

# Advocate Asset Management, LLC

**MARKET COMMENTARY**

**FOURTH QUARTER 2008**

These past few quarters were times of deep distress and confusion for all investors. A faint recognition is beginning to emerge that we are passing through a major inflection point that heralds a change in world conditions as we know them to be. Our belief is that while we are not going back to a stone-age economy or primitive barter practices, the creature comforts that we took once as privilege and then became 'needs' will likely be severely curtailed, and in some cases, abandoned along the way. Most Americans (indeed most Westerners) are in for an extended period of severe belt tightening.

This transformation is going to cause pain and misery on a national mind-set that believes that what 'was' should continue 'to be.' In our opinion, what worked before is over for most of the developed world. Exorbitant societal spending (including government expenditures trimmed back after this crisis has abated) and imprudent systemic financial leverage will be severely punished.

What we are now experiencing is a tug of war between the deteriorating global economy and the massive (and still expanding) global policy response. Many believe that the policy response team will eventually prevail over the lousy economic picture. The key here is not the 'if' but the 'when.' Even with a new President who promises change, the recession is highly likely to be a protracted one.

In this environment, we are maintaining our view that we have held for several years now. We feel that capital preservation is far more important than positioning portfolios to benefit from a hoped for sudden reversal of the current situation.

## **Outlook**

We see the biggest economic risk now as deflation. The last time this happened was soon after World War II and prior to that, the Great Depression years. That is why the Federal Reserve Board is working double time to try to inflate the economy to keep prices and demand from collapsing. Central banks across the world have lowered interest rates to record low levels. In an amazing statistic, the Bank of England lowered rates to a record low not seen since the founding of the Bank in 1694. A 300-year low!

The act of lowering interest rates will not be enough to prompt consumers to spend. Sure, creditworthy consumers might refinance their homes if mortgage rates decline enough. This will be substitution lending, the replacement of a higher-cost mortgage with a lower-cost mortgage. But this will not stimulate net lending. In fact, despite government efforts to increase lending, households have reduced their borrowing and (despite government intentions) banks have reduced consumer access to lending. Moreover, consumers have seen their wealth decline from losses in the value of their houses, their retirement accounts and their investment portfolios. This is not the type of environment that will stimulate additional

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Contents

### **Outlook**

*Our economic outlook*

### **Client Portfolios**

*Details of client portfolios*

### **Market Highlights**

*Brief overview of broad market performance*

### **Addendums**

*Trade Policy and Government versus Regulator*

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consumer spending regardless of the types of stimulus initiated by the government. This is still a crisis of confidence, the same crisis that we have written about since late 2007.

Governments perceive their mandate is to do something rather than to let the free markets sort things out. For virtually every government-perceived problem, there is a government program. However, in our experience, government programs, particularly those built in haste, tend to generate one more inefficient organization replacing another, with an expansive payroll and backward-looking policies.

The risk now is that governments in their desire to do something — anything — in contrast with *laissez faire* policies of the early 1930s, will likely allocate resources to the wrong areas and create enormous inefficiencies. They will support “old” industries and inadvertently starve worthy new areas where job creation *could* be positive.

At the time of the writing of this letter, we do not know the specific details of many of the Obama administration’s policies but we do have an idea of broad concepts. Spending targets seem to be mostly unrestrained. Multi-trillion dollar deficits are the expectation for many years into the future. The focus is on jobs creation through broad infrastructure spending. It will take a long time for much of the stimulus that the Obama administration is talking about to make its way into the real economy. Infrastructure projects take a lot of time to plan, prioritize, authorize, organize and place into action.

Keeping with the theme of enormous deficits, the new Congress is preparing to make additional tax cuts, this in spite of plunging federal tax receipts. This will do little to get consumers to spend. Much of the tax savings will be squirreled away to build up household savings or used to reduce onerous debt-payments.

