view, the answer is far simpler than the squabbling talking heads would lead one to believe:

- **Avoid individual stocks.** We've learned in recent months that disaster can strike any company, large or small, domestic or international, in any industry. Putting more than a few eggs in any single basket accentuates the risk of breakage. Use tax-efficient exchange traded funds (ETFs) instead



- **Own every winner.** We are confident that markets will rise in coming years. But we have no idea when, nor which industries or geographies will lead the way. Knowing which companies within each sector will be the biggest winners is even more of a guess. Owning every sector and company prevents failure by omission.
- **Make your enemies your allies.** Within your diversified portfolio, invest in inflation, in a weaker dollar, in devastated share prices, even higher taxes (muni bonds) at levels you can tolerate.
- **Stay balanced.** As sectors move in different directions, and at different rates, be sure to adjust weightings periodically so that your portfolio stays tuned to the channel you think you're watching.
- **Waste not.** Avoid needless drains on your returns – high management expenses and unnecessary tax exposure. Own low cost ETFs structured to minimize capital gains distributions. And own for the long term, not until you change your mind.
- **Sleep at night.** Ultimately, a portfolio that keeps you pacing the halls is the wrong one, no matter how well constructed it may be. If you are not comfortable, it's time to rethink your asset allocation, holdings, advisor, or all three.

In our eyes, these guidelines suggest a carefully diversified portfolio of index-based ETFs. We believe these rules are the best way forward given the market's current shade of grey. We will hold to these same rules if the gloom lifts next week or grows darker still, if the market doubles in the next year, or falls by half.

An index portfolio, seeking to achieve the total market return, removes the need for most of the questions that haunt investors, and can lead them to actions they regret. Is it time to sell? Have we hit a bottom? Is this company going to survive? Would I be better off in cyclicals, staples, or industrials?

#### **What optimism means now**

The market is often described as an interaction of pessimists wanting to sell as high as possible, and optimists hoping to buy as low as possible. We consider that to be a model precariously balanced on a pin, where investors must continually decide which side they are on. Any change in the economy or political dialogue can trigger a stressful rethinking of one's portfolio. We think life's too short for that, and the commissions too high.

We are realists about the markets and optimists about investing. While realistic enough to say we have no idea where the market will go month-to-month, we are optimistic that the diversified, index-based portfolios we create will earn the full



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range of global market returns and, over time, produce desirable outcomes for our clients. (And for ourselves – my personal and family assets are invested in exactly the same manner.)

### **No more paralysis**

I speak to successful business owners every day, people who have made their fortunes by making complex decisions in difficult situations with insufficient information. Many are feeling stuck right now, holding investments they don't believe in, just waiting for the grey to lighten up. Just waiting. I suggest there is an alternative to waiting. I believe this is an ideal time to take a close look at one's portfolio and see if it is built to withstand today's perils and to flourish when the markets turn around.

Today is square one. Let's make the most of it.

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