

# THE PRIVATE WEALTH ADVISOR

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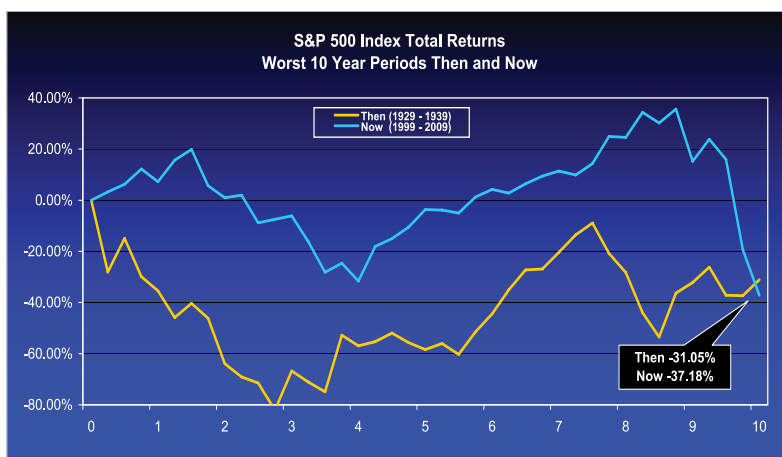
*Light at the end of the tunnel?*

A photograph of a dark tunnel with a road leading to a bright opening at the end, symbolizing hope or a solution. The road has a double yellow line down the center. The tunnel walls are rough and textured. The light at the end is bright and illuminates the road ahead.

by John M. Schneider, CFP<sup>®</sup>, President

• Worst Market Ever

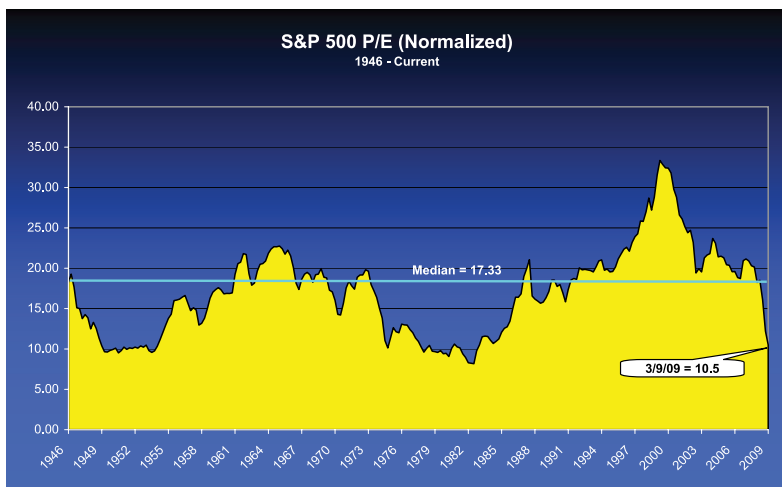
Throughout this downturn there has been much talk of things deteriorating into depression like conditions. While some have been busy speculating on the future, something key has gone overlooked and under emphasized. The past ten years (March 1999 through March 2009) look to be the worst ten years in market history. The combination of the bursting of the technology bubble and the current liquidity crisis put the ten year return of the S&P 500 Total Return Index at -37.18%. The downturn from 1929 through 1939 produced a total loss of -31.05%. This ten year number could get even worse as we move toward March of 2010, which will close the ten year period from the top of the market in 2000. The return from that point through March 9, 2009 was -48.04%. The market will need to deliver positive returns in the next 12 months in order to improve on this dismal number. While there is still uncertainty ahead, it is clear that equity investors have already suffered through events in the market that may have actually been worse than the Great Depression.



Source: Leuthold Group Inc.; Morningstar Inc.

• Cheapest Market in 25 Years

The continued market pullback in early March sent the normalized S&P 500 P/E ratio below 11 times earnings for the first time since the summer of 1984. In other words, the values of early March were as cheap as the stock market has been in twenty five years. The S&P 500 normalized P/E ratio actually dipped down to 10.5 by March 9, 2009, putting the reading among the lowest 10% of all weekly numbers since 1940. There is a silver lining to these dismal returns and sinking valuations. Subsequent ten year periods following ten year periods where the market returns were negative actually look very good. The average return in those periods has been 170%. The worst ten year period returned 101%. History is only a guide, but, given the very attractive market valuations, there is reason to have confidence in the stock market in coming years.



Source: The Leuthold Group, Inc.

• Now What?

*Given the dismal market we have just endured and the very compelling valuations it has provided, we believe the market lows set on March 9, 2009 will be the bottom of the market. The following information leads us to this conclusion:*

- Stock market valuations, near a P/E ratio of 10, are at levels last seen in the early 1980s. This represents a 40% discount to the historic median.
- Interest rates are low, which allows the troubled banks to take advantage of the spread on the money they lend versus the money they borrow. Good news from Citigroup, Bank of America and Wells Fargo in the spring is positive.
- Government intervention through stimulus will allow for a faster recovery.
- Each time the market has bottomed (October, November, March) fewer stocks have reached their 52 week low. This is a bullish signal.
- The 3 week market upturn starting on March 9, 2009 was among the largest 3 week rallies in stock market history. The breadth of the rally was a positive sign for the equity markets.
- Money being pulled from stocks in the early 2009 downturn was largely on the retail side of the market. Institutions used the pullback as an opportunity to add to equities at depressed prices. Again, a bullish signal.

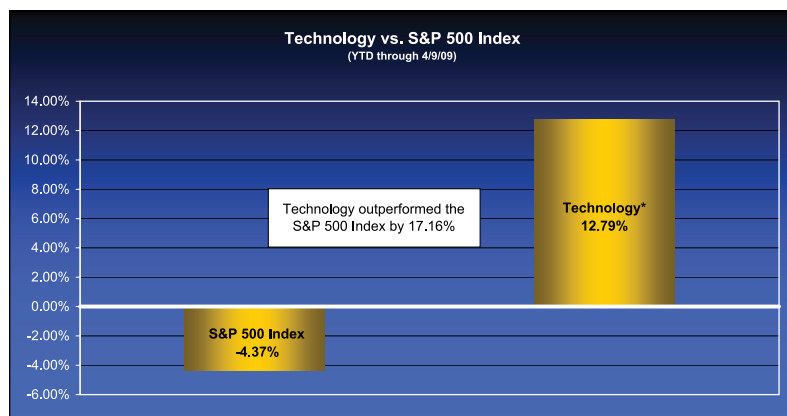
Although we believe the bottom has been set, we still need to be prepared for the unexpected. For our clients, we have set aside cash to satisfy needs for approximately 12 months. Beyond that, fixed income holdings are maintained to address the next several years of cash needs. Thus, on the stock side of portfolios, we can focus on maximizing the upside as the market recovers. This entails a shift from defensive names toward cyclical sectors of the market.

The cyclical sectors present options such as technology, industrials consumer discretionary, energy, materials and the downtrodden financials. We believe technology stocks are the best option for several reasons.

