

This summary reflects our views as of 12/09/08 (S&P 500 at 889)

Asset Class Review: U.S. Equities

Executive Summary

- The stock market has been very volatile in recent months, with large percentage swings reversing themselves from week to week, and sometimes day to day.
- From its peak, the S&P 500 is down over 40% as of this writing, and trailing 10-year returns have been abysmal, failing even to keep pace with inflation.
- The financial crisis that began with subprime mortgages has spread and is now impacting the entire financial system. This has led to massive deleveraging across Wall Street and Main Street.
- Earnings have declined from their peak, and are now well below their long-term trend line, which mitigates some of the risk of a large and sustained decline going forward. However, it is likely that earnings will go lower before they recover. We cannot know the timing or magnitude of the eventual bounce-back, but we do believe a recovery of some sort will begin within the next couple of years.
- The government has taken steps to address the crisis, and it's possible the worst of it is now behind us. However, macro-level risks remain. Continued weakness in housing, further write-down of bad credit- and asset-backed securities and derivatives, and the general reluctance of lenders to make loans (or provide credit) are obvious concerns. Other risks include rising commodity prices, excessive monetary liquidity, a run on the dollar, increased liabilities from entitlement programs, higher taxes, and increased regulation. Some of these factors could lead to inflationary pressures and higher interest rates in the next cycle.
- Based on our scenario analysis for future earnings and multiples, potential five-year returns even in a very bearish environment are likely to be the mid- to upper-single-digits, and are very likely to beat investment-grade bonds. Looking out 10 years, we think equity returns have a good chance of being in line with long-term averages.
- We currently favor large-caps over small-caps. Growth looks more attractive than value from a valuation standpoint, but not enough to meet our criteria for a tactical overweighting.

Valuation Rating

3

1 is extremely undervalued,
5 is extremely overvalued

Recent Performance

Performance Survey as of 11/30/08							
	S&P 500	Russell 1000	Russell 1000 Growth	Russell 1000 Value	Russell 2000	Russell 2000 Growth	Russell 2000 Value
YTD	-37.7%	-38.6%	-39.5%	-37.7%	-37.4%	-41.7%	-33.0%
3 Month	-29.6%	-31.0%	-32.9%	-28.9%	-35.7%	-39.0%	-32.6%
1 Year	-38.1%	-39.0%	-39.7%	-38.3%	-37.5%	-41.3%	-33.6%
3 Year	-8.7%	-9.1%	-9.7%	-8.6%	-10.1%	-10.9%	-9.5%
5 Year	-1.4%	-1.4%	-3.1%	0.1%	-1.6%	-3.3%	-0.2%
10 Year	-0.9%	-0.6%	-3.6%	1.6%	3.1%	-0.4%	5.8%

