4th Quarter 2009

Wisdom from the Bear

The last forty years have produced seven bear markets, along with numerous scares and panics. While each new bear market is framed by its own unique circumstance, they each have valuable lessons to teach and often share similar characteristics. Learning from the past is difficult, but failure to do so allows each new bear market reiteration to blindside investors.

With the most recent bear market behind us, it is helpful to examine the important lessons learned specifically from it. Below are ten such lessons:

1. **For every action there is a reaction –** To fend off the '02 bear market, Alan Greenspan and the Fed cut interest rates to historic lows. This helped remedy the fallout from the tech crash, but low rates for so long eventually contributed to the real estate melt-down. Bear markets are often unintended reactions to previous actions. Understanding this can be helpful in spotting future troubles.

2. **Understand securitization –** The real estate bubble led to adjustable-rate mortgages, interest-only mortgages, no document loans and lax lending standards. Subsequently, various types of mortgages were bundled and repackaged (or securitized) into toxic securities that impaired the balance sheets of some of the world's largest corporations. The last two years have highlighted the dangers of securitization and proven that a bad loan is a bad loan no matter how you package it. Understanding securities and their composition is paramount.

3. **"Financial innovation" might not be so innovative –** In the '02 Berkshire Hathaway annual report, Warren Buffet warned that "derivatives are financial weapons of mass destruction." Derivatives are basically instruments whose gains and losses are recognized based on the future value of an underlying entity. Derivatives are often used for speculation or hedging purposes in the interest rate, equity, currency, credit and commodity markets. The biggest danger when it comes to over-the-counter derivatives is the creditworthiness of the counterparty. If the counterparty goes bankrupt, a hedge can fail - exposing risk that was previously thought neutralized. Furthermore, derivatives can lead to excessive risk-taking as investors believe they have their risk in check. Losses in the derivatives markets can tax the global financial system. This was the case when AIG (a big player in the derivatives markets and a counterparty to many) ran into trouble and had to be bailed out by the U.S. government.

4. **Leverage can be hazardous –** Debt adds risk to personal and corporate balance sheets. This fact was all but forgotten during the last few years as individuals and corporations "levered up" to take advantage of low borrowing costs. While consumers piled on debt, so did the large investment banks: Lehman Brothers, Bear

Stearns, Merrill Lynch, Goldman Sachs and Morgan Stanley. As the financial crisis unfolded, these firms went bankrupt, merged or reclassified themselves as bank holding companies – thus altering the investment banking landscape. These firms played a large role in pushing the global financial system to the edge of disaster. The pain of the last two years has come as corporations and consumers have de-leveraged after a period of easy credit.

5. **Investing in the world pie isn't necessarily the answer –** After the tech crash, diversification became a hot topic because so much wealth was destroyed as investors concentrated their portfolios in the technology sector. In the aftermath, many diversified into the "world pie" by investing in nearly every country and sector worldwide - essentially becoming the market. The thinking was that not every market goes up or down in unison due to differing correlations among global markets. As the recent financial crisis peaked, investors witnessed correlation breakdown as the global markets retreated en masse. While diversification is important, this phenomenon has called into question the validity of the "world pie" strategies used by many investment firms.

6. **Liquidity matters –** Over the last several years, relatively illiquid alternative investments gained in popularity. Private equity and hedge fund assets swelled with the notion of outsized returns and investors gladly accepted lengthy "lock-up periods." As the credit crisis unfolded, private equity funds suffered as the IPO and mergers and acquisitions markets slumped. Some hedge funds were caught holding assets with no determinable value when the more arcane corners of the markets froze. Illiquidity combined with inaccessibility proved disastrous for many, including university endowments heavily allocated in these areas. Many investors and institutions are still struggling to determine the value of illiquid assets.

7. **Understanding behavioral finance is key –** On March 11, 2009, the Wall Street Journal ran an article titled *"Dow 5000? There's a Case for It."* The Dow actually bottomed two days prior at 6,547 and has rallied powerfully since, but on March 11th it felt like there was no bottom in sight. Such is the power of fear. As discussed in last quarter's commentary, *Understanding Behavioral Finance*, investors (and journalists) are not always rational and this can drive prices below or above where they should be. This past bear market reinforced the premise that emotions can be an investor's worst enemy.