First, earnings in the technology sector have held up well over the last three years, turning only slightly negative. A more capital intensive sector like industrials, on the other hand, has double digit negative growth during that time. The resiliency of technology earnings has allowed for positive cash flow, and many companies have stockpiled cash. Cisco has 28% of its market capitalization in cash. Oracle, Intel and Microsoft each have more than 10%. This cash is available for share buybacks, acquisitions or can be paid to investors through dividends. In other words, the large technology companies have flexibility that companies in other cyclical industries wish they had.

These stocks also look very attractive on a valuation basis. Looking at the last 15 years (excluding the tech bubble), technology stocks have traded at a 30% - 40% premium to the S&P 500 Index. Today, the premium is just 20%. These companies also have global business. Many of the top tech companies derive more than half their revenue from outside the United States. This allows them to tap into fertile, growing markets around the world.

How has our technology thesis worked thus far in 2009? Referring to the chart below, you will see that the S&P 500 Technology sector is positive by nearly 13%. In the same period, the broad S&P 500 Index has lost 4.37%. Technology is working in 2009. We expect this trend to continue as investors look for well positioned, attractively valued companies which can actively participate as the market recovers.



Source: Morningstar. \* The S&P 500 Technology sector was used as the proxy to measure the total return of technology for comparison purposes.

# ASSET ALLOCATION – CURRENT MARKET SUMMARY

## ● Growth vs. Value

Through March 20, 2009 large growth stocks led large value stocks by 12.57%. Comparatively, both large growth and large value have had poor years thus far. Large growth stocks have fallen nearly 8%, while large value stocks have dropped more than 20%. Large growth stocks currently trade at 1.94 times the P/E ratio of large value stocks. Historically, they have traded at 2.43 times the P/E of large value stocks, making large growth stocks approximately 20% undervalued versus large value stocks. Lower market capitalizations have continued to surprise. Small growth stocks are 9.1% ahead of small value stocks year-to-date. Currently, small growth stocks are no longer more attractive than small value stocks based on valuations. In fact, small value stocks are now boasting more desirable valuations.

## ● Large vs. Small/Mid

Small cap stocks have continued their struggle into 2009. Through March 20, 2009, large U.S. stocks have outperformed small U.S. stocks by 5%. Based on historic relative valuations, small cap stocks currently trade at a 2.1% premium to large caps. The premium puts the asset class approximately 19% above their fair valuation versus large cap stocks over the past 35 years. Continued uncertainty regarding the U.S. economy and lack of valuation discount makes small cap stocks appear unattractive at this time.

## ● U.S. Equity vs. International Equity

The discount for developed international stocks versus large U.S. stocks has continued to expand in the first quarter of 2009. The MSCI® Index is about even with U.S. stocks through March 20, 2009. Large international stocks are presently 14% undervalued based on their historic comparison with large U.S. stocks. European stocks have continued to underperform Pacific stocks in 2009, down nearly 15%. In comparison, Pacific stocks have not fared much better falling more than 13%. Despite poor performance, European stocks remain overvalued compared to Pacific stocks. Emerging markets were hit hard in 2008. However, the asset class surged in March and was only down approximately 2% by March 20, 2009. The drop in emerging market stock prices has pulled their valuations down drastically. Emerging markets stocks look fairly valued against U.S. large cap stocks, but they are attractive when compared to developed international stocks.

## ● High-Yield vs. Treasuries

The interest rate spread between high-yield bonds and Treasuries has widened toward the end of 2008. High-yield bond owners currently receive a yield premium of 16.17% for 10-year Treasuries (through Feb-

ruary 2009). Spreads continue to be at extreme levels and far above the historical spread of 4.99%. Current economic conditions make higher levels of defaults in the high-yield market very likely. It may still be early for the high-yield category, but the yields are attractive compared to Treasuries. In time money may begin to flow toward this asset class.

## ● Municipal vs. Taxable

Although municipal bonds have recovered somewhat in 2009, there is still a large disconnect to the historical comparison between municipals and Treasuries due to falling Treasury yields. Municipals remain an attractive option for bond investors, particularly for those in high tax brackets. Normally municipal bonds trade at 85% of the equivalent maturity Treasury bond. And as of March 20, 2009, they are priced to yield 145% of the 3.69% 30-year Treasury bond.

## ● Interest Rates and the Yield Curve

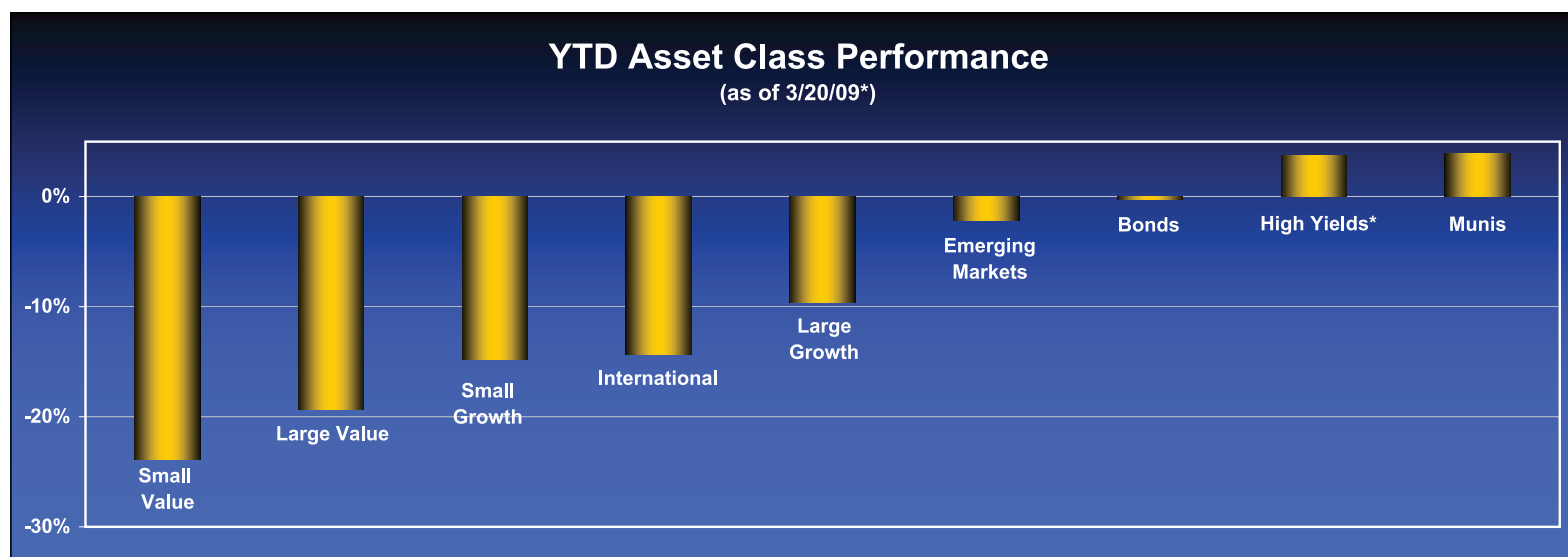
Treasury yields had another large drop in mid-March as the Fed purchased \$300 billion in Treasuries. Yields have fallen across the board for Treasuries as investors continue to search for safety amidst market volatility. Currently 2-year Treasuries are yielding 174 basis points less than 10-year Treasuries. Spreads between 2-year and 10-year Treasuries have remained consistent in recent months. Since 1980, 10-year Treasuries have typically yielded approximately 70 basis points more than 2-year Treasuries, placing the current level well above the mean.

