

IT'S OVER!

But, Is It Finished?

A Requiem for 2008, RII (Rest in Infamy)

and a Look Forward



Photo: Ji Lee

Investing in 2009

Although FiduciaryVest typically avoids issuing short term capital market forecasts, the current shamblesque condition of US and world economies is so unusual that it easily earns a “once-in-a-lifetime” label.

Where do we stand?

By coincidence, in early 2008, FiduciaryVest had embarked on a year-long project to develop a functional system for assisting clients to include tactical asset allocation techniques in their rebalancing actions, as a substitute for traditional target-rebalancing.

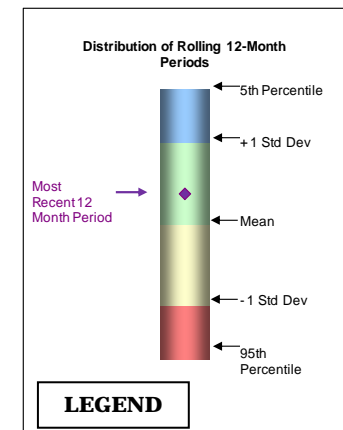
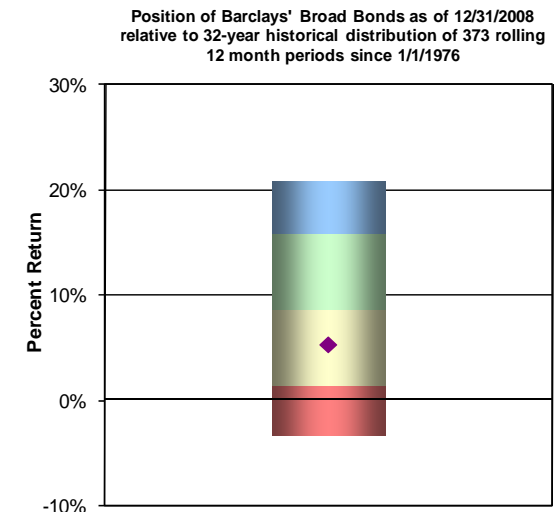
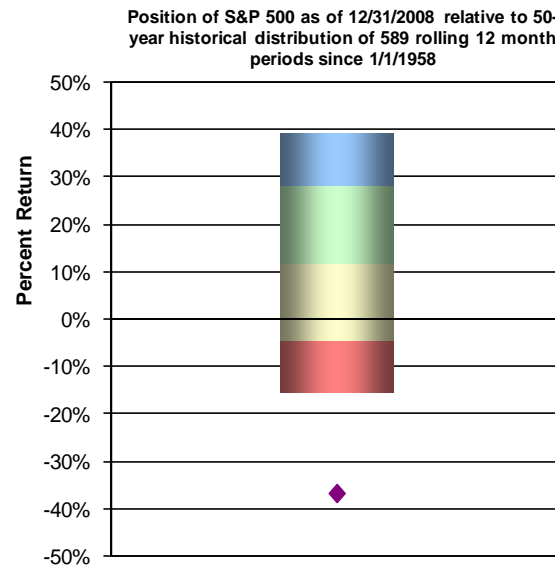
Our newly developed approach to the timing and size of rebalancing (focused primarily on equities) is based on many pieces of input, but the chart below shows one major “driver”: the current cyclical positions of two market indexes, compared to their ranges over hundreds of 12-month rolling periods that make up their history.

As discussed later in this piece, the equity markets can, and could very possibly decline from here. But, for long term investors, there are two factors to consider: (1) the present odds of significant downside movement are historically slim and (2) any new allocation they make to equities now will at least be done with the comfort that they are surely not “paying up”.

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This publication is NOT intended, or suitable as a basis for investment decisions. Before taking any significant action, readers should seek professional investment advice that will incorporate their specific investment needs and circumstances.

Global stock market valuations are likely to gyrate their way through 2009 and probably also walk on cracked eggs into 2010.



Why? At the macro level, the valuation of a broad index of common stocks is necessarily based on an underlying expectation for future earnings of the index's components...i.e., its collective price/earnings ratio. So, if analysts are publishing earnings forecasts that are mistrusted by traders and investors, then the market will discount share prices in proportion to their degree of uncertainty.

Will massive federal rescue efforts “work”?

The simple answer is: No one knows, or can know.

Only one thing is clear: Despite the unknowable impact, it has become a politically basic assumption that the Federal Government must massively “stimulate” the US economy.... meaning the injection of massive amounts of money that does not now exist into a variety of levels in the society. Pundits and politicians alike are fond of saying that all this money (more than \$2 trillion and counting, including fiscal 2009's operating budget) will come from “taxpayers' hard-earned money.” True. But for the most part, it won't come from the taxpayers they have in mind. Instead, the majority of people that will foot this bill are yet unborn; today's living taxpayers will likely struggle just to pay the interest.

Risk-free?

Credit rating bodies are not required to award a “risk free” rating to the US Treasury's debt. The US Government's taxing power is not unlimited and will, in fact become more limited within the next 8 years, as Social Security and Medicare benefits reach the permanent turning point when they become cash-flow-negative.

Within the next 18 months or less, the US Government will be:

1. Running a record annual budget deficit that will likely amount to \$1 trillion, and
2. Seeking to sell \$1 trillion or more of new and rollover US Treasury debt. As has been the situation for years now, the likely dominant source of 2009-10 US Treasury debt-buying will (necessarily) be the Chinese Government, and
3. Printing and flooding the world's economies with many billions of new dollars, which will amount to additional, unrecorded US Government debt (fiat currency?).

