

January 31, 2010

2009 and a Look Back at the Decade

The beginning of each year provides an opportunity to look back and summarize the performance of major asset classes. The figures and charts for 2009 (and the five-year and ten-year rolling periods) found on the enclosed pages tell an intriguing story about the wisdom of tactical asset allocation.

Some Perspectives on Portfolio Management in the Recent Decade

You've probably read or heard about 2000-2009 being labeled a "lost decade" for investors. The decade began with the bursting of the dot-com bubble and ended with the nationwide housing market downturn, subsequent financial market rout and a recession. Indeed, as the attached charts reveal, virtually all asset categories delivered low or negative returns over the decade, with US large-cap stocks returning -1.0%, averaged annually. And the higher average returns for some asset classes, such as real estate and emerging markets equity, masked the most gut-wrenching peak-to-trough declines (-70% or more) during the decade. Those wild gyrations represented extreme peril for normal, return-chasing investors and surely ended in catastrophe for some. Also remarkable was the still staggering loss at decade's end for investors who ran with the crowd in US growth stocks; because of the -62% cumulative loss in the dot-com crash, US growth stocks were still down -34% at decade's end! For many investors, even a 0% return would have been welcome.

How did our clients fare? The 10-year track record was solid, and certainly positive. Clients with us the entire decade avoided the big mistakes described above. Still, returns were disappointing compared to average returns in financial markets measured over the modern era (since 1926). But those averages mask tremendous variability in 10-year rolling returns. From 1965 to 1974, returns in US large-cap stocks averaged 1.2%; from 1989 to 1998, they averaged 19.2% (compounded per year!).

We believe the decisive element between achieving acceptable returns and disastrous returns in the past decade was judgment in allocating among asset classes. In turn, this required a sense for financial history, a nose for value and stable emotions. And managing emotions—brought on by the dot-com and housing bubbles and their subsequent bursting—has been our greatest challenge as investment counsel. During those trying events, we maintained our faith that the best outcomes would only be obtained by keeping cool heads.

The decade began with many investors wishing to take what we considered excessive risk. We remember well the prospective clients who didn't come aboard early in the decade because we shied away from market-leading growth stocks. We also remember others from only a couple years ago who were heavily into residential housing. Most rebuffed our suggestion that they

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diversify; one boldly stated that “real estate has never declined.” We mention this because all things come around again; there will be a day when it again appears that easy money is to be made in some must-have asset class and we will (hopefully) be urging caution.

The panic in financial markets that followed the housing downturn was the most challenging environment of all. We were conscious of other events in the past where the situation appeared bleak or catastrophic, and we knew how fortunes could be lost in panics. In this role, an appreciation of history and other humanities is as important as our analytical skills because investment management is largely about understanding human behavior. Reflection on the past helps us put current events into context and adjust to potential future events. At the investment policy level, we knew clients who abandoned their investment policies would be doomed to lock in their losses by missing the rebound. At the asset allocation level, we knew there would be opportunities to increase positions in areas that panicked investors had abandoned without reason.

As you review your recent account statements and go through your annual review cycle, you will see the rewards of sticking with your policies and of the tactical adjustments we made to nearly all client accounts in late 2008 and early 2009.

The Years Ahead

With moderate growth having started in the second half of 2009, it is evident that the economic system has not collapsed. True to its role as a forecasting tool, the US stock market started rallying in March 2009 and is now roughly at its 2006 price level.

As is human nature, many of us peer upward at the market peaks attained in October 2007 as the lost ground to be retaken. This is so despite the general understanding among economic observers that asset price levels at the peak were inflated by unsustainable levels of borrowing. Thus, the 2007 peak was illusory, although we will surely grow past it at some point. When we do, it is our fond hope that asset prices will reflect a more realistic view of our economy.

In the meantime, there is a lingering feeling of dread that the market declines of 2008 and early 2009 will occur again—a sort-of “post traumatic market stress syndrome.” The real challenge therefore is to manage emotions and expectations while seeing the realities as best we can, knowing that financial markets (and the public mood in general) will always swing between excessive optimism and pessimism.

The consensus among economists is that the great recession ended in the third-quarter of 2009 and that the recovery is tentative. As companies start feeling some increasing demand, hours worked will start to trend upward, which can already be seen in some economic surveys. As is common in all recoveries, new employment (or a reduction in unemployment) will lag because business owners are reluctant to make new hires until their existing workforce is maxed-out and they are truly confident of further growth.

Likewise, although by some measures residential real estate prices still have room to fall to return to historical trends, most of the decline is over. And there is a bright spot in the decline: prices are reaching levels where an average young family can afford to buy.

The savings rate is another Janus-faced statistic. The wild swing from slightly negative to more than 4% was the biggest blow to the economy because it reflected a rapid decline in consumer spending. But the higher rate is a good sign for capital investment and future productivity gains.