## ● Inflation

The twelve month Consumer Price Index (CPI) rate of change dropped drastically from mid-2008 through early 2009, moving from 5.6% to 0%. The data measurement will likely turn deflationary in the coming months. January posted the first positive month (0.4%) in seven months for the CPI. Due to high readings in the first half of 2008, the CPI rate will turn deflationary in first half of 2009. The second half of 2009 will be different since it will be compared to the lower second half 2008 reading. The Leuthold Group believes the CPI could finish up 2% for the full year of 2009.

## ● Real Estate

REIT performance has been dismal thus far in 2009. The category fell more than 30% through the first two months of 2009. From the peak in early 2007 through February 2009, the REIT index is down nearly 58%. REITs now trade at very attractive valuations. They are currently more than 55% below their long-term valuations. REITs will likely need help from the economy to begin a sustained rally. Even so, recent mutual fund inflows into the category have been positive, which is a good sign considering the increased risk aversion of investors.



Source: Morningstar, Inc. The following proxies were used to measure performance for their respective categories: Small Value = Russell 2000 Value; High Yields = Credit Suisse HY; Munis = BarCap Municipal; Large Value = S&P 500/Citi Value; Small Growth = Russell 2000 Growth; Bonds = BarCap US Aggregate; Large Growth = S&P 500/Citi Growth; International = MSCI EAFE; Emerging Markets = MSCI EM. Returns include reinvested dividends, capital gains and other earnings.

\* Performance through 3/20/09

# Resetting Expectations

A decade is a long time, and a great deal can happen during that time. Unfortunately, for someone who invested in the S&P 500 Index, making money was not something that happened in the last ten years. This span has been traumatizing to the psyche of investors who have come to expect double digit returns from their stock investments. During this period the market has experienced two major downturns: the technology bubble burst in 2000, and then the real estate market began to rapidly unravel in 2007, contributing to an unprecedented financial crisis and major market turmoil in 2008. While there certainly were opportunities to make money (the bull market from 2003-2007), the long-term result of the last decade has left many pondering the future of the stock market and the wisdom of holding stocks in their portfolio. Fortunately, there are very good reasons to believe the next ten years will be much better than the previous ten.

Today, fear and uncertainty currently dominate the investing landscape. This economic recession looks to be as deep as any since the Great Depression. While many are willing to offer up predictions, no one knows for sure when the economy will emerge from this slump. History has shown the market to be a leading indicator, meaning it usually begins to move higher well before the economy as a whole displays positive growth. Unfortunately, economic growth in the U.S. may not be seen until late in 2009 or in 2010. Several months lay between then and now, and questions regarding the market continue to mount. So, with extreme uncertainty surrounding both the economy and the stock market today, what do we know?

There is one key, very optimistic piece of information that equity investors can hang onto in these turbulent times: at current prices, the stock market is cheap. On the surface this may seem insignificant, but some perspective helps to highlight the importance of the market's cheap valuation.

The U.S. stock market, measured by the S&P 500 Index, had a median normalized P/E ratio of 17.3 over the last 60 plus years (refer to the illustration "S&P 500 P/E (Normalized)"). It has not traded below this long-term median in nearly 20 years, and has not been significantly below it in approximately

25 years. Investors have not been able to buy stocks "cheap" in about a quarter century. That is a long time to wait for stocks to be on sale. The wait is over. The path stocks have taken to arrive at their current valuations has been painful, but the result has created a long-term, once-in-a-lifetime investing opportunity.

At the end of January 2009, the normalized price/earnings ratio of the S&P 500 Index stood near 12. At a P/E of 12, the market sits more than 30% below its historical valuation. This is significant because valuations have been a key determinant of returns over long periods of time.

To illustrate how market valuation can affect returns it helps to examine the various components of stock returns. First is dividend yield. Dividend yield represents the portion of a company's income paid out to investors. Dividends have historically added 4% to returns. This number may seem high given the lower dividend climate we experienced since the bull market of the late 1990s, but dividend yield has been above 4% for the majority of the last 75 years.

The other component of stock returns is capital appreciation, or the rise in stock prices. This is a function of the earnings growth of the companies which make up the market and the correlating expansion or contraction of the P/E ratio investors place on those earnings. Earnings of S&P 500 companies have increased 6% per year over the last 50 years, a period which included several earnings recessions similar to the one we are currently experiencing. We assume this trend will continue. (We explain our reasoning later.)

Therefore, before any impact from the rise or fall of P/E ratios, investors could expect a 10% return from a large-cap stock portfolio:

4% from dividends and 6% from earnings growth pushing the stock price higher. Not surprisingly, the long-term return - where the impact of P/E movement evens out over 75 years - has been around 10%, and investors have come to view this number as their expected return.

But what happens when we examine a more realistic holding period of ten years and take into account the valuation on stocks (P/E) at the start of that period? What does that do to an investor's expected return?

If at the start of the period stocks are trading at around the long-term median of 17 times earnings, there is no reason to expect any boost or penalty to returns due to P/E movement. Your expected return should be approximately 10%.

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If, on the other hand, the S&P 500 Index starts the period with a valuation well above the 17 benchmark, stock investors should brace for some P/E contraction and lower their expected return. The most recent ten year holding period is a good example of the negative impact of a severe P/E contraction. Looking at the chart on page 5, we see that this period started with

a P/E ratio of around 25, which, by early 2000, quickly rose to above 30.

In this environment, investors can still reasonably expect 4% from dividends and 6% from earnings growth, but they should also expect those positive drivers to be negated by the negative force on stocks as the P/E contracts from 33 towards the long-term median. What actually happened was much worse. The market's P/E ratio kept falling past the historic benchmark of 17 and eventually bottomed out at 10 late last year. When the dust settled, investors were left with a total return of -1.3% for the period, well below the 10% historical return.