Key Factors

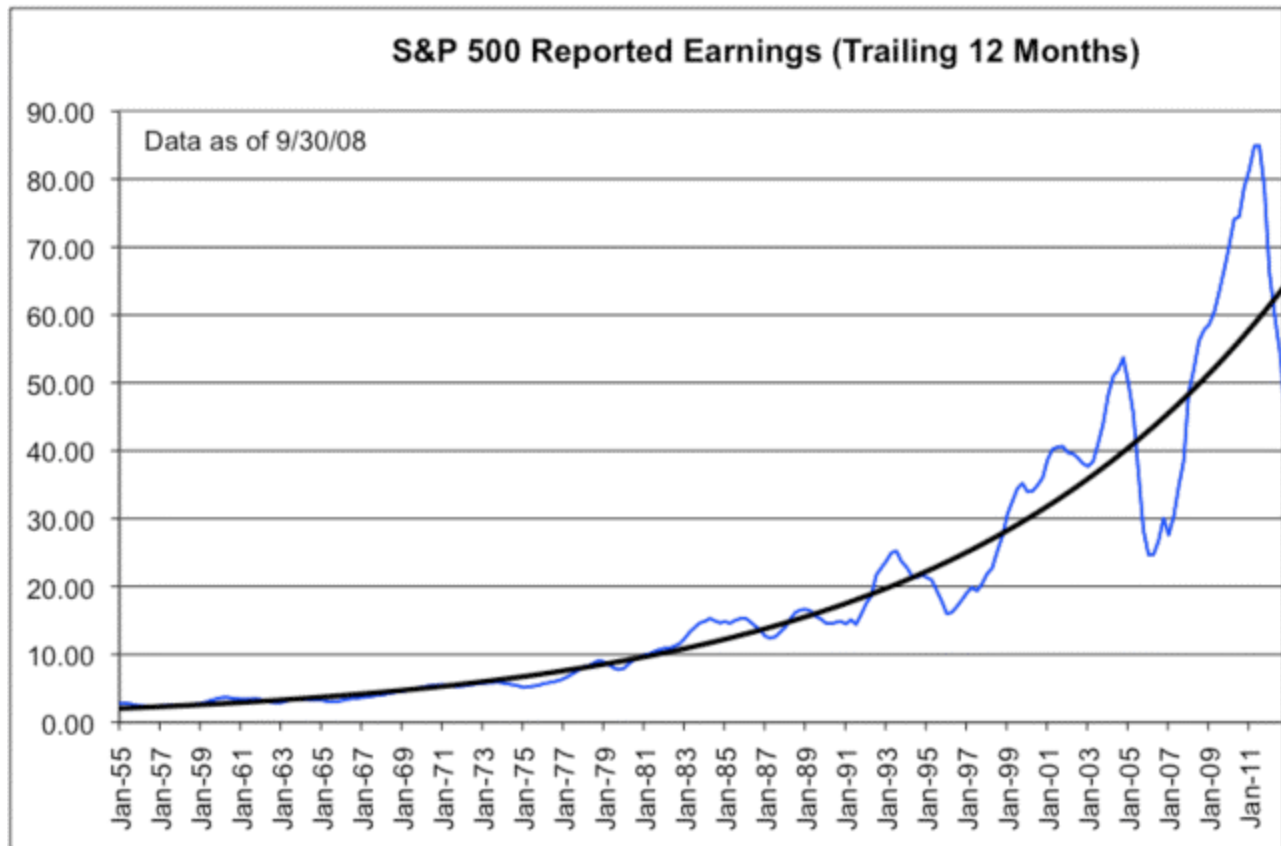
Economy and Profits: Longer-term, the economy and profits are the key drivers of stock performance. The data in these areas have been poor recently. Reported profits for the S&P 500 began declining on a sequential basis in the third quarter of 2007, turning sharply lower in the fourth quarter, and a quick recovery is unlikely. At present, reported earnings are almost 30% below their long-term trend growth rate, which means that mean reversion no longer poses the same risk it did a year ago. In prior cycles, earnings have bottomed out at between 20% and 40% below trend, with the swings becoming progressively wider as corporate American has steadily increased its financial leverage. Our assumption is that earnings will go lower before they start to recover, and we would not be surprised if the ultimate bottom for earnings is in line with or lower than the last trough in 2002, where earnings touched 42% below trend before rebounding. Furthermore, as we are in the midst of a massive systemic deleveraging, we think it is unlikely that earnings will rebound as strongly as in past cycles, when leverage contributed significantly during the recovery phase.

The economy continues to face some significant risks and headwinds: the credit crunch is less bad than it was at its peak, but banks (and other financial institutions) are clearly concerned about their capital levels, and lending conditions are still very tight, which puts downward pressure on growth. The counter-party risks associated with credit default swaps (CDSs) raise questions about bankruptcy contagion risk. And in terms of general cyclical considerations, rising unemployment and reduced consumer spending are likely to reduce aggregate demand.

The government is keenly aware of these risks, with close to \$1 trillion in bailouts and other government guarantees, policymakers appear prepared to do whatever they can to get the system back on track. The potential downsides to this government intervention include a ballooning federal debt, tax increases (both for corporations and individuals), and regulatory changes that

generally favor workers over employers and shareholders and/or impose additional operating costs on firms (e.g., Sarbanes-Oxley).

We must reiterate that accurate financial forecasting is challenging, and we are careful about how much weight we give these kinds of data.



Interest Rates: Interest rates are an important component of stock valuations primarily because they are part of the discount rate used to measure the present value of future earnings and also because they impact businesses' cost of capital. In terms of Treasuries, however, a very low interest-rate environment is usually associated with a weakening economy, which is not usually favorable for equities. Given the poor state of the economy, it is possible that the current low level of interest rates will be with us for a while, although we do not think they are likely to drop significantly from current levels. Over the longer term, into the next economic cycle, higher inflation and interest rates than we've seen in this cycle are a risk, and this is something we will be keeping a close eye on.

Because the Treasury market has some unique dynamics, interest rates on corporate bonds are another metric to consider when assessing how interest rates affect stocks. Low rates combined with low spreads versus Treasuries (the latter indicating decreased concern about the economy) would typically be bullish for stocks, whereas high rates or spreads reflect bearishness. Right now, both investment-grade corporate and high-yield bond spreads are far above average, which reflects bond investors' concerns about the economy and tight credit conditions.