Looking forward

The immediate future functioning of inter-linked world financial markets is at some degree of risk which no one can assess. Similar to a great ocean liner, mature world markets will roll and re-right themselves in a storm, provided the vessel's captain skillfully steers head-on into the waves. But, absent a functioning rudder and engines, both the captain and his ship would be helpless to deal with a 75-footer that batters them broadside.

It is a well publicized fact that market makers, analysts and even politicians all concur: the world's financial markets are largely frozen-up and local economies are consequently in nosedive.

Worst case

Suppose there is a collision of events within the next 18 months or so, many of which are already evident. We could see truly dire outcomes, IF several of the following occur:

1. Commercial banks are unable and/or unwilling to “answer the bell” for making loans, because of extremely slack demand and borrowers' diminishing credit quality.
2. Global demand for oil continues to slide; Middle Eastern sheikdoms (poster-child Dubai) experience significant cash flow problems and investment portfolio value-shrinkage.
3. China's formerly double-digit economic growth rate turns negative; China shifts its economic might inward to job-creating infrastructure projects; its appetite for buying US Treasury debt not only ceases, it reverses.
4. A major terrorist attack on the US, or a nuclear development in Iran, or Israel.
5. Politicians in Washington and/or major trading partners commit the typical (historical) error: they decide to “protect” US jobs via legislation and tariffs.

Best case

The near future is so uncertain that any broad market prediction, by anyone, is essentially a guess, despite supporting lists of reasons. But, given the currently unified determination of the world's major federal governments and their central banks, it would not be a high-probability gamble to bet that their efforts will fail. A best-case scenario....near-term bottoming of the stock market and a sustained, healthy level of credit activity would likely require most of the following:

1. Key: The US Congress produces sufficient, accountable funding for “stimulus” activities that are in fact economically stimulating.
2. Banks find a growing number of attractive opportunities for lending and a credible number of business borrowers seek to finance growth-related activities.
3. Consumer confidence begins to show an upturn.
4. Global free trade expands, or at least does not contract.
5. Long term US and major stock market investors become convinced that share valuations are not only historically, but also *fundamentally* cheap.
6. The US Dollar continues to be the world’s reserve currency.

A 2009 “sure-thing” in money management

Severe profitability stress is suddenly being visited upon portfolio management firms, after decades of market-driven profit growth. Because virtually all long-only equity managers’ fees are a percentage of quarterly market values, a 40-50% decline in assets under their management leaves behind a grim prospect for their 2009 revenues. This will surely cause organizational fallout, unless there is an almost immediate, strong stock market resurgence.

FiduciaryVest’s pro-active review: Our job in 2009 will include enhanced review of clients’ manager/ mutual fund organizations, in order to identify and evaluate the impact of their necessary decisions about personnel and other resource reductions. Note: Passively managed investment products will not be exempt from the impact.

Hedge funds

The gaggle of diverse investment strategies that have collected themselves under a roof labeled “hedge funds” face a spectrum of possibilities in their near future. Essentially all of them are organized as limited partnerships. Whether or not a particular fund actually hedges anything is not assured.

One of the popular design-hallmarks of these partnerships is that while the General Partner (manager) is typically in line to be paid 20 percent of partnership profits, the percentage is computed on cumulative profits.

Most hedge funds target annual returns that fall somewhere between “inflation-plus” and 12 percent. The year 2008 was not only poor for hedge funds; the average of reported returns for the year is nearly -20 percent. In many cases, the year’s sizeable negative return will effectively shut off the general partners’ profit sharing spigots for the foreseeable future. In the past, “under water” general partners have often resorted to simply terminating the partnership and distributing the capital accounts to limited partners....a tactic which frees the general partner to form a new hedge fund partnership and start the process all over again. We shall see whether this happens in 2009.

Impact of the Madoff scandal

The exposure of a classic Ponzi scheme is always cause for tut-tutting about the absence of reasonable enquiry that allowed the scheme to flourish. The Madoff one was massive, beyond precedent. Two simple elements to require:

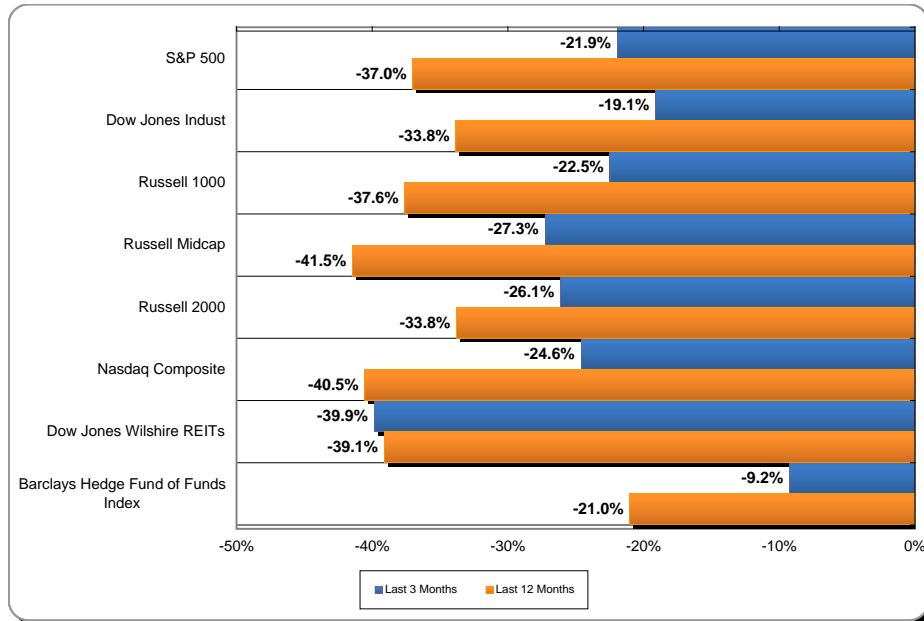
1. A reputable, specialized independent audit firm that can be researched and interviewed.
2. Evidence of professionally reviewed systems of internal control....over cash, in particular.

