

# Ponderosa Investment Group LLC

# INVESTMENT LETTER

Second Quarter 2008 • V9

Stocks were sharply lower in June amid renewed concerns that fallout from the housing crisis and credit crunch will drag down the economy.

Meanwhile, inflationary pressures from higher gas and food prices make it more difficult for the Fed to balance the goals of boosting the economy with keeping inflation in check.

Stock valuations are more attractive, but not yet compelling. The return outlook for stocks from current levels is in the mid-to-high single digit range over the next five years. The return expectation for bonds is lower—in the low-to-mid single digit range.

We are getting closer to seeing tactical opportunities in stocks, REITs, and high-yield bonds, and will continue to watch valuations closely.

*The Investment Letter is mailed quarterly to my clients and friends to share some of my more interesting views. Certain material in this work is proprietary to and copyrighted by Litman/Gregory Analytics and is used by Ponderosa Investment Group, LLC with permission. Reproduction or distribution of this material is prohibited and all rights are reserved.*

## Quarterly Investment Commentary

The first half of 2008 dramatically reinforced the idea that over the short term the stock market is *predictably unpredictable*. A sharply negative first quarter was followed by two months of positive returns, but the selloff resumed with a vengeance in June, with large-cap stocks (as measured by the 500 Index) dropping 8.4% for the month and almost 3% in the second quarter. The S&P is now

2008 Index Performance	2 <sup>nd</sup> Qtr.	YTD
Citigroup 3 Month T-bill Index	0.39%	1.11%
Lehman US Aggregate Bond Index	-1.02%	1.13%
M.L. US High Yield Master II Index	1.81%	-1.28%
S&P 500 Index	-2.73%	-11.91%
Russell 2000 Index	0.58%	-9.37%
MSCI EAFE N\$ Index	-2.25%	-10.96%
Dow Jones – AIG Commodity Index	16.08%	27.22%

down 12% for the first half of this year, and is about 18% below its October 2007 high. The market offered few places to hide. Mid- and smaller-cap stocks fared better than large in the second quarter, but still got slammed in June and now have high single-digit losses for the first half of 2008. International stocks (as measured by the MSCI EAFE Index) had a rough month, losing 8% in June and 2.2% in the second quarter. Foreign stocks are now down -11% through the first half. REITs were hit hard, dropping almost 11% for the month, putting them in the red for the first half.

Domestic high-quality bonds were flat in June, and down just over 1% for the second quarter. Though not a good return in a normal environment, bonds nevertheless provided balanced investors with a margin of protection from stock-market losses, which is part of their role.

### What is Driving Stocks Lower Again?

As always happens in an environment of fear, I'm being asked (and asking myself) a lot of questions. What is going on, and how bad could it get? Is there anything I should be doing about it in the portfolios? This environment is in many ways unique and presents its



own set of challenges, which I'll address more specifically in a moment. But more generally, I want to start by saying that I've been through a number of crises, and while each of these periods presented its own particular challenges, one thing that is common to them all is that a sense of accelerating bad news, escalating risk, fear, and panic were almost always present.

The Federal Reserve's unprecedented actions to shore up credit markets a few months back led many to hope that we were past the worst of the financial crisis and that the stock market had hit bottom. But while the Fed's actions may have significantly reduced the risk of a full-scale financial meltdown, the losses from bad loans are continuing to be worse than expected. Meanwhile, the positive feedback loop of soaring home prices and easy credit is now gone, and with it has gone a major source of consumer spending (which of course is a major driver of the economy). Add in the impacts of high levels of household debt (which suggests the need to retrench rather than spend), higher gas and food prices, a weakening labor market, and, by one measure, consumer confidence at a 28-year low, and it seems increasingly likely that consumer spending will continue to deteriorate.

The damaging combination of a slowing economy and higher inflation (the widely feared "stagflation") has also led to questions about the ability of the Fed to support economic growth and employment without stoking fears that it has gone soft on inflation. What it all means is that risks to the economy remain high, and the financial markets are now more fully discounting this risk, which is an unemotional way of describing the battering taken by stocks in recent weeks.