Supply and Demand:

- Cash on the sidelines (as defined by total money market fund assets) as a percent of stock market value had been climbing sharply over the past year and a half, and at almost 33%, cash levels are at all-time highs. (Cash reached 23% in 1982, and nearly 30% at its all-time high in early 2003.) At current yields, cash is unlikely to offer a compelling long-term substitute for stocks, and this cash represents significant buying power.
- Foreign flows into U.S. stocks have recently shown some signs of weakness. Foreigners were generally net sellers over the summer, and while September showed fairly strong inflows (perhaps due to a surge in the dollar that began in July), October data—where the market was at its worst—was not available as of this writing. Foreign demand is a potentially unreliable source of flows (a declining U.S. dollar makes our investments look less appealing to foreigners, and visa versa) and could negatively impact interest rates and stock prices if it slows materially. However, a source of potential longer-term foreign support for U.S. equity prices that is hard to quantify is the growth in sovereign wealth funds (SWFs). These are state-run investment funds that invest a portion of a country's currency reserves. Those countries with excess reserves to invest in this way include China and other developing countries with positive trade balances, as well as many of the oil-exporting countries. It is estimated that the SWFs are worth as much as \$3 trillion and are growing rapidly. Their objective is generally to capture higher returns than those offered by government securities (such as U.S. Treasury bonds), which means investing in areas like private and public equities and real estate.
- Private leveraged buyout funds have raised an enormous amount of money. According to a recent article in *The Economist*, private equity firms still have around \$450 billion of capital that has been raised, but has not yet been spent. With the typical levels of leverage (i.e., debt) employed by buyout funds, this could result in significant buying power once the credit markets normalize. In the short run, the deleveraging of hedge funds has led to forced selling, putting downward pressure on stock prices in certain parts of the market.
- Flows into domestic equity mutual funds have been in a negative downward trend for the past couple of years, and have been mostly in the red for the past year and a half. Not surprisingly, this coincides with strong positive flows into bond and money market mutual funds. Outflows are a negative for stock prices as they decrease demand. Negative flows can also be a sign that investors' risk tolerance is declining. However, flows also often reflect the lagged effect of investors chasing performance, and to this extent the metric is of less value.

Strength/Weakness of the U.S. Dollar: Until recently, the dollar had been in decline for the better part of six years. This had the effect of making U.S. exports less expensive to foreign buyers, and as such can be positive for earnings, particularly for companies that are more export-oriented. However, a weakening currency can have a negative impact on the financial markets in that it hurts the performance of foreign investors. If this results in foreigners pulling money out of the U.S. markets, it can cause a decline in stock prices and a rise in interest rates.

Fiscal Policy/Political Factors: Presently there are several potential risks. The federal budget deficit has skyrocketed thanks to a number of factors, including the recent financial bailout, but also including the ongoing operations in the Middle East and a general increase in government

spending. Declining tax revenues from a weak economy will exacerbate this issue. Growing entitlement programs such as Social Security and Medicare pose longer-term problems. At some point, higher taxes are likely to be necessary, and government borrowing could cause interest rates to rise. Beyond the deficit, policy responses the financial crisis could lead to increased regulation (Sarbanes-Oxley being an example from a couple years ago), which may or may not prove effective. The probability and magnitude of these risks vary, but each can have an adverse impact on the equity markets: Higher taxes can hurt corporate earnings (via reduced consumer spending, and higher corporate tax rates), sub-optimal government spending diverts resources away from the private sector into areas with less economic value, and overly restrictive regulation imposes additional costs on businesses. (Please note: We are only speaking of the economics of these issues, and are not making judgments about their social value.)

Valuations and Potential Returns

There are many ways to assess the attractiveness of an asset class. For many years we relied on valuation-based metrics, and have since migrated towards forward-looking scenarios and potential return analysis. We still consider the traditional valuation methodologies—various earnings-discount models, comparing current P/Es to historical P/Es, and so forth—but the limitations and short-comings of these approaches can be limiting, whereas the forward-looking scenario analysis helps us better understand what the market is—and is not—pricing in.

Potential Returns Analysis: Essentially this approach involves looking at a range of potential earnings and P/E multiple scenarios, which are then used to give us a price target for the S&P 500 five years hence. By comparing those price targets to the S&P's current price (and adding in dividends), we arrive at a range of potential returns. We do not pencil out extreme outlier scenarios, since this would result in ranges that are so wide as to be useless, but we do consider very unusual environments as long as they are within the bounds of historical precedent, both bullish and bearish. If it looks like stocks could produce good returns even in a bearish scenario, that tells us that the market is probably attractively priced. Conversely, if a very bullish scenario is required in order to justify current prices, that suggests the market might be expensive.

Although the typical time frame for our analysis is five years, the massive deleveraging and changes to the financial system make even a five-year analysis seem potentially short. Looking out 10 years, assuming that earnings return to their trend level (we think this is quite reasonable), and applying an average or even slightly below average P/E multiple, we think equity returns have a good chance of being in line with long-term averages.

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