Traditional alarm signal: an investment advisor whose primary credential is “star quality” clients. (Ponzi artists and other shoddy advisors seem invariably able to align themselves with an impressive number of famous-name clients.)

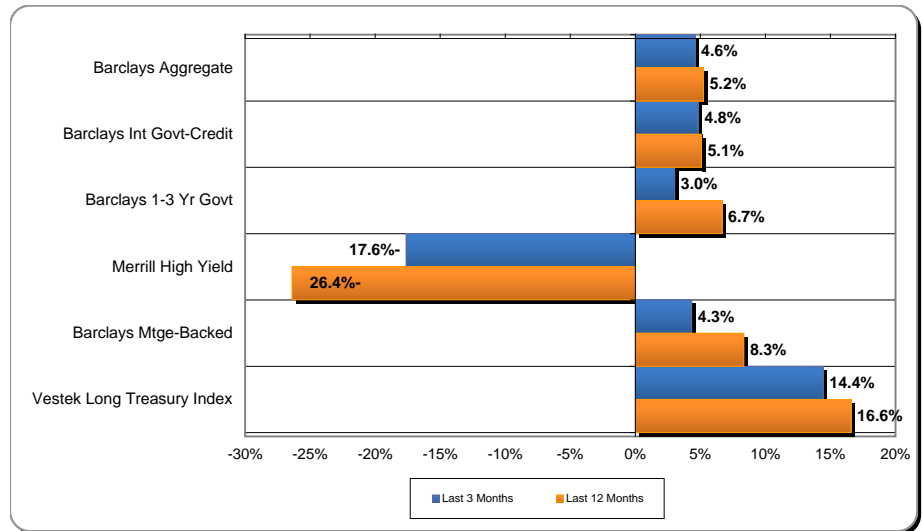
Because of a combination of the Madoff scandal and the recent market-stress on most “hedge funds”, FiduciaryVest has already begun an increased level of due diligence procedures to verify the current existence and functionality of internal controls in any such investments that have been made by our clients, or suggested to them.



