

INVESTMENT REVIEW AND OUTLOOK

REVIEW

2009: Near Death Experience – Miraculous Recovery

Financial market participants experienced two extremes in 2009. As the year began, the entire global financial system appeared to be on the verge of collapse. After a disastrous finish to 2008, stocks plunged still further in January and February. Panic was widespread, infecting institutional and individual investors as well as business leaders. However, thanks to massive governmental stimulus and nascent indications of economic stabilization, global stocks staged a remarkably sudden reversal beginning in March. Since that time, risk assets of all types have been on the march, rising almost without interruption through year end. At the same time, measures of perceived risk, such as credit spreads, investor sentiment and equity market volatility, have all moved steadily lower. As a result, asset class and sector performance in 2009 contrasted sharply with that of 2008. Treasury bonds went from the top of the heap in 2008 to the bottom in 2009, while junk bonds, emerging market equities, commodities and small/mid cap stocks went from the bottom to the top quartile. It was a wild ride, and when all was said and done the S&P 500 had rallied more than 60% from its low on March 9, and finished with an impressive 26% gain for the full year.

Avoiding the Big Drawdowns – Seeking Stable Returns

In investing, how you got there is almost as important as where you end up. Return figures are sometimes bandied about without any regard for the risks taken to achieve them. One way of lowering risk is to lower the volatility of returns. This is important, not just because it leads to a more efficient compounding of capital, but also because it greatly reduces the risk of emotional decision-making. In last quarter's letter we made the point that very little can be learned about an investor or a portfolio by looking at one year's results in isolation – *that performance is a continuum.* This was never truer than in 2009, coming as it did on the heels of one of the worst years in stock market history, and encompassing both bear and bull market extremes. 2009 was clearly an outlier. To get a more complete picture, one needs to look at results over a market cycle, or ideally, over *multiple* market cycles. Our goal has always been to produce not just strong end point returns, *but also a less volatile pattern of returns.* For example, through conservative stock selection and timely asset allocation shifts, Moody, Lynn & Co. portfolios avoided the catastrophic losses suffered by many in 2008. The trade off was not entirely unexpected – our portfolios lagged the averages in the first phase of the rally off the bottom. This underperformance also occurred as we emerged from the bear markets of 2000-03, 1998 and 1994. *It is encouraging that our high quality equity holdings began to outperform last quarter, after underperforming in the initial post crash rally. That strength has continued into the new year.*

OUTLOOK

Seeking the Right Asset Mix for a Wounded Generation of Investors

In our last letter, we stated that, “as night follows day, recovery follows recession.” And despite continued skepticism, the evidence of economic improvement continues to grow. The issue for investors is *how much of the recovery is already priced into equities?* We think the answer is *a lot. With the liquidity-driven phase of the rally behind us, attention will turn to the sustainability of the recovery and the ability of corporations to show further earnings progress as well as revenue growth.* The situation is still tenuous, but we think that revenues and earnings will be strong enough to avoid a major setback for the market in 2010, although a meaningful correction (+/-10%) is probably overdue. Catalysts for such a correction might be the first hints by Fed officials about a change in interest rate policy or perhaps some news that puts a dent, at least temporarily, in the China growth story. Meanwhile, there is a good deal of talk about a “double dip” recession. While this scenario cannot be dismissed lightly, we think the odds are against it. Double dip recessions are extremely rare and the Federal Reserve and the President’s economic team are keenly aware of this risk. There is a lot of stimulus money still in the pipeline and more could be on the way at the first sign of weakness. *The authorities will do everything in their power, particularly in an election year, to avoid a slide back into recession in 2010.* Of course there are other factors beyond GDP growth that will have a bearing on the direction of equity markets in 2010, notably interest rates and inflation. As we mentioned, the precipitating factor behind a market pullback could be a move up in interest rates. However, with unemployment likely to remain stubbornly high and with so much excess capacity around the globe, it is hard to see much more than a token tightening, if that, before the end of the year. Of course, inflation represents an ever present danger to investors and there is concern that today’s hyper stimulative policies are sowing the seeds of tomorrow’s inflation. We are alert to this risk, but do not think it is a concern in the short to intermediate term. The deflationary headwinds of high unemployment, slack capacity and deleveraging are simply too strong.

The question for investors is- do you get up on the dance floor like everyone else and pretend the crash was a bad dream? Or, do you pay attention to the unresolved problems, do a little dancing, but be ready to grab a chair when the music stops?

from The Boeckh Investment Letter

This question is very much on our minds as we try to fashion an asset allocation that capitalizes on the opportunities of a recovering global economy while protecting against the very serious unresolved problems facing the United States and much of the developed world – *the problem of too much debt being chief among them.* For conservative individual investors with finite investment time horizons, the question is all the more daunting. Asset values have quickly reflat, and unprecedented monetary and fiscal policies are distorting many traditional risk/reward and asset class relationships. If 2008 proved anything, it was that the modern concept of diversification (the accumulation of as many asset classes as possible) offered no protection against a global bear market. Meanwhile, “risk free” assets, whether sovereign or municipal, offer little or no return

while bearing meaningfully higher risks than in the past. ***When there is no safety in diversification and no return in safety, what is the prudent investor to do?*** There are no easy answers, but what follows is our current best thinking on an investment strategy for 2010. Many of the components are a repeat from last quarter's letter.

- Maintain a margin of safety appropriate to these more uncertain times. Despite the historically low yields available on cash and short term instruments, they represent a necessary liquidity cushion and/or opportunity fund for portfolios of all types. ***Nearly all good investment decisions involve some degree of discomfort, and the discomfort of holding cash today may be an indication of its merits.***
- Emphasize sustainable income in portfolios, particularly from high quality dividend paying stocks. ***If, as we believe, returns will be more muted in 2010 and beyond, the return provided by dividends will be all the more important.***
- Keep the focus on the large cap, high quality equity segment. It is one of the few statistically cheap asset classes in the world today. Within that sub segment, maintain a tactical tilt toward U.S. equities. The demographic and sovereign credit problems of Japan and parts of Europe are serious. ***The U.S., with its better demographic profile and more flexible economy may see a more vigorous rebound in 2010 than its European or Japanese counterparts.***
- Add to emerging market and commodity exposure on pullbacks. After a supercharged performance in 2009, these areas may be vulnerable to a correction, particularly if the U.S. dollar continues to stabilize and/or appreciate. Many emerging market economies and stock markets were the first out of the chute when financial markets recovered. Accordingly, they could be the first to enter a more negative interest rate tightening cycle. ***The disaster of 2008 proved that commodities and emerging markets are more a high beta play on the global economy than a diversification tool.***
- Our outlook on bonds is generally cautious. Even though the risk of a significant change in Fed policy in 2010 is low, rates could still drift higher from today's "emergency" levels, creating a headwind for Treasuries and other high grade bonds. The easy money, spread narrowing phase of the bond market recovery is already behind us.
- We continue to believe that a position in gold is warranted. Just as our cash and short term bonds are a hedge against the risks of deflation; our gold holdings represent a hedge against the risks of inflation, currency debasement and/or further sovereign debt problems.

As always, we welcome your comments and questions. We appreciate the confidence and loyalty that our clients have shown over the years. Despite the unprecedented financial events of 2008-2009, Moody, Lynn & Co. ended the year with assets under management of \$870 million, just 13% below the peak reached in 2007.