FIDUCIARYVEST
Investment Strategies for Fiduciaries

White Paper **January 2009**

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.

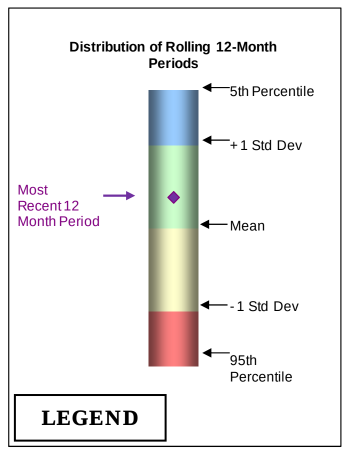
Where do we stand?

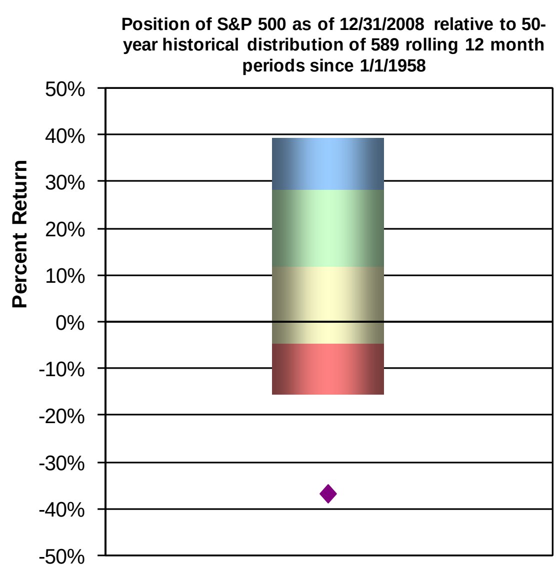
By coincidence, in early 2008, FiduciaryVest had embarked on a year-long project to develop a functional system for assisting clients to include tactical asset allocation techniques in their rebalancing actions, as a substitute for traditional target-rebalancing.

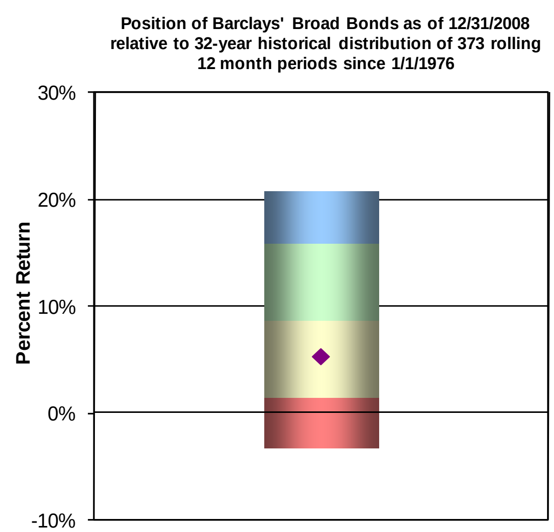
Our newly developed approach to the timing and size of rebalancing (focused primarily on equities) is based on many pieces of input, but the chart below shows one major "driver": the current cyclical positions of two market indexes, compared to their ranges over hundreds of 12-month rolling periods that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

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







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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 rati0. 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.