Consumers *will* spend on the necessities — food, shelter, medical, perhaps education. But in contrast with former recessions when consumers continued to spend (on net), in this cycle, they will save (for the U.S. consumer, the first time in years). This will promote further corporate cash-flow squeezes, add to job cuts and contribute to further pressure on home prices. The un-virtuous circle will cause a further spiraling downward of the world economies. *There is very little governments can do until this downward spiral hits bottom and runs out of inertia.*

Fiscal policy will not resolve the current crisis. We believe that governments can attempt to change the economic path for some time by attempting to create a sense of confidence, but they really cannot halt the extent of the ultimate downturn. A large enough set of stimulus programs will help to counterbalance the decline in private expenditures and possibly reduce some unemployment. However, the downside of these policies is that they will cause large and growing external imbalances to the economic system which, in turn, will depress world growth. The global shift to excessive stimulus spending also may come wrapped in protective trade barriers (with changes in tariffs as permitted under the current policies of the World Trade Organization) as each country tries to ensure that its home-grown industries are not disadvantaged *vis a vis* its neighbors.

#### *Advocate’s View on Future Recovery*

Let us remember that the process of recession and recovery, of creative destruction and rebuilding, is nothing new to human history. It has served societies well to go through processes that destroy inefficient and outdated structures, whether economic or social, and replace them with more appropriate structures for the times. So, ultimately, there will be an economic recovery, albeit a slow one and one that assuredly looks different from what we now

call normal. What must come to pass is a worldwide recovery of output stimulated by real demand combined with sustainable balances in international trade. It just takes time. Probably, a lot of time.

Prognostication of market 'bottoms' or 'tops' is pure speculation based largely upon an extrapolation of the past. Rather than naively trying to predict a turnaround, Advocate's outlook of future scenarios includes four possible future paths for the ultimate recovery. These include the following:

*The "L" shaped recovery.* This is where the world economies bottom out but there is no dynamic force stimulating the recovery. We just muddle along. The economic weakness decelerates and the world-wide negative GNP growth reverses to an anemic level of positive growth in the sub-par range of 1% to 2% per year. This is a dangerous scenario. This is where the 'P' in the 'P/E' price-earnings ratio declines to new cycle lows, penetrating the equity market lows of November 2008. The continued slow economic growth and the lousy lowered operating earnings of corporations discourages those who were told last year to "stay the course", "buy the dips", "look to the long term for a recovery." The false hope nurtured by the behemoth Wall Street firms and the humongous bank wealth management operations causes considerable psychological damage to their clients. Most investors' appetites for traditional risk is fully sated. "Better to be safe than sorry" becomes the new investment mantra. We place a probability of 60% on this scenario.

*The "W" shaped recovery.* This scenario is based upon hope and expectation. The consensus overestimates the degree and the timing of the recovery. When the recovery is weaker than expected or the recovery is pushed back several quarters, the economic participants lose some hope and some individuals and companies decide that this malaise will "...never end" with the result being that they further capitulate. Consumers continue to save and companies let their inventory wind down. People stretch out certain purchases and services that are not absolute necessities; corporations focus on survival, not profits. The incipient economic recovery is short-circuited and falls back into recession. We place a probability of 30% on this scenario.

*The "U" shaped recovery.* This is a gradual recovery that starts tentatively and is stimulated by huge government efforts to stem the slide and return the world economies to a positive growth path. This scenario requires a strong likelihood that virtually all of the collective efforts of the world's governments will be successful. Some companies will succumb to bankruptcy but the capitalist system will be saved. We place a probability of 10% on this scenario, albeit due largely to wishful thinking.

*The "V" shaped recovery.* This is where a vigorous bounce takes us back to and through the prior high of the former world economic GDP levels. The stock markets will revive and bounce to high valuations without testing the November 2008 lows. Low-rated corporate bonds will generate fantastic positive returns. At-risk municipalities will be able to service their debt and so municipal bonds will also experience a major recovery. This appears to be the common theme among the major investment banks, brokers and advisory firms these days, based upon surveys of investment experts. In our view, this is the least likely scenario.

We think that this recession is going to be far longer than many expect. Investors are going to lose patience. They are going to capitulate in severe indifference (this is what makes lasting bottoms). The buy-and-hold-for-the-long-run mantra is going to be severely tested before this cycle is completed. As noted by John Mauldin, in inflation-adjusted terms, the stock market is about where it was 35 years ago (1973) in the terms of the dollars purchasing power! If you

reinvested dividends and let them compound (inflation-adjusted), that gets you to purchasing-power values that existed in 1991. He also observes (as we have maintained in the past), "...it takes a lot of buying to make a bull market. It only takes an absence of buying to make a bear market."