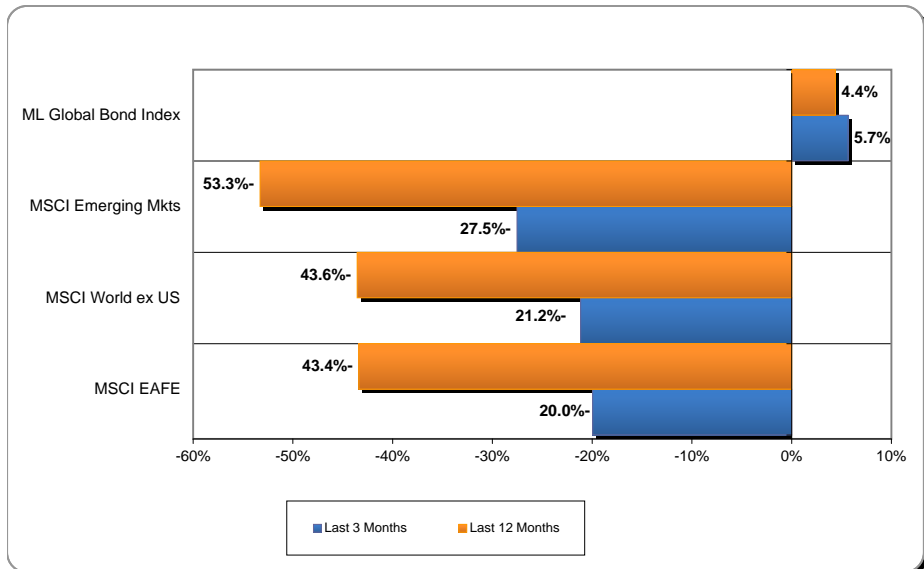
US Equity



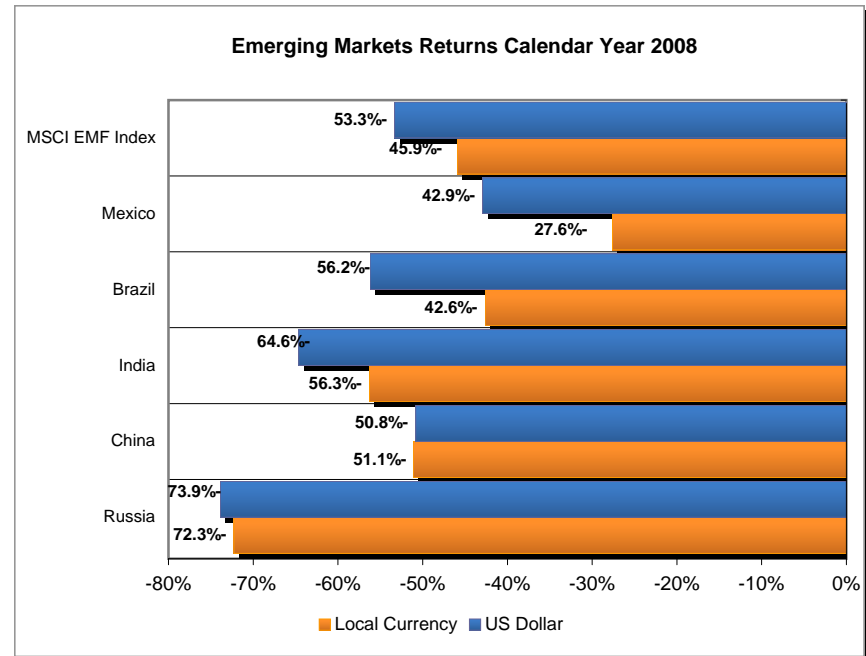
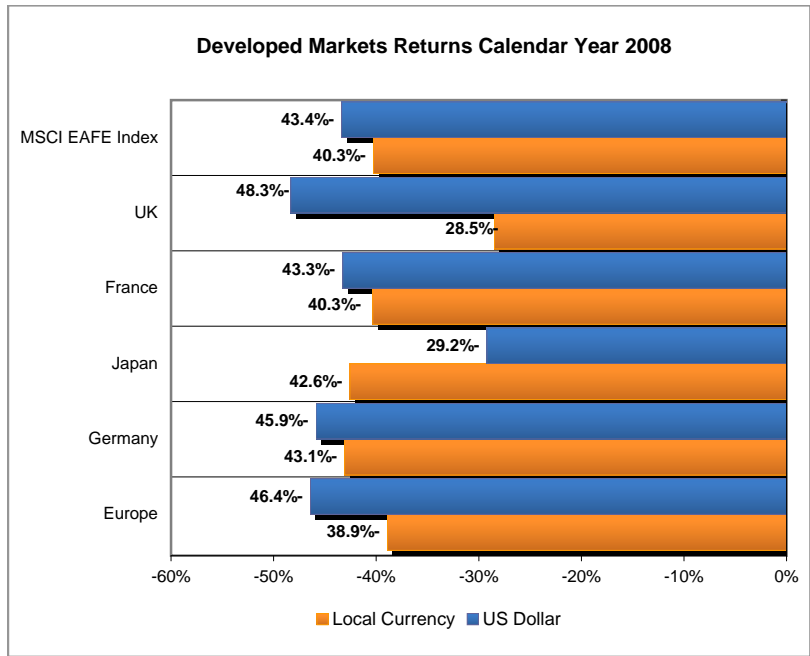
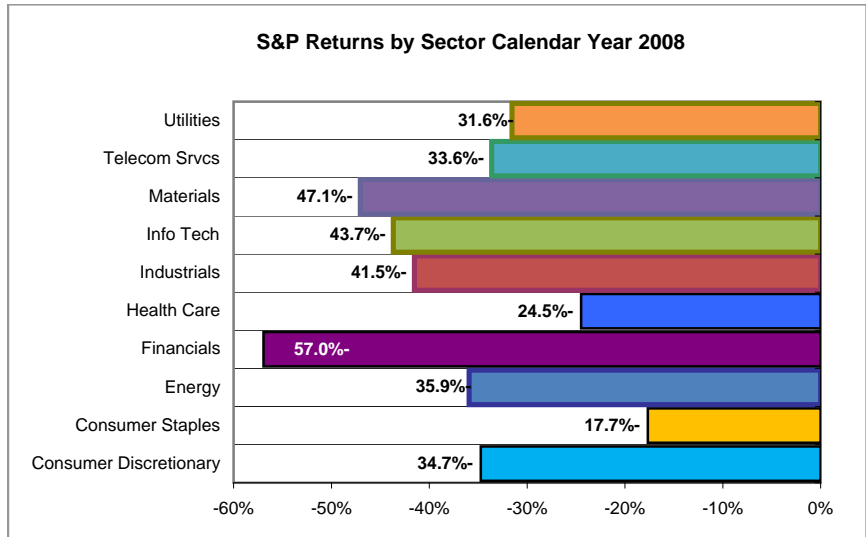
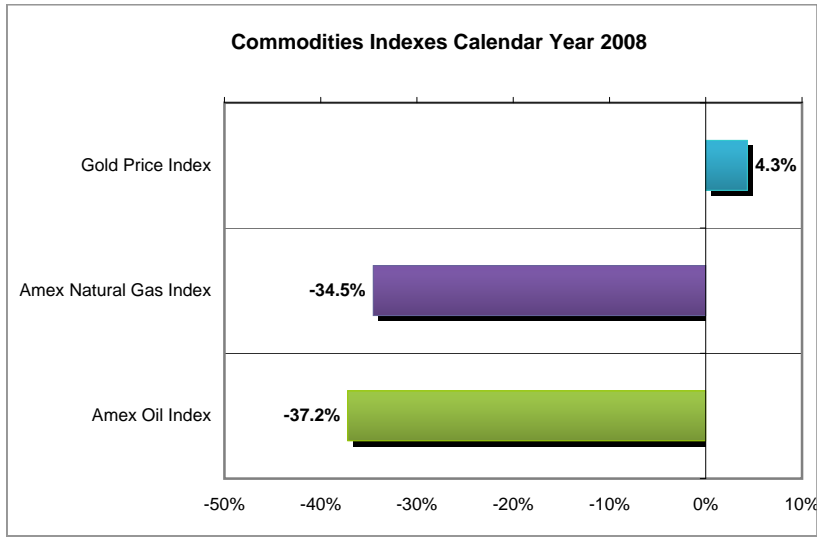
US Fixed Income