8. **Government action is necessary during a crisis –** The U.S. and other governments deserve credit for staving off a complete financial meltdown. While it was not a pretty thing to witness, coordinated government action successfully addressed the global credit crisis. Through stimulus packages, monetary easing, bailouts, ad hoc solutions, and a host of acronyms (TARP, TALF etc.), the U.S. and others demonstrated that success was the only acceptable outcome.

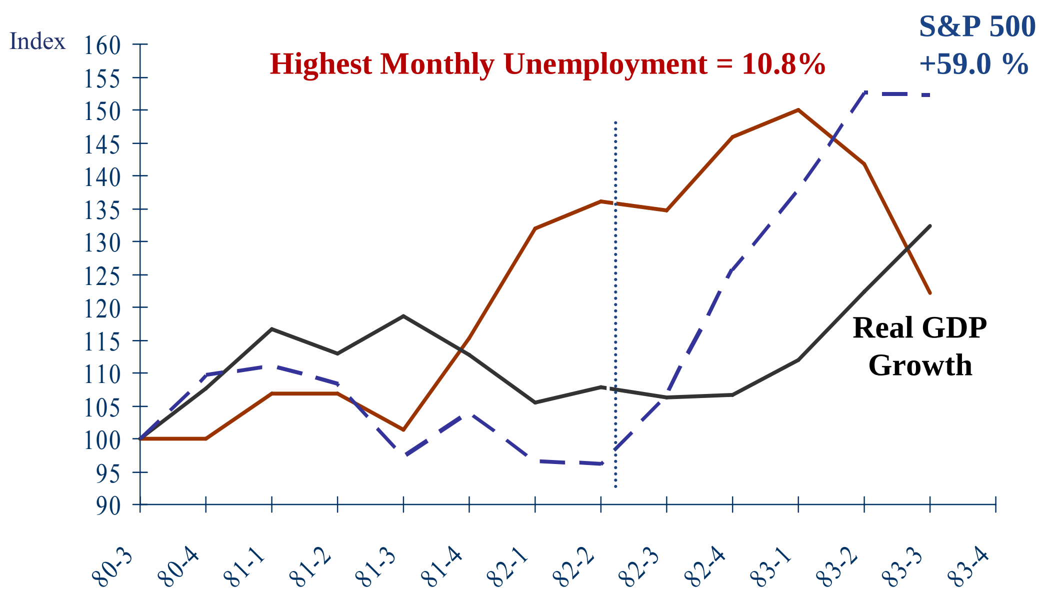
9. **Markets recover** – Through September 30th, the S&P 500 has rebounded 56% (not including dividends) since the March 9th low. As illustrated in our first quarter commentary, *Is it Different This Time?,* markets have a history of rebounding powerfully after establishing lows. This tendency is easily forgotten in the panic near bear market troughs.

10. Capitalism isn't without risk - Winston Churchill said, "democracy is the worst form of government except all the others that have been tried." The same can be said for capitalism as an economic model. Even with all of the blood, sweat and tears caused from booms and busts, capitalism remains the most viable economic model in the world.

Current Thoughts on the Recovery

In terms of GDP, unemployment and the stock market, the current recovery is similar to what was experienced after the '82 bear market (see chart below). By focusing on the vertical blue dotted line, one can see that the S&P 500 surged well before gross domestic product (GDP) improved. The stock market is a leading indicator and historically anticipates the direction of the economy.

Real GDP, Unemployment, S&P 500 During '81-'83



The unemployment rate is a lagging indicator and trails behind the economy. As can be seen above, unemployment continued to rise even after the S&P 500 rebounded and did not subside until GDP recovered. With the recent surge in the S&P 500, an unemployment rate of 9.8%, and mixed readings on the economy, the current recovery has striking similarities to this time period. It is likely unemployment will continue to rise even as we get better news on the economy. While unnerving for many, this news is to be expected and should not meaningfully derail the recovery.

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Looking Ahead

While the recent stock market surge has been powerful, a pause or pull-back of some kind is to be expected. This will inevitably bring out the doomsayers again, but we do not foresee developments that warrant a major shift in our investment strategy at the present time.

We are pleased with the progress of our clients' portfolios. We have successfully shifted out of defensive positions into economically sensitive ones that have enabled us to capture significant upside in the current market. We will continue to do our best as new trends develop and there are still many opportunities for investors with cash on the sidelines.

DARRELL & KING
INVESTMENT COUNSEL, LLC

503 Faulconer Drive, Suite 6 • Charlottesville, Virginia 22903
434-977-7010 PHONE • 434-977-6313 FAX • www.darrellandking.com