*Key Variables to Monitor*

We believe that there are six key variables to monitor in this cycle. The change in these variables will ultimately guide our level of optimism and investment decisions.

*Rate of change in changes to economic variables.* Currently, the numbers across macroeconomic factors continue to get worse. Consequently, the change to the downside is accelerating. Until these metrics begin to stabilize, then there is no "count" forward before a recovery could be expected to begin. Given the sharp free-fall in the September-November 2008 period, we think that a test of those equity market lows is a minimum expectation before a lasting bottom is reached.

*Unemployment trends.* Initial jobless claims continue to ravage workers around the globe. There is a large discrepancy between the official statistics on unemployment (latest figure in the U.S. is 7.2%) while the real number is closer to 13% if one includes those forced to work less than 40 hours or have become discouraged and left the official category of job seekers. That difference in the 'headline' statistics is what will contribute to growing mistrust in what our government is telling us.

*Trends in housing prices nationally.* According to the Case-Shiller Index of 20 metropolitan areas, prices are continuing to drop. The National Association of Realtors head economist asserted several times in 2007 and early 2008 that the bottom in housing prices had been reached. The lesson is that one needs to examine the source of information to establish likely credibility prior to including it in one's appraisal. With home prices continuing to decline and unemployment rising, a larger number of homeowners are suffering from financial distress. About 60% of those who were in trouble and negotiated new arrangements with their lenders are back into delinquency. The increasing level of job losses will place further stress on households who went on a monumental borrowing binge during the past several years.

*Valuations (P/E ratios relative to past major-market declines).* We use extensive research compiled by Professor Robert Shiller of Yale University on valuation indicators (normalized ten-year average P/E ratios) over a period of 130 years of U.S. economic history. He has determined that P/Es are now at reasonable market levels (about 14 times earnings on the S&P 500 Index at 840 and the expected earnings of the S&P at \$60) but considerably far away from being "cheap" (10 times earnings or lower). To become cheap, the S&P 500 would have to decline to about 600 (implying an additional decline from stock price index levels current levels of about 30%). *The point to remember is that at major market bottoms, P/Es are always cheap.* We are not there yet. While one should "never say never," we think that the market has a high probability of disappointing again and at least testing the 2008 lows.

*Investor sentiment.* Examining many years of history, Merrill LUNCH's strategist Richard Bernstein noted that the other major Wall Street strategists typically get positive on the markets near market highs and become pessimistic near market lows. Not unlike many retail investors. They reflect their optimism or pessimism by recommending a high (or low) level of equity exposure, respectively. Currently, this indicator is in neutral territory. Given the reliability of this indicator in the past and the extreme trend of downward performance since this past

September, one would think that this signal would have transitioned over to the Bullish readings. It has not yet.

Multiple scenarios – ranging from the absurdly positive to the most fearful - are presented by government, investment firms, economists and the like. And, disconcertingly, their opinions change within short periods of time, sometimes within weeks or even days.

*Analyst earnings revisions.* Analyst forecasts are still too optimistic, if one believes them at all. These analysts are guiding corporate earnings expectations on Wall Street during this terribly disruptive period. Earnings are coming in much worse than the guidance numbers or the analyst estimates. As a reference point, think about what analysts' expectations were for U.S. GDP during early 2008. The consensus estimate was for 3% annualized growth during the fourth quarter of 2008. By the time that the actual fourth quarter earnings were announced, the consensus had deteriorated to a negative 6%. That is a massive 9% swing in a fourteen trillion dollar economy or more than a one trillion shortfall in analysts' estimates or corporate earnings. So much for accuracy. Not just wrong. Absolutely incorrect.

In addition, we were flabbergasted that all ten analysts in a recent Barron's forecast saw stock prices rising 10% to 20% during 2009. We think that this scenario will take much longer and we don't see this happening smoothly. Based upon many of the reasons mentioned in this letter, corporate earnings are going to be far worse than the consensus of most analyst projections. And, let's not forget that earnings do drive stock prices. We do not see a catalyst at this point for stock prices to rise substantially.

