

## NAVIGATING TROUBLED WATERS

Tough times have gotten tougher. Despite hopes initially raised by the inauguration of a new President, the passage of a new stimulus package, and the adoption of a new bail-out program, the harsh reality of today's downwardly spiraling economy has weighed heavily on the financial markets. The fourth quarter of 2008, which included an amazing ten days of 5% or greater declines in the S&P 500, has given way to the first quarter with its steady stream of more modest, but nonetheless persistent declines—a kind of Chinese water torture in stocks. Even the recent rally has done little to improve investor sentiment.

As stocks reached new lows for much of the quarter, fear seemed to reach new highs almost daily. It's little wonder, then, that U.S. Treasury securities and perhaps gold have been the asset classes in greatest demand. As a result of the flight to quality and the Federal Reserve's bold moves in mid-March, the interest rate on Treasuries remains exceptionally low despite the looming prospect of inflation, which is the likely outcome of the stimulus program and huge federal deficits totaling 10-15 % of GDP that will ultimately have to be brought under control. At this point, a little inflation would be a welcome sign that demand has picked up, but the slack economy has so far kept consumer prices depressed.

In our view, restoring the health of the financial system and availability of credit is the element most critical to an eventual turn in the cycle, and on that front there are some encouraging signs. Notably, since early December, the corporate bond market has functioned effectively as a means of raising capital. The yield spread on investment grade corporate debt (i.e., the difference between the interest rate paid by quality corporate issuers and that paid by the Treasury) has receded somewhat from the extraordinarily high levels of well over six percentage points that they reached late last year, and new issues are being met with open arms by institutional and private buyers. As a result, new investment grade bond financings are coming to market at a healthy clip—\$285 billion in the three months ended February compared to \$168 billion in the previous *six* months. Corporate treasurers see the low absolute level of rates as an attractive opportunity to finance, and investors see the spread to Treasuries as a compelling risk premium. In the municipal market, financings were slower to materialize, in part because of the uncertainty about potential state budget deficits prior to the passage of the federal stimulus package that included significant aid to states. Now that the picture is a bit clearer, we are seeing a pick-up in municipal financings, and prices have rallied from their November lows, indicating that the credit markets are thawing.

### *False Positives?*

Other, albeit tentative, signs of improvement are evident. The money supply is rapidly expanding, thanks to the Federal Reserve's aggressive policy easing. Applications for both new mortgages and re-financings are rising, and existing home sales are increasing. February housing starts were up 22% from January's low and far above consensus expectations. Real hourly earnings have been gaining ground since November, so the 92% of the work force who are employed are seeing upticks in pay. Retail sales (*including* autos) were up 1.8% in January, and were off only 0.1% in February. Finally, the Conference Board's index of leading indicators appears to have flattened out in the last three months. Maybe these and other indicators are giving a false positive signal—or perhaps they are a sign that the bottom is near. Only time will tell.

Still, most indicators are decidedly negative at this point. Single family housing permits and starts are near their lowest point since the data began being compiled in the late 1950s. Automobile sales in January were near their slowest levels since the 1960s. Strapped for credit, lacking in confidence, and—in a growing number of instances—looking for jobs, consumers have cut their spending and increased their savings. In turn, this drop in demand has put pressure on manufacturing, which is experiencing the lowest level of capacity utilization in years—and laying off workers as a result. Until credit begins to flow and the stimulus program gains traction, it's unlikely that the vicious cycle can be broken. Needless to say, between stocks and real estate, the wealth destruction has been horrific—about \$11 trillion in 2008 alone, or well over a year's disposable income. No wonder consumers are curtailing their spending!

The recession, now in its sixteenth month, is already 60% longer than the average downturn of ten months since World War II, with little prospect for recovery before at least another six months go by. Adding to the pain for investors is an alarming increase in the exposure of fraudulent behavior, which has served to further erode confidence. As if the Bernie Madoff scandal weren't enough, Stanford Financial and a series of other, smaller firms have allegedly committed fraud, causing investors

justifiably to ask why the SEC has been so lax in uncovering these scams. Many are questioning where their money can truly be safe.

The search for safety has resulted in massive flows from equities and other risky assets into cash and quality bonds. Much of the money has gone into Treasury securities. According to Merrill Lynch, U.S. individuals have increased their holdings of Treasuries substantially. (In fact, Merrill recently forecast that the proportion of household financial assets in U.S. bonds will increase ten-fold from 0.2% now to 2.0% in 2013, reflecting a higher savings rate and helping to fund the U.S. deficit.) Interestingly, despite the move into fixed income, yield spreads remain way above historical levels. Put another way, the normal asymmetrical relationship between return and risk in bonds (i.e., investors receive a relatively small reward if all goes well but take on significant downside risk if an issuer defaults), is now more symmetrical. Thus, the bond market reflects a high level of risk aversion and appears to foretell a period of extraordinarily high default rates over the next couple of years—in other words, the continuation of a severe recession.