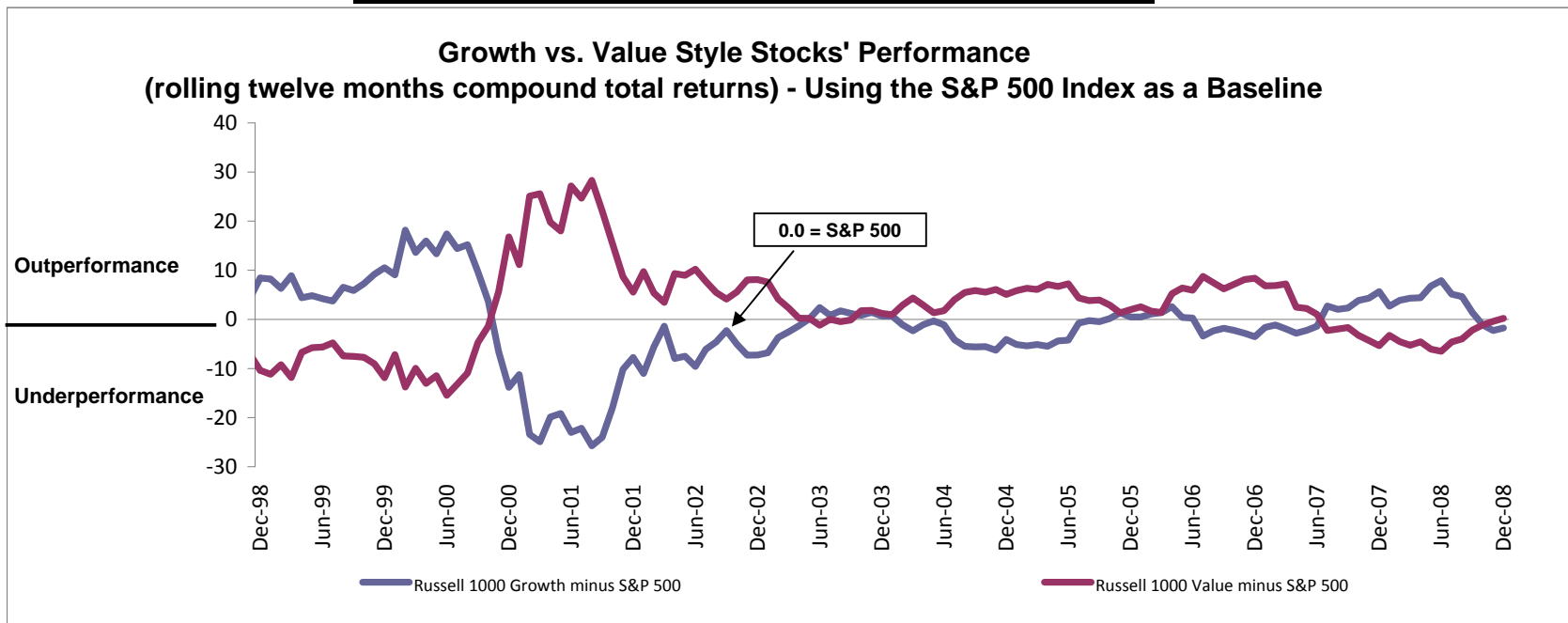
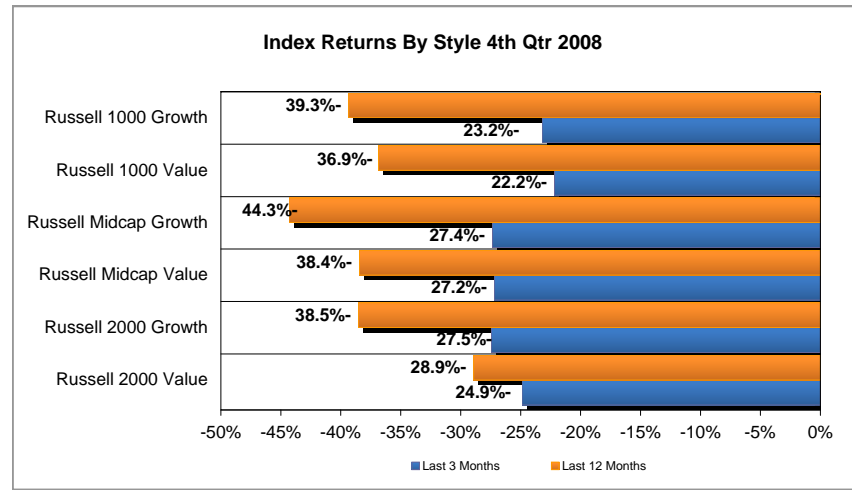
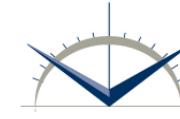