#### *Conclusions*

Investment concepts such as "risky" and "safe" will be turned on their heads. In the past, "risky" meant volatility risk; uncertainty risk. The price tomorrow could differ markedly from the price today. In the evolving markets, "risky" will mean the risk of losing purchasing power due to high rates of inflation and the debasement of currencies all over the world. In the past, "safe" meant bank CDs, bonds, fixed-return insurance contracts, money market funds, and (for awhile), auction-rate preferreds (ARP's). Now "safe" will indicate those types of investment that have a high probability of holding their purchasing power while the government is reflating our way out of this economic hole. We believe that in the evolving environment, many fixed-income investments will be deemed "risky" while certain types of stocks will become "safe."

We are looking for short-term opportunities to invest in trading positions on both the long and short sides of the markets; it would be foolish with what is in front of us to try to think long-term at these still-elevated valuation levels given the huge uncertainties in front of us. This is similar to a guerilla insurgency in which we try to hit and run to capture some appreciation as we wait for better values (meaning lower prices) to emerge and for markets to calm down when a more-certain recovery becomes visible.

#### **Client Portfolios**

On the equity side, our intent is to keep exposure low. This is our top-level decision, the allocation to various asset classes. We believe that the macroeconomic data still points to a difficult economic environment. Government policy intervention only makes this situation worse, as government fiat power allows broad, retroactive, and somewhat arbitrary revisions to rules of law. This is an uncertain environment, and investors do not like uncertainty.

We spent the earlier part of the fourth quarter of 2008 reducing equity exposures significantly across client portfolios. We had written to all of our clients in late September requesting

permission to reduce equity exposures (to levels well below each client's investment policy, close to zero).

During early October, we sold off remaining positions in Energy, Oil Equipment & Services, Financials, Technology, Global Healthcare and Utilities. Our only significant remaining core exposure is in Healthcare. We continue to like the Industrial, Technology and Healthcare sectors, but we are not buying in at the current price levels. We continue to monitor the Oil Services and Alternative Energy sectors, which are appealing, but not at current price levels. We are leery of the Utility sector, as the risk of government intervention is significant. We have shorted various sectors in the past and will likely do so in the future, but unpredictable government intervention creates short-term rallies that make this strategy riskier at this time.

During late October, we did commit a portion of assets to Gold through an exchange-traded-fund. We like this precious metal as a hedge against rampant inflation as governments are competing to reflate with abandon. We intend to increase this exposure as gold's price fluctuates and reaches our target price.

We have no direct exposure to corporate bonds. Where we do have a fixed-income mandate, our commitment to fixed-income is mostly in short-term (one- to three-year duration) U.S. treasuries, although some portfolios also have small commitments to long-term U.S. treasuries and inflation-protected U.S. treasuries ("TIPS"). We intend to increase TIPS exposure on periodic dips in prices.

The best theoretical investment during 2008 was long-dated U.S. treasury bonds. That is not likely to be the best investment in 2009. The only way governments get out of their financial messes is to debase (or cheapen) their currencies. So, investing in intermediate-term TIPS in our minds is the investment of choice. As far as low-rated junk bonds, it is far too early to think about investing in these equity-like securities. One wants to invest in junk bonds once there is a glimmer of broad-based recovery. The rate of defaults in low-rated credits will zoom to record levels judging by the downward trajectory of the economy.

One of the most important lessons we learned was the extreme difficulty in determining the timing of the various outcomes. As volatility rose to record levels (to more than twice the level reached at the nadir of the past several market meltdowns), one could get seriously hurt on both the long side of the market as well as on the short side of the market. This was, in part, what did happen in so many hedge funds last year.

Currently, client equity exposures remain low (although if the market declined to levels reached during last November, we would be a cautious buyer of equities). Cash reserves remain very high.

This is what in our minds is required in order to fulfill our mandate of preserving client capital. This is the flexibility that our particular investment strategy affords.

### **Market Highlights**

We can say with some confidence that we knew what was likely to occur; we just could not know exactly when it would occur or how quickly the change would take place once it started.

For some years, we have been alerting clients and friends to the fact that there was a strong likelihood of a dangerous debt collapse around the corner. As to the timing, we originally thought that the trigger might be the bursting of the tech bubble in late 1999 and 2000. But that

was another bubble to be popped. Markets recovered the losses suffered during the 2000-2002 period during the period 2003-2007. Then with speculation rampant and the world seemingly awash in liquidity, the debt collapse began in earnest.