### ***Profit Outlook***

Just as bond spreads portend a rise in defaults, stocks reflect a bleak outlook for corporate profits. Having declined over 50% from their highs through the end of February and having reached lows last seen in 1996, the major indices appear to discount a drop of at least 50% in earnings. Yet forecasting profits in this environment is hazardous at best. Despite huge asset write-offs in the financial sector over the last year, it's anyone's guess how much more is still to come. In almost all other sectors, the rate of economic contraction is causing revenues to slow and margins to narrow, and we read about downwardly revised estimates daily. Over just the last six months, 2009 earnings estimates for the Standard & Poor's 500 Index have collapsed from a range of \$80-90 per share to more like \$50-60. Using a figure of \$55, the price/earnings ratio for the index would be about 14x, 10% or so below its long-term average. By this measure, the index doesn't look overly "cheap." On the other hand, P/E ratios are often distorted at low points in the cycle. If profits were to recover to, say, \$80 sometime in the next three years (still well below historical highs), the P/E ratio would be a much more reasonable 9-10x. Another interesting view of today's valuations was offered by Professor Jeremy Siegel of the Wharton School in a recent *Wall Street Journal* article. He argues that, if earnings for the S&P were weighted by the market value of the companies reporting them, which is the way S&P calculates the price movement of its index, profits per share would be 80% higher than the reported figure for 2008. Instead, S&P calculates earnings on an un-weighted basis, so a large loss by Citigroup (which now has a very low market value) offsets a profit of the same amount by Exxon (the largest stock by market capitalization).

The critical question, in our view, is what level profits will reach as the economy eventually climbs out of its doldrums. On that score, we expect it will take considerable time to rectify the excesses of easy money, unlimited leverage, and free spending. It seems highly unlikely that either financial intermediaries or consumers will re-gain nearly the leverage they attained when the cycle peaked over a year ago. In the new environment, of course, institutions will be more tightly regulated in order to prevent a recurrence of the financial meltdown we've just experienced. Those institutions, in turn, will be more disciplined in their lending practices. Even without such restraint, we suspect that consumers will, at least for a time, be sobered by the long recession and less willing to take on burdensome debt. Already, we've seen the savings rate move from virtually zero in the second half of 2007 to roughly 4% in the most recent period. While lower leverage and an uptick in savings are definite positives for the stability of the economy and our ability to fund more of our own federal deficit, they will serve as a kind of brake on the recovery. Therefore, the recovery in earnings is likely to be saucer-like rather than V-shaped.

**Personal Savings Rate – United States, 1979 - 2009**



## *Having a Plan*

In light of the foregoing, it's fair to say that uncertainty prevails. Indeed, it's probably at an all-time high. In such an environment, we believe that it's vitally important to have a plan. By that, we're not suggesting that clients stick resolutely to a road-map created long ago under radically different circumstances. In fact, since most people's view of risk has changed considerably in recent months, this is an excellent time to revisit one's strategic asset allocation to make sure that it still applies. Having a clearly defined plan helps to minimize the emotional content of investment decisions at a time when emotions are running high.

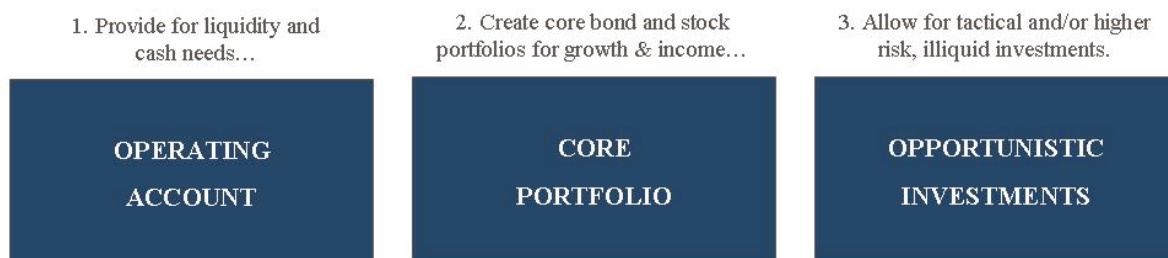
Most approaches to asset allocation begin with an assessment of one's return objectives, needs for cash flow, and tolerance for risk. Then, various asset classes are combined into a hypothetical portfolio, taking into account the historical and/or projected returns of the different asset classes together with the variability, or risk, of those returns and the degree to which they are correlated (e.g., how similarly the returns of municipal bonds track those of U.S. stocks over time, etc.). Simulations of the hypothetical portfolio's performance, volatility, etc. are run in order to see how it could be expected to behave over time, and then adjustments are made to come up with the mix of assets best suited for a particular client's objectives.