*Continued on page 5*

## Resetting Expectations

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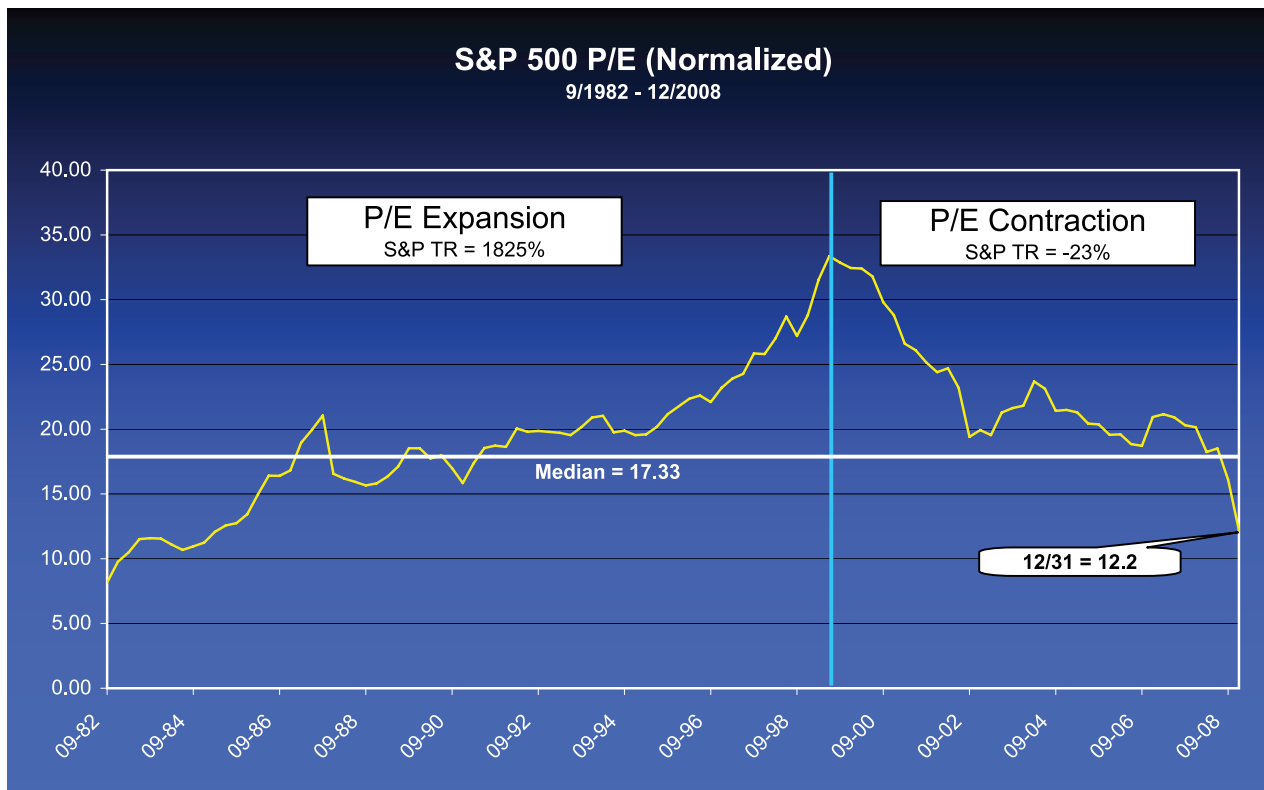
Conversely, when there is an opportunity to buy stocks at historically low P/E levels, the stock returns can be amplified, delivering results significantly above the long-term average. For example, the S&P 500 Index P/E fell below the long-term average in the mid 1970s and bottomed out in the early 1980s. Faced with a starting valuation of around 10, investors could reasonably expect their return over the holding period to be above the

term average valuation will likely hinder long-term success.

A natural question would be what could prevent the P/E of the market from returning to the long-term average of 17 in the next ten years? Two events could seriously hamper the P/E expansion of the market. One possibility is that inflation could spike. High inflation rates result in lower P/E ratios for

optimistic about future earnings growth. As mentioned earlier, despite several downturns in corporate earnings over the last 50 years, the long-term trend has been a 6% annual increase. Clearly we are in the midst of another such downturn. The S&P 500 Index earnings could decline over 30% from their peak in 2006. However, earnings will rebound when the economy rebounds, and it does not take a pair of rose-colored glasses to see how earnings can grow 6% again: 3% GDP growth, 2% inflation, and some marginal expansion at the company level.

Additionally, many American based companies derive a substantial portion (in many cases, greater than 50%) of their revenue from international markets. Having exposure to numerous markets around the world diversifies a company's revenue stream. It also allows a company to tap into the exceptional economic growth of some emerging economies such as China and India. Doing business in these countries will complement growth in the U.S. All of these factors support our confidence in the belief that 6% earnings growth is reasonable going forward.



Source: The Leuthold Group, Inc.

10% average. Using our Private Wealth Advisor model, we calculate an expected return of approximately 17% - 4% from dividends, 6% from earnings growth, and the rest from P/E expansion over time.

Buying stocks during the late 1970s and early 1980s resulted in a much different result for the ten year period as compared to buying in 1999. From 1981 to 1990, the annual return for the S&P 500 Index was close to 15%. The additional 5% per year can be attributed to the expansion of the market P/E as it moved back to the long-term median. When it comes to returns, the starting point can be very important. Owning stocks when the market is significantly below average valuations greatly increases the likelihood of long-term success. Alternately, owning stocks when the market is well above long-

stocks, primarily due to their connection with interest rates. High inflation and high interest rates are the reasons P/Es remained low in the late 1970s and early 1980s. With all the money being printed to fight the current financial crisis, the future effects of inflation and interest rates are up for debate. For now, we envision a continuation of the low inflation environment that has existed for the last 20 years. The other main risk to P/E expansion is that earnings growth will not materialize. P/E ratios capture the value of future growth opportunities, and if investors come to view those opportunities as limited, the current valuations will suffer.

While earnings are expected to decline in 2009 as the economy continues to struggle with this recession, we believe the long term outlook for stocks is very positive. We are

The economy in the U.S., like any other economy, goes through cycles. History has shown the markets to be resilient. There is still growth in the S&P 500 companies. The current downturn (and the media's portrayal of it) can make things seem dire, and what will happen to the market in the next six to twelve months is difficult to predict. With that said, there is no legitimate reason to believe that the long-term trend discussed in this article has ended for the market. Owning stocks at valuations substantially below the long-term average will provide an excellent opportunity to make money in the next five to ten years, an opportunity that has not presented itself in decades. ●

# High Tech

In case you have not heard, the United States is in a recession. According to the National Bureau of Economic Research - the group which marks the points in the business cycle - the current recession began in December 2007. Recessions are nothing new, but this one is unlike any we have experienced in our investing lifetimes. For one, there is the prevailing acknowledgement that this is the worst downturn since the Great Depression. And then there is the unprecedented nature of this downturn: housing bust followed by deleveraging and a severe financial crisis.

Two factors – the severity and complexity of the economic situation - are combining to produce a level of investor uncertainty that is much greater than the typical anxiety that accompanies the burden of predicting the future. When the banking system is on the brink of collapse, when Wall Street is being overhauled, when the auto industry is close to bankruptcy, when home prices drop 25% - when all of these things and others occur simultaneously, how much damage can one expect to the broader economy? How does such a downturn resolve itself and usher in the usual recovery process?

Now we are in earnings season, the time each quarter when U.S. companies provide some insight into what is occurring at both the industry and company level, insight that might help with these questions. Since this is the first earnings season since the economy imploded in November, investors are watching closely for confirmation of the macro economic data or some rays of hope for the stock market. So far the news has been overwhelmingly negative. Not only has the earnings data and executive commentary reinforced the widespread uncertainty, but it has also become clear that corporate earnings – an important determiner of stock prices – have declined significantly, by over 30% in 2008, and this will likely be followed by another double digit drop this year.

Whatever the economic environment, our fundamental strategy has been to construct and maintain a portfolio of companies with better earnings growth than the market as a whole. Better earnings growth usually results in better stock performance over the long-term, assuming a reasonable price is paid for the stock.