During the period up through March of 2000, speculation was rampant. Valuations of all stocks were at the highest levels ever monitored in the history of modern economies. Price-earnings multiples were in the range of 40x to 50x earnings (implying an earnings yield of only 2.5% to 3.0%, which is very low.) These were the highest P/Es in reported economic history, certainly since the formation of the stock markets during the late 18th century. There was a huge expansion in debt (that began to accelerate during the early 1980s but actually dates back to the early 1950s when purchases of appliances and cars were beginning to be done on the “lay-away plan,” the mantra of which was “buy now; pay later”).

The broad market declined 45% and began a recovery (2003-2007) that brought the market up to and slightly through the prior all-time high (October 2007). The defining moment (in retrospect) at the market peak was the thought that there was unlimited liquidity available to those that desired assets for speculation. Subsequent events have fully discredited that thinking.

We understood the risks and were mostly successful in limiting client capital losses. The broad U.S. stock market was down about 37% during 2008. A broad base of government and corporate bonds appreciated 5.2%, but this was mainly due to government bonds, which were up in the double digits. International markets were down about 43% (MSCI World Ex-US Index) with the emerging markets down 53% (MSCI Emerging Markets Index).

We believe in the inevitability in cycles that must run their course before recoveries are well founded. As perspective, the high-tech bubble correction brought the broad-based S&P 500 Index down about 45%. (The NASDAQ declined 75% and never recovered to reach its prior high.) The current market decline from the peak in October 2007 to the end of November 2008 was also down about 45%.

However, beyond that is where the differences begin to emerge. The current correction is far more widespread globally. This is impairing many more industries and sectors, and has affected the financial sector (banking, insurance, real estate), consumer spending, housing supply and demand, the financial viability of retirement plans, basic supply–demand dynamics of commodities, manufacturing capacity, the deterioration of service-sector employment, the viability of municipalities and states as well as many other areas known (and as yet unknown). It seems inconceivable to us that this market will have reached its ultimate decline at about the same level of decline as the high-tech bubble did in 2002. Things are so much worse by orders of magnitude. We expect the market to follow suit.

The consensus forecast seem to indicate that the U.S. economy will continue to be weak during the first and second quarters of 2009 but then begin to climb back into positive territory during the third or fourth quarter. While odds of a depression seem low — Bernanke and his advisors seem determined to flood the economy with dollars — Wall Street analysts have high confidence that Fed and Treasury policy actions, lower oil prices, reduced inventory levels, and a slight revival in auto sales later this year (at heavily discounted prices) will combine to produce above-trend real GDP in 2010 (compared with a poor 2009). We are not so sanguine.

We see the U.S. dollar remaining strong for a while longer during the worst of this crisis, until attempts to print money overwhelms even those who find shelter in the dollar. Weak overseas

growth, a strengthening dollar (which will adversely affect U.S. exports), as well as actions of corporations to conserve cash (such as reducing dividend payouts, halting company stock buyback programs and a major slowdown of merger activity) will create further headwinds for U.S. stocks.

So, what is behind the current volatility in the U.S. market? This may be discounting a hope and a prayer of successful actions promised by the Obama administration (that we believe cannot possibly deliver the impossible). When this shortfall becomes readily realized by investors — sometime toward the end of the first quarter into the second quarter (March – May, when the expectations of weak results for third and fourth quarter become more apparent), the markets may decline and test November 2008 lows.

### **Concluding Thoughts**

This past period was extraordinary for all investors. Little consensus, unexpected and unpredictable government actions, volatility and confusion reigned. We appreciate your loyalty and appreciation for the work that we are attempting to accomplish during these difficult times. We know that you have vested in us a very important responsibility and we are prepared more than ever to embrace these challenges and perform to the best of our abilities.

We pride ourselves on our service and availability in responding to your needs and requirements. We appreciate your confidence and loyalty. Thank you.

Please contact us at 312-578-8300 or via email if you have any questions or would like to discuss our outlook in detail.

*January 15, 2009*

### Addendum: Trade Policy

Trade protection can deepen global economic problems and shut off a potential engine of growth at a time when consumer demand and business investment are sagging globally. The World Bank forecasts that global trade will shrink by 2.1% this year, the first such decline since 1982.