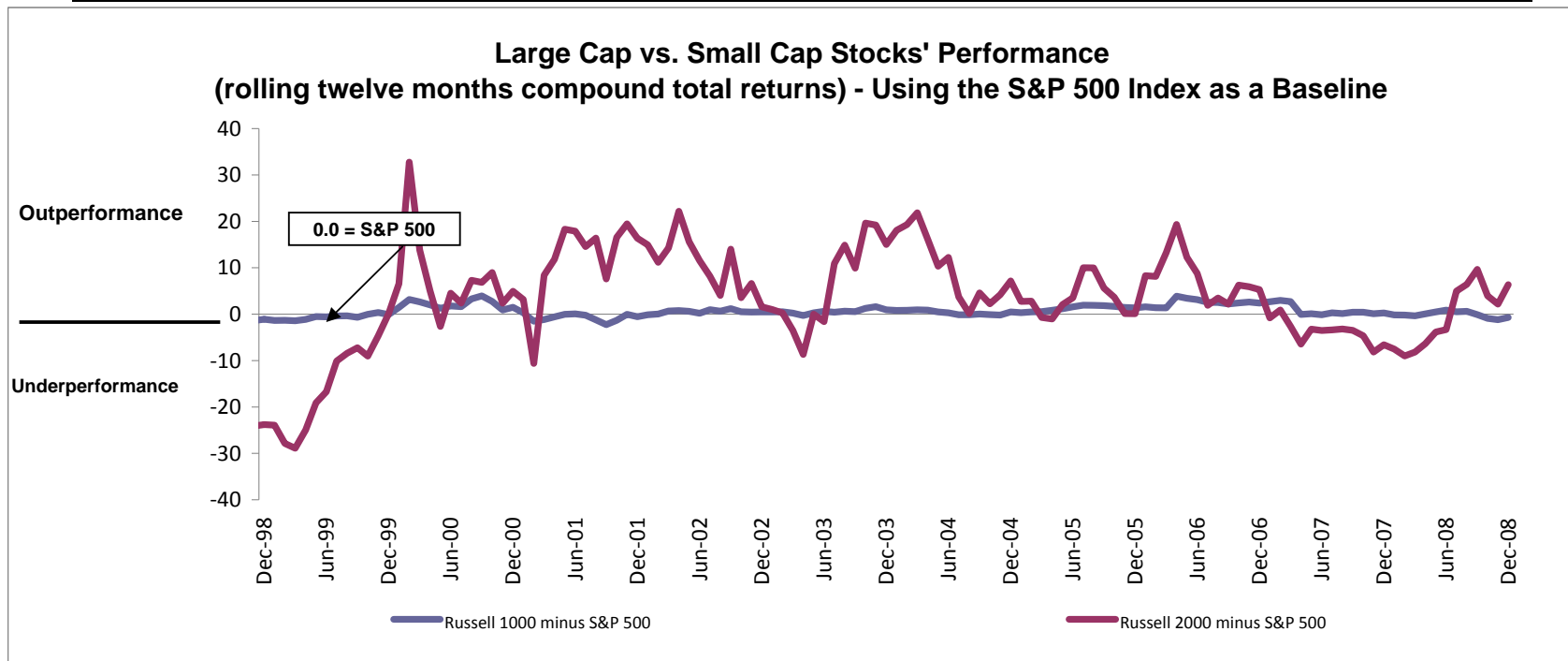
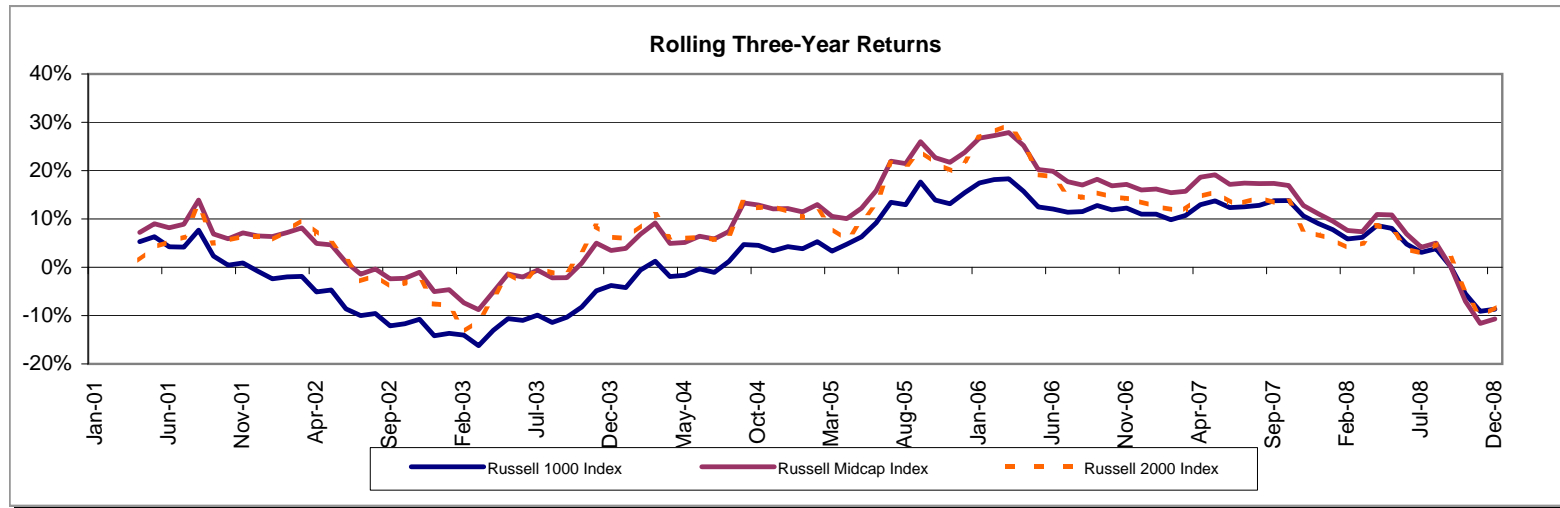
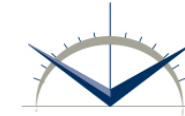
International (returns measured in US Dollars)

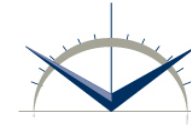


*We invite you to view our more in-depth commentaries on this and other key topics at www.fiduciaryvest.com/research_whitepapers.html