In accordance with this strategy, we have had a significant allocation to defensive businesses such as consumer staples and health care. These businesses are stable, selling products and services that are considered essential to day-to-day life, and as such, are usually relatively resistant to economic downturns. But as previously

mentioned, this is not a normal economic downturn. Stories abound of people cutting back on medicines, surgical procedures, and even food. Though it is surprising to see these companies report slower growth or declines in earnings, compared to the cyclical parts of the business world, earnings are holding up relatively well, as are stock prices.

While this defensive posture helped portfolio performance in 2007 and 2008, now that we are already a year into the recession and stock prices have fallen 50%, we have begun shifting portfolios for a cyclical recovery. Typically, according to sector rotation strategy, in the late contraction phase of the economy financial stocks would be the first sector to move up and lead the broad market in its recovery. But we believe this recession is different, and, due to the poor profit fundamentals in financials, the stocks will not rebound as expected. For one, in an economy plagued with high debt levels, loan growth should be weak. Even when banks start to benefit from better interest spreads, the improvement will likely be overwhelmed by rising credit problems in consumer debt and commercial real estate. Finally, the possibility of nationalization will hang over the sector until there is a clear path to solvency. In short, the fundamentals in financials will not support a sustainable rally for this traditional market leader. However, these stocks will provide short-term dramatic investment opportunities.

Longer-term, we believe technology stocks offer the best opportunity for outperformance when the stock market rebounds, precisely because these businesses have better profit fundamentals. (Better than financials or any other cyclical sector for that matter.) There are two reasons why technology earnings should decline less than other sectors during this steep profit recession. First, technology (particularly computer information systems) helps corporations improve productivity. This is a very important issue, especially in times when demand is soft and companies are desperately searching for ways to preserve their profits. While technology budgets will certainly be cut during this recession, the ultimate return on technology investment will help tech projects

remain high on corporate priority lists. Other corporate expenses, such as advertising, travel, transportation, industrial machinery and real estate, will likely see much larger declines. Furthermore, unlike the last downturn, the current

one was not preceded by a boom in technology spending, so there is no “spent up” demand (demand pulled forward) to work off in computers, software and communications equipment as there is in housing and automobiles.

Second, technology should be a large beneficiary of the continued growth in developing markets. Businesses, governments, and

consumers in emerging economies are playing catch up with technology adoption. As businesses in particular continue to grow and mature, it seems very reasonable they will want to capture the high productivity businesses in the U.S. get from their information systems. In order to do so, they need to invest more in technology. Large U.S. vendors such as Microsoft, Cisco, and Oracle are the established leaders in foreign markets. These companies should benefit greatly from the increased adoption of information systems in these rapidly developing economies.

So far the evidence coming out of earnings season is supporting our thesis. Two leading companies in the industrial sector are General Electric and Caterpillar. For General Electric, fourth quarter earnings were down 43%. Analysts expect earnings to decline 28% in 2009. Caterpillar looks no better. The company's latest quarter earnings showed an earnings/share (EPS) decline of 28%. The company expects the business climate to worsen and EPS to decline more than 50% from 2008 levels.

The news is no better in the energy sector. Schlumberger, a major oilfield service company, reported a modest 7% decline in earnings during the 4th quarter. Unfortunately, 2009 looks much worse. The company expects earnings to fall by 30% this year. Integrated oil firm ConocoPhillips reported a whopping 48% decline in the fourth quarter and expects a 60% drop in 2009. The trend is more of the same for commodity

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## High Tech

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driven materials companies such as Alcoa and U.S. Steel, both of which benefited greatly from booming profits last year. Alcoa's earnings were down 40% in September and swung to a loss in December. Losses are expected for all of 2009. U.S. Steel expects a loss in the first quarter and earnings to drop 50% from 2008 to 2009.

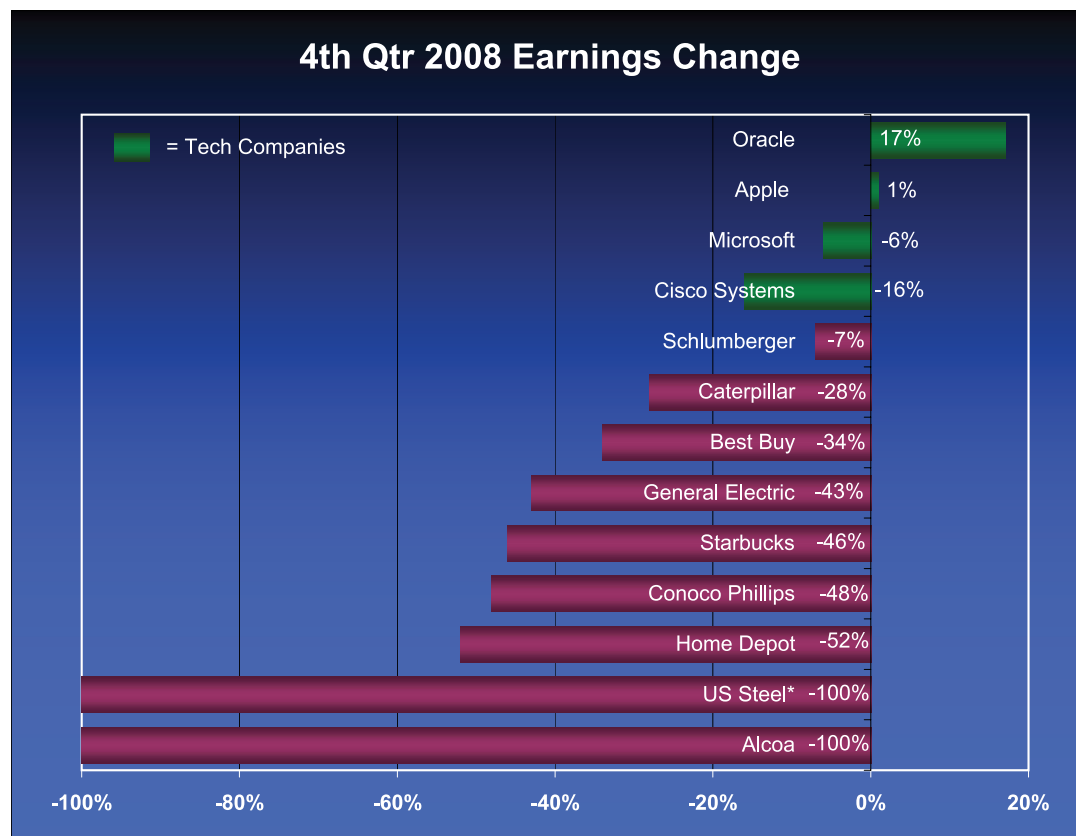
Finally, there are consumer discretionary stocks. This sector is comprised of companies in industries such as retail, hotel operations, and media business as well as the struggling auto makers. Needless to say, with consumers pulling back on spending, the severe economic downturn has impacted these companies very negatively. Starbucks reported a profit decline of nearly 46% in the fourth quarter. Best Buy expects a 20% drop in earnings in February, following a 34% decline in November. Home Depot is predicting a drop in earnings of 60%, following a 24% drop in October. Even Target, a business which should draw shoppers looking to stretch their dollars, forecasts a 30% earnings decline.