As always, there are positives as well. Outside the financial sector, corporate balance sheets remain generally healthy and earnings have

been okay. One source of strength has been exports, which so far have managed to offset much of the impact of the housing decline on GDP. But this could diminish if our slowing economy means we also export economic weakness to the rest of the globe, and there are signs that this is happening.

### **Making Decisions in an Uncertain Environment**

*"History is merely a list of surprises. It can only prepare us to be surprised yet again." —Kurt Vonnegut*

Though I have experienced market crises before, I also recognize that history never repeats itself exactly, so almost anything can happen from here. One possibility is that things will get worse before they get better in the stock market. Even without a bad recession, fear and pessimism can take hold of investor psychology and send the market down further than what would be justified by long-term economic fundamentals.

In this type of environment, a sense of perspective and a reliance on my investment discipline helps me avoid becoming panicked by short-term concerns and paralyzed by longer-term uncertainty. Like it or not, we are always faced with making decisions in an uncertain world and this will not change. However, my experience in past market cycles and the analysis of the current market environment leads me to two important conclusions.

First, as I've have written in previous commentaries, I do not believe it is time to get more defensive and reduce the equity exposure even more. It is easy to put too much weight on negative scenarios when bad news dominates the daily headlines, but I view stocks as priced to outperform bonds over most five-year scenarios.



Second, big market downturns invariably present opportunities, and without them, I would not have the chance to identify tactical allocations that add value to the portfolios over time. Bubbles lead investors to make errors in judgment and misprice assets on the way up. On the way down, riskier assets often fall to bargain prices when investors are in the grip of fear. My investment discipline (and my focus on what is knowable) can help me identify those asset classes where investor panic has led to excessive undervaluation. Later in this commentary, I note three asset classes (U.S. equities, REITs, and high-yield bonds) that may be headed in this direction that I'm monitoring carefully.

### **Setting Return Expectations**

The annualized return for the S&P 500 over the past 10 years is just under 3% -- more than 70 basis points below that of risk-free Treasury bills! In the decade prior, stocks returned a whopping 18.6%. It would be nice if this history meant that, having come through a decade of above-average returns and a decade of below-average returns, we could now start from scratch and simply expect "average" returns of 10% to 12% a year on equities. Unfortunately, though, the market is forward looking and doesn't care where it's been. As I look forward to the next five years, my general expectation is for a low-return environment overall—for both stocks and bonds. I note, however, that the market's selloff in June has brought equity prices down far enough to make my potential return range on equities higher than it was just a few weeks earlier. Stocks are now priced at levels that are not all that far from the point at which I would tactically overweight U.S. equities in the portfolios (a big day in either direction can change this, but at the end of June we're within 6% to 8% of the trigger point).

Given the late-June level of the S&P 500 as well as a range of scenarios I have considered carefully, I believe the most likely range of annual-

ized returns for large-cap U.S. stocks over the next five years is approximately 5% to 9%, though obviously returns could (and probably will) fall outside that range in some 12-month periods. I base the estimates on a multi-year outlook in order to focus on the factors (fundamentals and valuations) that I believe will drive returns over the next market cycle and to distance ourselves from the day-to-day noise that causes short-term volatility in asset prices.

The return range is based on the S&P 500 level in late June, and at that level the market appears to be in a fair-value range, meaning that I think it is pricing in a reasonable level of economic weakness. But as I wrote in the 1<sup>st</sup> quarter commentary, a further decline in the S&P 500 could make stocks look attractive enough relative to fixed-income alternatives to justify a tactical overweighting. If this occurs, the plan is to increase exposure to large-cap stocks by 5% by purchasing an S&P 500 ETF or index fund. I would fund the overweight from the investment-grade bond and money market allocation.

As always, there are risks attached to any returns-based tactical (fat-pitch) opportunities and one worth mentioning now is the risk that an overweight to equities followed by a continued fall in stock prices could result in the portfolios violating their 12-month loss thresholds. As mentioned earlier, I would not be surprised if the stock market gets worse before it gets better, and though I believe I can identify a level at which stocks are attractive from a long-term perspective, it's highly unlikely I'll be buying stocks right at the bottom.

A decision to overweight stocks would become more complicated if we see additional asset classes also become attractive; REITs and high-yield bonds are two timely examples.



