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Is It Safe To Go Back In?

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The first quarter of this year continued to show us that we live in "interesting times." The quarter ended with the S&P 500 down -11% which means that since the beginning of 2008 the S&P had lost -48%![1] The actual experience during the quarter was much more "schizophrenic." Enormous daily volatility and widespread fear took the index down -27% by March 9 to a level last seen in September 1996! Then it turned around and had the fastest 20% gain since 1933.[2] Since the stock market has grown at an average rate of 6.88% a year from 1950 through the first quarter of this year,[3] a drop of 27% in 68 days, and a rise of 22% in 14 days are truly exceptional.

As I am writing this in late April there is a cautious change of sentiment. Obama sees "glimmers of hope," Federal Reserve Chairman Bernanke sees "green shoots," and the stock market has been up for five weeks in a row. A number of commentators in the media think that we have "seen the bottom." Is it now a good time to buy back into stocks if you plan on holding for at least five years? Perhaps. However, the ride might become extremely painful over the next year or two. There are a number of reasons we might want to remain both cautious and nimble in our investing.

The Bad News

Economies world-wide are still contracting, albeit more slowly now. In the U.S., industrial production just hit a 10-year low.[4] There were a record 3.1 million foreclosures in 2008, and real estate experts expect another 3 million foreclosures in 2009.[5] The latest edition of the Beige book, the Fed's periodic survey of business conditions, reports that only "five of the twelve Districts noted a moderation in the pace of decline."[6] Unemployment is continuing to rise and many experts expect it to keep rising through 2010.[7] In the big picture, what began as a housing loan crisis morphed into a global financial crisis, which in turn has developed into a world-wide recession.[8]

In my opinion, the recovery from this recession will be slower and more fitful than past recessions. At every level of government, and in most areas of private life, we have been carrying too much debt in order to live beyond our means. It will take time for millions of Americans to restructure their lives, finances and priorities to support more sustainable ways of living, and to reduce excessive debt. In the meantime, we can count on seeing more high profile bankruptcies, with their attendant collateral damage such as sharp increases in unemployment and episodes of fear in the stock market. So there is no way of knowing at this time if our

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current brief stock market recovery is merely a "bear market rally," or the beginning of a successful long-term change in trend.

The Good News

Even in a recession most businesses remain profitable, and the dislocations in the marketplace can open up exceptional opportunities to the vigilant investor. I have full confidence in the ingenuity and adaptability of the American people. I am cautiously optimistic that the strategies of world-wide financial cooperation and the various stimulus packages will shorten our down cycle and have already avoided a world-wide depression.

Prior to this most recent crisis, I put in place a variety of safety features on your portfolios that I feel have minimized your losses when compared to market averages. More recently I have rolled out a brand new program that gives me limited discretion to reallocate your portfolios. This authority will allow me to take quick defensive action and will give me an increased ability to take advantages of opportunities as I uncover them. I have also been watching at least one significant opportunity develop.

The Case For High Yield Bonds

Since I manage money that my clients cannot afford to lose, I always weigh the near-term as well as the long-term risk/reward ratio. In my judgment the stock market remains risky near-term, and I know of no way to adequately hedge that risk at this time. On the other hand, I believe that there are good opportunities for growth in the asset category of high yield bonds and I do have a way to manage the risk in this asset class.

The Opportunity. In my opinion, in 2008 the asset class of high yield bonds was driven down to unrealistically low levels due to both wide-spread panic and forced selling by hedge funds. One measure of valuation is to compare the interest rates earned by high yield bonds to the interest rate earned by similar duration Treasury bonds. During ordinary times high yield bonds have historically earned from 2% to 4% more than comparable Treasury bonds. At the bottom of the 2002 down market this spread opened up to more than 10% before recovering to the normal range over the next two years. (This recovery was a very profitable time to be in high yield bonds.) In late 2008, the high yield spread briefly topped 20%(!), and it appears to have begun a recovery.[9] Since December 2008 high yield bonds have been gaining in value and the spread has narrowed to 15.44%.[10] The opportunity, then, is to invest in High Yield Bonds and potentially earn a higher dividend while also participating in capital gains as their recovery continues.

The Risk. Lower rated bonds are subject to greater fluctuations in value and risk of loss of income and principal. There are two major risks for any investment: Default Risk (can it go broke?), and Market Risk (can it go down in value?). For safety we must manage both of these risks. To hedge default risk, we never buy a single issue of anything, either stock or bond. We only use investments that contain hundreds of different issues, so we have the relative safety of diversity. During ordinary times, to hedge market risk, we invest in a variety of asset classes. However, as we have seen in the last year, a "buy and hold asset allocation" strategy does not

adequately protect us in severe financial contractions when all asset classes can decline at once. New strategies are needed for exceptional times.

For the past several years a colleague of mine and I have been developing and testing a proprietary system to risk manage high yield bonds. I have tested it successfully on my own accounts, though past performance is no guarantee of future results. Up to now I have been unable to offer this system to my clients because I did not have the ability to move quickly with a large number of accounts. The principal of our system is quite simple: we have a mathematical model that trails a stop-loss closely behind the upward movement of each individual high yield bond product we are invested in. Unlike stocks, high yield bonds are not very volatile on a daily or weekly basis, so a stop-loss can be triggered very early in a downturn. In this way we can hedge against a bear market rally in high yield bonds in a way that we are unable to do with stocks. I do not recommend investing in high yield bonds without a hedging strategy.

As always, our first emphasis is on achieving your financial goals in the safest possible manner in a way that is appropriate to your individual risk tolerance. Feel free to call me to discuss your individual investment situation at any time.

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The views expressed are those of the author as of the date noted, and are subject to change based on market & other various conditions. They may not reflect the views of United Planners Financial Services of America.

Certain risks exist with any type of investment & should be considered carefully before making any investment decisions. Keep in mind that current & historical facts may not necessarily be indicative of future results.

[1] Morningstar.
[2] Yahoo Finance Charts
[3] *Ibid.*, S&P 500 Index
[4] Paul Krugman, *New York Times*, April 17, 2008
[5] *CNNMoney.com*, January 15, 2009
[6] *Op.Cit.*, Krugman
[7] *Ibid.*
[8] Niall Ferguson, *Los Angeles Times*, February 6, 2009
[9] *Bloomberg*, Factset, Merrill Lynch HY Master Index, January 23, 2009
[10] *Bloomberg*, Merrill Lynch HY Master Index, April 17, 2009