Relative to what leading corporations from other cyclical sectors are going through, major technology companies appear to be much more resilient. Microsoft reported a drop of 6% for the December quarter. Management did not issue guidance, but analysts predict just an 8% decline for 2009. Oracle actually reported a 17% increase in earnings per share in November. They expect a slight increase in 2009.

Apple reported an increase in earnings based on the strength of the iPhone and continued market share gains in personal computers. For 2009, earnings are expected to drop, but only by 3%. Cisco reported a 6% increase in October 2008 (prior to the economy's nose dive); earnings are expected to decline 16% in 2009. While this outlook is worse than that for either Microsoft or Oracle, the expected earnings drop is less than we are likely to see at the average company in the industrials, energy, materials, or consumer discretionary sectors.

Outside of the volatile semiconductor industry, technology earnings have held up better than other cyclical sectors. Furthermore, that relative strength is expected to continue, and, once this becomes clear to investors, it should result in higher valuations for technology stocks when the broad market eventually rebounds.

Aside from better earnings performance, another reason money should flow to the technology sector is that there are now fewer options for growth investors. The economic developments of the last year have narrowed the list. Banking may not be a growth business for a very long time, especially



Source: Baseline and company reports. \* US Steel data based on March quarter when drop in steel prices take full effect.

with the government involved. The new found thrift among consumers is likely to crimp growth in industries dependent on consumer spending. But, in our opinion, technology is still clearly in the growth camp. Prior to this downturn, steady technology investment in the mature markets and new adoption in emerging markets was driving double-digit growth rates for technology companies. Even Microsoft, a company with \$60 billion in sales, grew 18% in its last fiscal year. And unlike housing, banking, or technology itself in the late 1990s, these profits were not illusory profits generated by unsustainable forces. They were real. The underlying fundamentals were strong, and should therefore return when the global economy rebounds.

Lastly, investors should be attracted to the high-quality balance sheets found in the sector. With the credit markets still tight, businesses that rely heavily on debt financing are finding it hard to borrow at reasonable rates, if they can borrow at all. This is leading to problems ranging from much higher interest costs to defaults and even bankruptcy.

Technology businesses, in general, do not face these risks because they don't carry much debt. In a recent analysis of leverage in all the market sectors, BCA Research, an independent research firm, found that technology has a debt/equity ratio less than half (18%) that of the next lowest

sector (health care, 45%). Some companies, including Microsoft, Apple, and Qualcomm, do not have any long-term debt at all. Meanwhile, on the other side of the ledger, the cash balances at these companies are remarkable. On average, our top tech companies hold cash equal to 21% of the total market value of the outstanding stock. At Cisco and Apple, the cash is nearly one third the market cap. With statistics like these the technology sector stands out as a safe haven in a business environment where access to capital is tight, and financing risk is a new and serious concern.

It is true that the NASDAQ has dropped more than the broad market since September's downturn, but in the month of January, when December quarter earnings were being reported, the NASDAQ has outperformed. This may mark the beginning of our long held conviction that as we move through the earnings cycle, investors will recognize the resiliency shown by large technology companies and reward stocks accordingly. The superior fundamentals in the technology industry will become even more obvious as the year progresses. ●

At the time this was written, the following stocks mentioned in the article ( Microsoft, Cisco, Oracle, General Electric, Caterpillar, Qualcomm) were owned by clients of Private Wealth Advisors, Inc.

## Emerging Challenges

As the market moved higher and higher in the years leading up to 2008, emerging market stocks lead the charge. With these economies growing at such a rapid pace, money flowed to the companies domiciled in these fast growing nations. China emerged as the pace setter for developing nations and the leader in opportunities offered to investors throughout the world. The world's largest nation based on population boasted double digit GDP growth and demonstrated a seemingly unquenchable thirst for natural resources as it continued to develop and build up infrastructure. At times it seemed as if the unprecedented growth would not end. As the global slowdown spread in 2008, the growth certainly did end.

China – the world's growth engine for the better part of this decade – was hit hard in last year's downturn. Chinese stocks fell over 50% in 2008. The slowdown was felt across the other emerging nations, as the broad index for these countries actually declined slightly more than the Chinese stock market. The start of 2009 has not been much better for the markets of these developing nations. Both the Chinese stock market and the broad emerging markets index were down almost another 15% through early March.

Global growth is expected to fall to one-half a percent in 2009 according to the International Monetary Fund (IMF). The emerging economies are obviously not immune to the global down swing. In fact, their slowdown is quite serious. Some believed these nations could provide protection against rapidly declining growth in other parts of the world. Thus far, the opposite has been true. In a matter of months, measures of growth in both industry and trade shifted from acceptable levels to a breathtaking decline. Asian economies displayed the most severe declines, but the pain has been felt in Europe and Latin America as well.

China's economic slowdown has been sharp. Economic growth slumped to 6.8% in the 4th quarter of 2008, dragging the year long number down to a seven year low of 9%. Not long ago, in 2007, China posted a jaw dropping 13% GDP growth rate. The 2008 slowdown broke a five year streak of double digit growth. That streak turned China into the world's third largest economy, just behind the United States and Japan.

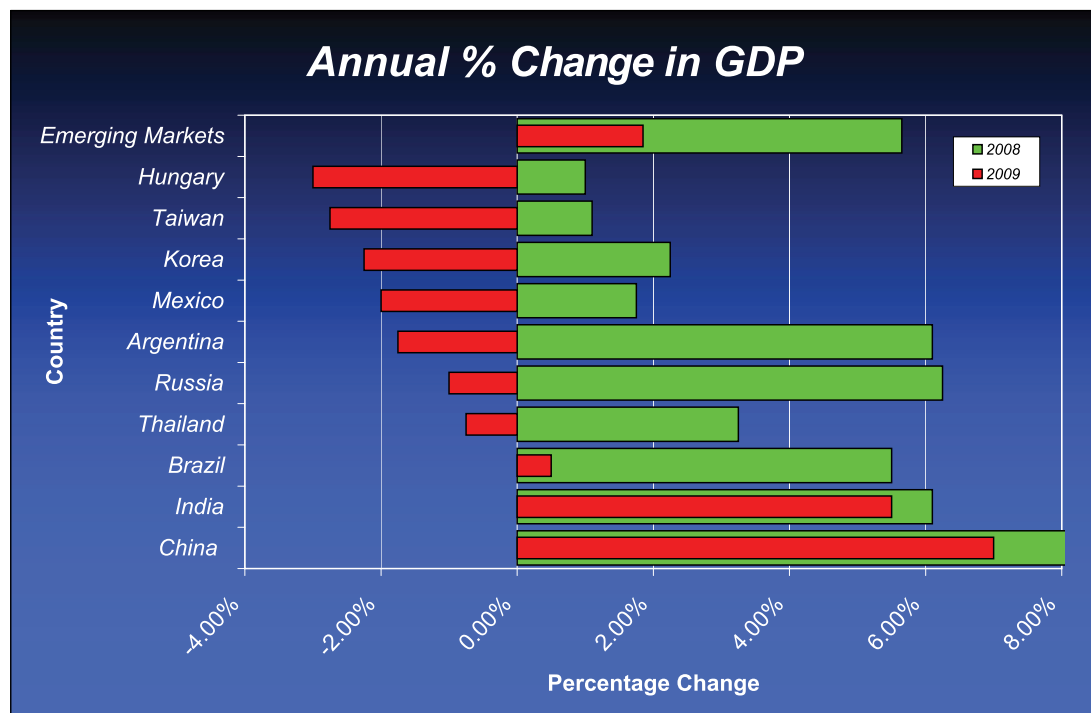
The rapid consumer spending decline has impacted the vital export portion of China's economy. Exports account for approximately one-fifth of China's GDP growth. The export machine seems to have lost its momentum. December 2008 showed the worst performance for exports in China since 1999. The Chinese government implemented a nearly