### **Where Does That Leave Us?**

Barring a further selloff in U.S. stocks that makes potential returns look better, single-digit returns for stocks are not very exciting. And bonds don't look very exciting either. Given the current investment-grade bond index yield and current interest rate levels, I see potential bond returns only in the 3% to 5% range, which reflects some ratcheting down of bond prices over the next five years as interest rates move higher.

Given my expectation that stock and bond returns will fall in the low-to-mid single digits, it follows that potential returns for the neutral portfolio allocations will be limited. But I also hope that my ability to identify tactical opportunities will allow me to improve the potential returns. Indeed, I have recently devoted time to intensifying research on REITs and high-yield bonds, two asset classes that are down meaningfully from their highs and that may offer higher return potential in the years ahead.

### **The Road Ahead**

Despite my expectations for a challenging, lower-return environment, I believe value can be added from both of the tactical asset allocation and manager selection decisions. And I believe that in aggregate, the actively managed funds that I use will beat their benchmarks over the long term. Many of the fund managers I respect most say they are buying shares of high-quality companies at bargain-basement prices. Consequently, even though the overall market does not look compelling to me from a top-down valuation perspective, the current economic and market turmoil appears to be creating significant return opportunities at the bottom-up individual stock level. Indeed, it is often when the overall trend is negative that disciplined investors can build a portfolio for long-term out-performance by carefully taking advantage of the opportunities created by these dislocations. It requires patience and the ability to weight

long-term analysis above short-term fear, but it is what distinguishes successful investors.

I appreciate your confidence and trust.

Best Regards,

Jim Cheadle  
Ponderosa Investment Group, LLC

### **Contact Information**

4888 NW Bethany Blvd. Suite K5, #154  
Portland, OR 97229

Phone # (503) 286-0005

Fax# (503) 286-1050

Cell # (971) 227-0097

E-mail [jcheadle@ponderosaig.com](mailto:jcheadle@ponderosaig.com)



## **Footnote Disclosure**

This newsletter is limited to the dissemination of general information pertaining to Ponderosa Investment Group, LLC. Past performance is no indication or guarantee of future results. The data and information in these materials is provided for informational purposes only and should not be used or construed as a recommendation or solicitation to buy or sell any security or fund. All data provided by Ponderosa Investment Group, LLC is based solely upon research and information provided by third parties. Index performance or any index related data is given for illustrative purposes only and is not indicative of the performance of any portfolio. Note that an investment cannot be made directly in an index. Individual client needs, asset allocations, and investment strategies differ based on a variety of factors. Any reference to market indices is included for illustrative purposes only, as an index is not a security in which an investment can be made. Index returns shown are total returns which include both security price movement and reinvested dividends. Index returns shown over a 12-month period are annualized. Citigroup 3-Month Treasury Bill Index is an unmanaged index representing monthly return equivalents of the yield averages of the last 3 month U.S. Treasury Bill issues. Barclays U.S. Aggregate Bond Index is a broad-based bond benchmark that represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for the government and corporate securities, mortgage pass-through securities, and asset-backed securities. This is an unmanaged bond index and it is not possible to invest directly into. BofA Merrill Lynch U.S. High Yield Master II Index tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market. Qualifying bonds must have at least one year remaining term to maturity, a fixed coupon schedule and a minimum amount outstanding of USD 100 million. Bonds must be rated below investment grade based on a composite of Moody's and S&P. S&P 500 Index is an unmanaged market index generally considered representative of the stock market as a whole. The index focuses on the large -cap segment of the U.S. equities market. Russell 2000 Index is an unmanaged group of stocks considered to be a representative of the small-cap segment of the U.S. equity universe. MSCI EAFE Index is an unmanaged equity index which captures large and mid-cap representation across Developed Markets countries in Europe, Australia, and the Far East represented in U.S. Dollars. It is a market-capitalization weighted index of 21 non-US, industrialized countries. Dow Jones -UBS Commodity Index is an unmanaged broadly diversified index that allows investors to track commodity futures through a single measure. It is composed of future contracts on physical commodities. The index is designed to minimize concentration in any one commodity or sector. It currently has 19 commodity futures in seven sectors.