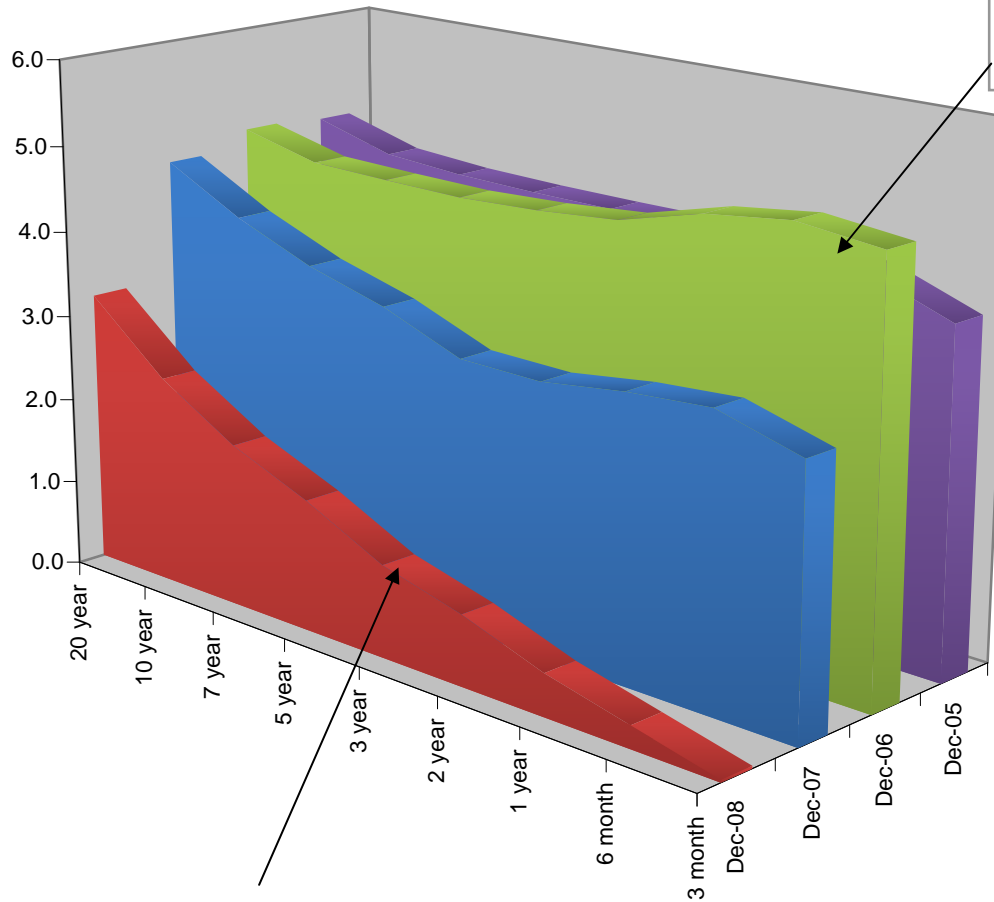








**U.S. Government Bond Yields
At Selected Quarter End Dates**



2 years ago:
Yields were "inverted"...a condition that is inherently unstable and is often an indicator of expected recession.

Now:
The Fed has dramatically (again) reduced the short term Gov't borrowing rate, essentially to zero, in order to stimulate borrowing and mitigate economic disarray and credit contraction.

The FV Periodic Table of Investment Returns

Annual Returns for Key Indices (2001-2008)

Ranked in order of performance (Best to Worst)

2001	2002	2003	2004	2005	2006	2007	2008	10 Year Forecast
REIT 13.9%	Commodities 23.9%	Emerging Mkts 55.8%	REIT 31.6%	Emerging Mkts 34.0%	REIT 35.0%	Emerging Mkts 39.4%	MLM Index 13.6%	Emerging Mkts 21.1%
Intermediate Bond 9.0%	Global Bond 22.7%	Small Cap 47.3%	Emerging Mkts 25.6%	Private Equity 27.6%	Emerging Mkts 32.2%	Private Equity 20.4%	1-3 Yr Govt Bond 6.7%	Private Equity 15.1%
1-3 Yr Govt Bond 8.5%	US TIPs 17.0%	Mid Cap 40.1%	Private Equity 25.1%	Timber 19.4%	International Equity 26.3%	Timber 18.4%	Aggregate Bond 5.2%	REIT 14.5%
Aggregate Bond 8.4%	Aggregate Bond 10.3%	International Equity 38.6%	International Equity 20.3%	Commodities 17.5%	Small Cap 18.4%	Long/Short Equity 13.7%	Intermediate Bond 5.1%	NCREIF Timber 14.3%
US TIPs 8.0%	Intermediate Bond 9.8%	REIT 37.1%	Mid Cap 20.2%	International Equity 13.5%	Large Cap 15.8%	Hedge Funds 12.6%	Global Bond 4.4%	Small Cap 14.0%
High Yield 5.3%	1-3 Yr Govt Bond 6.0%	High Yield 29.0%	Small Cap 18.3%	Mid Cap 12.7%	Mid Cap 15.3%	US TIPs 11.6%	3-month T-Bill 2.1%	Mid Cap 13.9%
3-month T-Bill 4.4%	REIT 3.8%	Large Cap 28.7%	Global Bond 12.7%	REIT 12.1%	Long/Short Equity 14.4%	Global Bond 11.3%	US TIPs -1.1%	International Equity 12.9%
Hedge Funds 4.4%	Hedge Funds 3.0%	Private Equity 23.3%	Long/Short Equity 11.6%	Long/Short Equity 9.7%	Hedge Funds 13.9%	International Equity 11.2%	Hedge Funds -19.1%	Large Cap 11.6%
MLM Index 3.6%	Timber 1.9%	Commodities 22.7%	Timber 11.2%	Hedge Funds 7.6%	Timber 13.7%	Commodities 11.1%	Long/Short Equity -19.8%	Hedge Funds 10.0%
Small Cap 2.5%	3-month T-Bill 1.8%	Global Bond 20.2%	High Yield 11.1%	MLM Index 6.3%	Private Equity 13.4%	Intermediate Bond 7.4%	High Yield -26.2%	MLM Index 9.5%
Global Bond -2.6%	High Yield -1.4%	Long/Short Equity 17.3%	Large Cap 10.9%	Large Cap 4.9%	High Yield 11.9%	1-3 Yr Govt Bond 7.1%	Small Cap -33.8%	Global Bond 9.4%
Emerging Markets -2.6%	Long/Short Equity -1.6%	Hedge Funds 15.4%	Hedge Funds 9.6%	Small Cap 4.6%	Global Bond 8.2%	Aggregate Bond 7.0%	Commodities -36.6%	Long/Short Equity 8.6%
Long/Short Equity -3.7%	MLM Index -1.6%	US TIPs 8.3%	US TIPs 8.5%	3-month T-Bill 3.1%	3-month T-Bill 4.9%	Mid Cap 5.6%	Large Cap -37.0%	High Yield 8.1%
Timber -5.3%	Emerging Markets -6.2%	Timber 7.7%	Commodities 7.6%	US TIPs 2.8%	Aggregate Bond 4.3%	Large Cap 5.5%	REIT -37.7%	Aggregate Bond 6.9%
Mid Cap -5.6%	Private Equity -7.8%	Intermediate Bond 4.3%	Aggregate Bond 4.3%	High Yield 2.7%	1-3 Yr Govt Bond 4.1%	3-month T-Bill 5.0%	Mid Cap -41.5%	Commodities 6.3%
Private Equity -11.2%	International Equity -15.9%	Aggregate Bond 4.1%	MLM Index 3.5%	Aggregate Bond 2.4%	Intermediate Bond 4.1%	MLM Index 2.9%	International Equity -43.4%	Intermediate Bond 6.2%
Large Cap -11.9%	Mid Cap -16.2%	MLM Index 3.9%	Intermediate Bond 3.0%	1-3 Yr Govt Bond 1.7%	US TIPs 0.5%	High Yield 1.9%	Emerging Mkts -53.3%	1-3 Yr Govt Bond 6.1%
International Equity -21.4%	Small Cap -20.5%	1-3 Yr Govt Bond 2.0%	3-month T-Bill 1.3%	Intermediate Bond 1.6%	MLM Index 0.4%	Small Cap -1.6%	Private Equity not available	3-month T-Bill 5.3%
Commodities -22.3%	Large Cap -22.1%	3-month T-Bill 1.2%	1-3 Yr Govt Bond 1.1%	Global Bond -8.5%	Commodities -2.7%	REIT -15.7%	Timber not available	US TIPs 5.3%