\$600 billion stimulus plan in November 2008 in an attempt to counteract the impact of falling exports. The focus of the stimulus was on infrastructure spending and boosting the sagging real estate sector. This type of action shows a clear shift from an outward-oriented growth model, which had been relied on in recent years, to a more locally focused growth model. It remains to be seen if the Chinese can make up for the drop in overseas spending within the country.

The combination of falling export demand and financing, tighter financial constraints, and lower commodity prices could be a ma-

wear on the region. Brazil, which boasted a large trade surplus as commodities roared, had its balance of trade swing into the red in January 2008. The country lost more jobs at the end of 2008 than at any other time in the last 16 years. Oil and gas producers have also been hit hard as prices have declined. These lower prices will mean less revenue to pay debts taken on during the commodities boom. The IMF projects just 1.1% GDP growth for Brazil in 2009.

Commodity rich developing nations will need prices to trend back towards mid-2008 levels in order to revive their economies. In order



major hurdle for these economies throughout 2009. Commodities played a major role in the boom for many emerging economies, as previously mentioned. China has displayed a seemingly unquenchable thirst for commodities in the last five years. In 2008, as its economy began to slow, its demand for commodities declined. This, in turn, drove commodity prices lower. With pricing rapidly moving downward since July 2008, it has been painful for commodity producing nations. Latin America is a prime example.

For nearly six years, the sharply upward trend in commodity prices was a major boost to Latin America's governments and corporations. Latin America's economic growth averaged 5% from 2003 through 2008, 300% higher than the prior three decades. Money flooded these commodity rich nations.

The reliance on natural resources to drive economies in Latin America has started to

for prices to move higher, China will need to rekindle its appetite for resources. This will certainly happen, but the timing is unpredictable, especially if China relies less on other nations' export needs to drive its economy in the short-term.

Given the drop in emerging market stock prices in the last 18 months, it makes sense to begin to look at re-establishing positions in the asset class. With that said, we still believe the best way to gain exposure to these markets is through large U.S. multinational companies. These companies derive a significant portion of their revenue from developing market countries (like China and India). While these economies will be growing at a slower rate in 2009 than the past few years, their growth rates are still well above developed nations. This growth will help fuel earnings for U.S. multinationals and attract investors to capitalize on depressed market prices. ●

## Another Bubble?

As more and more bad news was laid at the feet of the financial markets in the fall of 2008, many investors scrambled for a safe haven. With so much uncertainty ahead, “better safe than sorry” became the motto of many. Some moved to cash, but even conservative investments like money markets came under fire after one money market fund “broke the buck”. In the end, the only entity those running scared could truly trust was the U.S. government. So, they purchased Treasuries. And then they purchased more Treasuries. The demand was so great, that at one point in mid-December 2008 a Treasury auction saw the 3-month T-bill rates pushed negative for the first time since auctions began in 1929. At the same time, the U.S. also sold \$30 billion of bills at zero percent interest for the first time since it began selling the debt in 2001. Fear was high and some investors were willing to abandon basic investment tenants for the promise of safety.

This trend of money flowing rapidly toward Treasury securities has pushed yields to historically low levels. The massive flow of money toward equities may have created another market bubble – a Treasury bubble. While investors concerned primarily with preservation of capital may be comfortable earning very little in the short-term, at some point things will change.

Bond yields have been on a fairly steady decline over the last 25 years. In the early 1980s, the 10-year Treasury yield was in the mid teens. Even by 1988, the 10-year yield was still above 10%. From that point forward, there has been a steady decline. This gradual drop in interest rates has been a positive for investors in Treasuries. As yields decline, prices rise: holding bonds in this period has been very beneficial. Some might call it a bond bull market.

There is a flip side to this phenomenon. As interest rates rise, the price of bonds decline, and the decline can be significant as the maturity of the bond becomes greater. Take a 30-year Treasury with a 3.5% coupon and a 3.805% yield for example. Since the time to maturity is so long, the duration (sensitivity to a change in interest rates) of the bond is high. The duration of a 30-year Treasury is approximately 18.8, meaning the price of the bond will move 18.8% for every 1% move in interest rates.

Given the historically low level of interest rates today, there is a significant amount of in-

terest rate risk involved in holding these Treasuries. If the 30-year rate would move two percent higher, the value of the bond would decline approximately 37%. And, given the government’s recent efforts to bring the economy out of this recession through spending, the likelihood of higher inflation and interest rates seems high. Sure, you can hold the Treasury to maturity and receive your principal upon maturity, but the opportunity cost is high given the low interest rate you would receive for a long period of time.

Even a 10-year Treasury can have a significant negative impact on a portfolio in a rising interest rate environment. A 10-year Treasury with a 2.5% coupon and a 2.81% yield to maturity has a duration of close to 9, so the same

ties. Given the low valuations and depressed prices, the equity markets should be poised to deliver solid returns in the coming years. If the inherent risk of equities is too high, or if there are certain assets specifically earmarked for fixed income, there are still better choices available than Treasuries.

The 2008 downturn created opportunities in several asset classes. Municipal bonds have higher yields than Treasuries across all maturities. Historically, municipals should trade at 85% - 90% of Treasuries. Given the tax-free aspect of the asset class, investment grade municipal bonds are more compelling than government debt. Investment grade corporate yields are also substantially higher than Treasuries.



Source: US Treasury Dept.

two percent spike in interest rates would result in an 18% decline in price - not as drastic a fall as the 30-year Treasury, but still a substantial price decline for an asset class viewed as safe.

To avoid significant interest rate risk but still lean on the “safest” investments, investors would be relegated to owning short-term Treasuries and money markets. Both investments offer paltry yields today. Most money markets offer yields of less than one percent (with some close to zero). Short-term Treasuries are no better. The yield on a 1-year Treasury is just 0.57%. With high inflation almost certainly on the horizon, these investments will not allow investors to keep their heads above water on a real return basis.

In order to stay ahead of inflation, investors will need to move money away from these safe havens and begin to take some risk in order to allow their assets to grow sufficiently. The most obvious destination would be equi-

Bank notes are another attractive segment of the fixed income market. These senior secured loans were impacted by the lack of liquidity in 2008. Today they are priced approximately 35% below par. Defaults have remained fairly low thus far in 2009. Even with the high probability of rising defaults in the short-term, the upside potential for bank loans is significant as the asset class recovers. Also, yields for the asset class are near 6%, and their weekly rate resets eliminate interest rate risk.