This approach to planning may be all right as far as it goes, but it has significant limitations and accordingly we've moved beyond it. Most importantly, it does a poor job of protecting against a severe and protracted downturn of the type we have experienced lately, when nearly all asset classes collapsed in unison. The theory that diversification can insulate a portfolio against exceptional volatility (a theory that essentially went out the window last year) encouraged many investors to be fully invested, keeping relatively low levels of cash on hand and being under-invested in quality fixed income. As a result, some have been forced to liquidate assets at severely depressed prices in order to meet their needs for cash.

Another deficiency of the conventional approach is that it tends not to differentiate adequately between high-risk and low-risk assets, at least in terms of how it is communicated. Since all asset classes are grouped into the same "pie chart," it's easy to lose sight of the concept of risk and how it applies to your particular portfolio. Further, liquidity constraints aren't explicitly highlighted.

For these reasons, we prefer to think of assets as falling into three groups, or "buckets," for purposes of asset allocation, as illustrated in the accompanying chart. The buckets are simply intended as a way to conceptualize various parts of the portfolio rather than as actual accounts, although some may prefer to maintain separate accounts for certain types of assets. On the left, the "operating account" is meant to contain highly liquid assets that are available to meet spending requirements and the need, where applicable, for a "rainy day fund" or other significant source of cash. The amount in this pool varies, depending on the normal need for cash flow and the amount of cash thrown off by the rest of the portfolio, but it might be between one and two years of cash needs. Typically the assets are invested in money market funds or other very short-term, low-risk credit instruments.

### **Asset Allocation: A Logical Approach**



The other two buckets consist of assets with potentially greater returns and typically longer holding periods, and their composition will vary greatly depending on the portfolio's objectives and how the client views certain asset classes—as "core" or "opportunistic." For most clients, the core portfolio is invested in a combination of stocks, emphasizing U.S. equities, and quality bonds. Viewed as a strategic investment positioning, the core portfolio is intended to be left largely intact except for periodic re-balancing to maintain a consistent exposure to each asset class selected. The opportunistic bucket holds investments that have greater perceived return potential, in some cases for short periods of time, and are more likely to be varied.

Where this approach becomes particularly interesting is in how it applies to an individual client. For instance, some may see international stocks as a part of their core portfolio while others may see them as opportunistic--something to be moved in and out of the portfolio depending on one's view of currency movements or the state of foreign economies relative to the U.S. Similarly, hedge funds, private equity or high yield bonds might be considered by some as core and others as opportunistic. In addition, part of the opportunistic portfolio may be allocated to cash, awaiting an appropriate investment or the right moment to put the cash to work, as distinguished from cash in the "operating account" held for liquidity purposes. *The point is that grouping assets into distinct pools is helpful in causing an investor to think through the role of each part of the portfolio so that its purpose is really clear.*

None of this is to say that building portfolios in this way would have fully insulated one against the onslaught of the bear market, but we do think it helps to conceptualize one's investments more effectively than the conventional model. Looking ahead, most investors are caught between the desire to protect capital while re-building it over time, and we believe our approach helps rationalize the ways in which different parts of the portfolio can accomplish these objectives.

### ***New Colleagues***

We're very pleased to welcome our new colleagues from Winslow Management Company, which became part of Brown Advisory on March 31. Winslow, founded in 1983, is the leading investment firm focused on green technology, an area that we believe has increasing appeal and a very bright future driven by technological innovation and regulatory change. It's clear to us that, in an era of climate change, continued population growth and resultant resource scarcity, huge public and private resources will be devoted to conserving energy and finding new and cleaner, more efficient sources. Having the knowledge to identify the most promising investment opportunities, as well as to avoid the pitfalls, will provide a key competitive advantage and, most importantly, serve our clients well.

Winslow's investment professionals adhere to the simple philosophy that investors can achieve significant growth over the long term by investing in companies that are contributing to cleaner environments. Its portfolio managers, supported by a strong team of analysts, have over 20 years of green investing experience and maintain a deep understanding of the technologies and investment trends driving the green business revolution.

Our two firms have enjoyed a working relationship for more than a decade. In fact, Jack Robinson, Winslow's founder and Chief Investment Officer, was featured at a client conference that we sponsored in Baltimore exactly a year ago. Brown Advisory and Winslow share similar cultures and values, including a resolute commitment to independence, the free exchange of ideas, and a research-based investment process. Winslow's mission, its services, its investment team, and its Boston location will remain the same as it continues to build its business.

William L. Paternotte, CFA

*Note: Brown Advisory launched its new web site, [www.brownadvisory.com](http://www.brownadvisory.com), on March 16. We encourage our clients and friends to visit us there.*

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