Merrill Lynch 90-day T-Bill Index	Barclays High Yield Credit Bond Index	S&P 500 Index
Barclays 1-3 Yr Govt Bond Index	NCREIF Timberland Index	Russell Midcap Index
Merrill Lynch US Inflation Protected Securities Index	Merrill Lynch Global Broad Bond (ex US) Index	Russell 2000 Index
Barclays Intermediate Govt/Credit Bond Index	Cambridge Associates Private Equity Index	MSCI EAFE Index
Barclays Aggregate Bond Index	Credit Suisse-Tremont Long/Short Equity Index	MSCI EMF Index
Credit Suisse-Tremont HFI Hedge Fund Index	Dow Jones-AIG Commodity Index	
MLM Commodities Futures Index	NAREIT Equity Index	



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Historical Capital Markets Returns

as of December 31, 2008

	Quarter	6 Months	1 Year	3 Year	5 Year	10 Year
Broad market measures/market sectors:						
S&P 500 Composite Index	-21.9%	-28.5%	-37.0%	-8.4%	-2.2%	-1.4%
Dow Jones Wilshire U.S. 5000 Total Market Index	-22.9%	-29.6%	-37.3%	-8.4%	-1.7%	-0.6%
NASDAQ Composite Index	-24.6%	-31.2%	-40.5%	-10.6%	-4.7%	-3.2%
Mid-sized & small stocks:						
S&P Midcap 400 Index	-26.0%	-34.3%	-37.3%	-10.0%	-1.4%	3.2%
Russell 2000 Index	-26.1%	-26.9%	-33.8%	-8.3%	-0.9%	3.0%
Investment style indices:						
Russell 1000 Growth Index	-22.8%	-32.3%	-38.4%	-9.1%	-3.4%	-4.3%
Russell 1000 Value Index	-22.2%	-26.9%	-36.9%	-8.3%	-0.8%	1.4%
Russell 2000 Growth Index	-27.5%	-32.5%	-38.5%	-9.3%	-2.4%	-0.8%
Russell 2000 Value Index	-24.9%	-21.2%	-28.9%	-7.5%	0.3%	6.1%
Specialty equity:						
Dow Jones Wilshire U.S. REIT Index	-40.0%	-37.1%	-39.2%	-12.0%	0.7%	7.7%
CSFB-Tremont Long/Short Equity Index	-7.5%	-19.4%	-19.8%	1.4%	5.0%	7.9%
Broad fixed income:						
Barclays Aggregate Bond Index	4.6%	4.1%	5.2%	5.5%	4.7%	5.6%
Barclays Govt/Credit Bond Index	6.4%	4.7%	5.7%	5.6%	4.6%	5.6%
Barclays Intermed Govt/Credit Index	4.8%	3.6%	5.1%	5.5%	4.2%	5.4%
Barclays High Yield Bond Index	-17.9%	-25.2%	-26.2%	-5.6%	-0.8%	2.2%
Fixed income sectors:						
Barclays Credit Bond Index	4.0%	-2.6%	-3.1%	2.0%	2.7%	4.9%
International equities (in US Dollars):						
MSCI EAFE Index	-20.0%	-36.4%	-43.4%	-7.4%	1.7%	0.8%
MSCI EMF Index	-27.5%	-47.1%	-53.3%	-4.9%	7.7%	n/a
MSCI Europe Index	-21.3%	-37.3%	-46.8%	-4.5%	2.4%	0.4%
MSCI Pacific Index	-13.9%	-31.2%	-36.4%	-9.1%	1.9%	1.9%
MSCI World ex USA Index	-21.2%	-37.5%	-43.6%	-7.3%	1.9%	1.2%

Returns for periods longer than 12 months are annualized.