The spending occurring at the government level will, most likely, lead to higher inflation in the coming years. With higher inflation comes higher interest rates. Rising rates pose a threat to holders of intermediate and long-term Treasuries. Given the meager yields offered by government securities, it is prudent to look to other fixed income asset classes that offer superior opportunities. ●

# ASSET ALLOCATION – KEY FACTORS

## ● *Fixed Income / Equity*

The Private Wealth Advisor is published on a quarterly basis. Changes are made to our portfolios throughout the year (especially given the renewed volatility of the market), but not discussed in print until the next issue is released. Managing a portfolio purely based on changes printed quarterly will not accurately reflect the tactical decisions made within Private Wealth Advisor portfolios. Additionally, measuring the success of these changes accurately is problematic given the regulatory environment of our industry. This information is not intended to be used in trading or managing your investments.

Allocation of your investment assets between equity and fixed income is largely dependent on three factors: cash flow needs, risk tolerance levels, and current market forces. While the first two are client specific and also the primary drivers for overall allocation, market forces should not be ignored. The S&P 500 Index normalized price/earnings ratio stood near 10.5 in early March 2009. This level put stocks in the lowest 9 percent of all weekly readings since 1940. Historically, buying stocks at these general levels has resulted in better than average long-term returns. Considering the low yield environment in the Treasury market, equities are looking more and more attractive. In addition to equities, non-government debt offers solid opportunities.

## ● *Equity Allocation*

We continue our bias toward large companies versus small companies, both domestically and abroad. This has worked in our favor in recent months as small caps have buckled under the pressure of the worsening economy. Small caps managed to hold up relatively well last year versus large caps as the market and economy deteriorated. The economic sensitivity of small caps has been more prevalent in 2009. While small cap valuations have come down significantly, they are still not compelling at this time. Large company growth stocks have showed strength versus value stocks, based primarily on the trouble of the banks within the value sector. Our shift toward the technology sector has started to

look very favorable in 2009. The technology sector was actually positive by about 2% through March 20th, while the broad S&P 500 was lower by nearly 13%. We still prefer the faster growing companies (large growth stocks) that derive a substantial portion of their revenues from foreign economies. Technology companies fit this profile perfectly. Valuations of foreign stocks have become more attractive during this pullback. Emerging market stocks may be particularly attractive since it will be difficult for the world economy to expand again without countries like China leading the way.

## ● *Fixed Income Allocation*

With the Federal Reserve target rate at 0%, it is difficult to find any kind of attractive yield in the traditionally safest investments, especially Treasuries. We continue to hold floating-rate bank loans as our primary short-term fixed income vehicle. This asset class began to recover in mid-December 2008 and has held up thus far in 2009, delivering positive returns. Even with the small bounce, these loans still trade between 65 to 70 cents on the dollar. Defaults stand near 4% at this time. Even though defaults will likely increase in the coming months, these senior secured investments offer substantial upside. High quality municipal and corporate bonds also offer an attractive alternative to Treasuries.

Municipals are actually yielding more than Treasuries, and they offer tax-free income. In such a low yield environment, we believe it is wise to look for alternative sources of income. Our preferred solution is to commit a portion of a portfolio to real estate properties or limited partnerships owning a variety of properties. Real estate generates a steady income stream, often higher than today's low bond yields. In addition, properties have a much higher likelihood of appreciating over time versus other fixed income investments, thus adding to a portfolio's total return.

## PRIVATE WEALTH ADVISORS' ASSET ALLOCATION

### EQUITY ALLOCATION



ASSET CLASS	TARGET WEIGHT	BIAS	ACTIONS
LARGE CAP	77.00%	OVERWEIGHT	STABLE
MID CAP	5.00%	UNDERWEIGHT	STABLE
SMALL CAP	0.00%	UNDERWEIGHT	STABLE
INTERNATIONAL LARGE CAP	15.00%	NEUTRAL	STABLE
INTERNATIONAL MID CAP	0.00%	UNDERWEIGHT	REDUCING
INTERNATIONAL SMALL CAP	0.00%	UNDERWEIGHT	STABLE
EMERGING MARKETS	3.00%	NEUTRAL	ADDING
	100.00%		

### FIXED INCOME ALLOCATION



ASSET CLASS	TARGET WEIGHT	BIAS	ACTIONS
SHORT-TERM BONDS	70.00%	OVERWEIGHT	STABLE
INTERMEDIATE-TERM BONDS	30.00%	UNDERWEIGHT	STABLE
LONG-TERM BONDS	0.00%	UNDERWEIGHT	STABLE
INTERNATIONAL BONDS	0.00%	UNDERWEIGHT	STABLE
HIGH-YIELD BONDS	0.00%	UNDERWEIGHT	STABLE
INFLATION PROTECTED	0.00%	UNDERWEIGHT	STABLE
	100.00%		

# WHAT WE DO

## ● **Tactical Asset Allocation Portfolio Management**

Our proprietary modeling strategy is used to determine opportunities in various asset categories globally. Asset allocation decisions are formulated by our Investment Committee using a long term relative valuation matrix.

*The strategy has two primary goals:*

- Reduction of risk by minimizing exposure to expensive segments of the market.
- Improved portfolio returns by investing in undervalued segments of the market, using both passive and active management to execute these strategies.



Front Row (L-R): John Schneider, CFP® (President), Joseph Scarpo, CPA, PFS (CEO), Stuart Miller, CFP® (Chairman)  
 Back Row (L-R): Daniel McCurry, CFP®, Scott Miller, CFP®, Jody Werner, Michael Passalacqua, CFP®, Michelle Bender, CFP®, Keith Biskup, Arthur McAuley

## ● **Individual Managed Stock Portfolios**

The S&P 500 Index is used as the benchmark for investing in individual stocks for our clients. We rank sectors top to bottom using technical indicators and fundamental analysis.

Once our Investment Committee chooses the sector allocation for the portfolios, our team of research analysts populate each sector to our desired weightings using individual stocks and sector/industry indexes.

## ● **Individual Bond Portfolios**

Private Wealth Advisors uses all fixed income opportunities when designing our bond portfolios for clients. We balance interest rate risk and credit (default risk) for our clients by using all available fixed income instruments. An example portfolio might consist of individual municipals and corporate bonds, closed end mutual funds, index funds and actively managed open end mutual funds.

## ● **Real Estate Portfolio**

Regional real estate is acquired with the goal of providing high current income, along with tax benefits for our clients. The professionals of PWA Real Estate, an affiliate company, seek opportunities in our region to build diversified property portfolios for our clients.

## ● **Alternative Investments**

In addition to real estate, Private Wealth Advisors employs a variety of alternative investment vehicles appropriate for a client's risk tolerance, investment goals and investment experience, e.g., oil and gas limited partnerships and long/short portfolios. Our goal is to provide competitive returns while managing overall portfolio risk.

## ● **Coordinated Financial Advice**

Our principals have a combined 70 years of experience in counseling clients in virtually all areas of personal finance including:

- Estate and Trust Planning
- Retirement/Elder Care Planning
- Income Tax Planning
- Business Succession Planning
- Employee Benefit Planning
- Philanthropic Planning

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