On a cautious note, major industrializing countries (Russia, India, Brazil, Ecuador, etc.) are lining up to impose punitive tariffs to keep products manufactured outside their borders out of their economies. Look how well this served Argentina for the past 60 years (an unmitigated disaster)!

While global trade arrangements have greatly reduced tariffs during the past several decades, they do little to fend off protectionism. Under World Trade Organization (WTO) rules, countries establish formal tariff levels which are often very high, and then apply lower tariffs. This approach affords them the leeway to boost tariffs unilaterally without violating WTO rules. According to the latest WTO survey, 16 countries launched 85 new anti-dumping cases during the first six months of 2008, compared with 61 investigations the year earlier. We expect a sharp rise in those numbers because the economic crisis deepened during the second half of the year.

Interestingly, almost half the complaints target China.

### Addendum: Government vs. Regulator

The U.S. government and most international governments have been focusing on getting their financial sectors rehabilitated. Central banks have taken unprecedented steps to place monetary reserves into circulation. Their policy objectives for their banks are two-fold:

1. Repair your balance sheets by selling the toxic non-performing debt or doing something to get this 'stuff' off the books
2. Lend to worthy borrowers.

Has anyone taken the time to realize that these two directives are contradictory? You can go left or you can go right, but you cannot go both left and right simultaneously! Right now, the financial sector is borrowing money at a record clip and holding it tightly to shore up their capital ratios. This makes them appear stronger in the eyes of the regulators as they try to work out of their problem loans and debt instruments that are non-performing.

The current volatility in the markets since December 2008 is a vote for government changing the trajectory of the sharp decline. The original TARP program has morphed several times such that it appears to us that only those running it really know what is going on. Congress is investigating these managers of TARP and the other alphabet-soup agencies that have recently been created.

The advent of the new administration taking office shortly means that major changes are likely in store for the supervisory role of government in our economy. The top-down management is decidedly socialist in nature. Uncle Sam is now offering his broad shoulders to halt the run on financial institutions.

Our view is that regardless of which party is in power, the decline will take its course no different than an out-of-control forest fire burns everything in its path until there is nothing left to conflagrate. Whether program A or program B, the major governmental support is for major corporate entities that were the bulwark of the U.S. economy, at least in 1980.

However, the real growth in employment during the past 20 years has come from small businesses and there is no bailout for them (although they need the help just as badly as the large corporations). In fact, we have read that more than 80% of all new jobs created during the past 10 years have come from small entrepreneurs with less than 500 employees. Has any thought or provision been made by our federal government to help these folks who are now effectively cut off from virtually ALL sources of credit? How do they survive and maintain cash flow to keep their workers employed? Whom do they lobby? How? With what resources?

What does this do to the reserve currency known as the 'dollar?' Who will buy the debt that the U.S. treasury is selling? Not the Europeans. They are deep into their own mess. The Chinese? No. They need to keep their powder dry to assist their unemployed and disenfranchised. The Arabs, who are wealthier than everyone it seems from last year's oil priced at much of the year above \$100 per barrel (with extraction costs under \$20 per barrel)? Elements within their over-leveraged economies, heavy into infrastructure and massive real estate projects, are just beginning to go into default.

What will the Fed do? The managers of the stimulus packages seem to be advocates of the theories of John Maynard Keynes. They are going to fight the recession and deflationary tendencies with stimulus. The implications? We need to adjust our thinking and our portfolios for that likely outcome.

What is taking place on a global scale is a huge tug-of-war. On one side is the natural cyclical forces that work to compress the economy — deleverage, destruction of debt, destruction of equity and the feared risk of deflation. On the other side, are individual national governmental (in a now somewhat coordinated) efforts to stimulate the world economies in such a massive manner in an attempt to overcome the natural cyclical compression of the economy. They will try to avert the tendency of deflation by releasing huge amounts of capital from effectively fictitious balance sheets.

This will result in inflation. By inflating their currencies, central banks the world over debase their currencies and permit the holders of debt obligations to pay off creditors with cheapened debt — with monies that are worth less (on a purchasing power basis) than they borrowed. This is a clarion call to all holders of debt to move to very high-quality issues and shorten maturities. This also turns on its head former concepts of investing such as what is “safe” and what is “risky”.