Credit continues to be stubbornly tight, but recent surveys indicate credit standards have largely ceased to tighten. For those with good credit, borrowing rates are low, and this should continue for some time because the Federal Reserve is likely to keep rates low until economic growth becomes more robust.

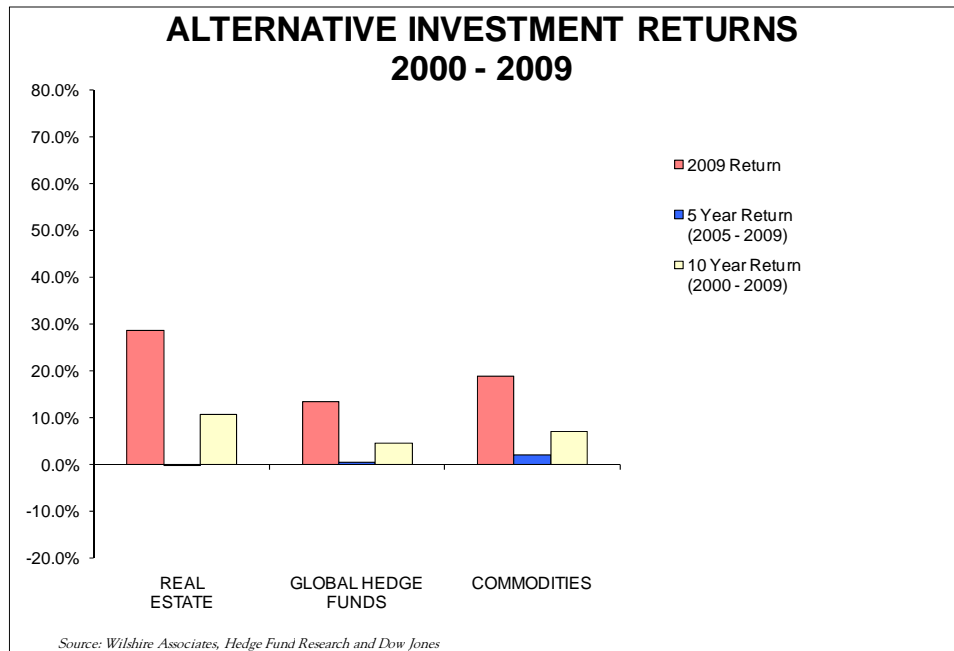
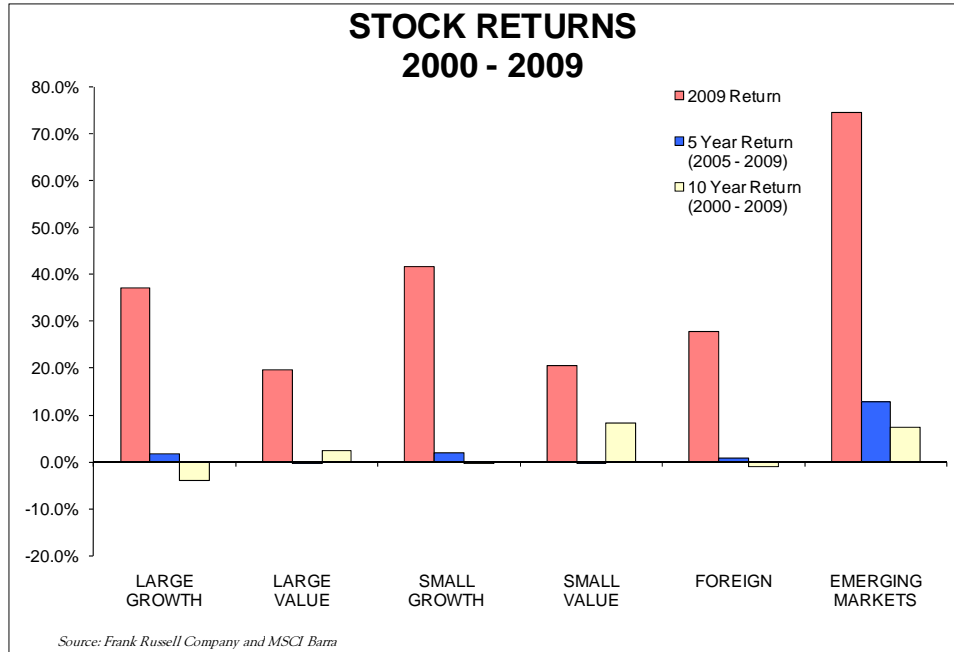
Looking ahead, we believe the US stock market is unlikely to charge upward from here without greater assurance that revenue is improving. Cost cutting by companies has generally buoyed bottom line earnings, but revenue growth is constrained by consumers, who make up about two-thirds of the economy and are spending less as they build their savings and pay off debt.

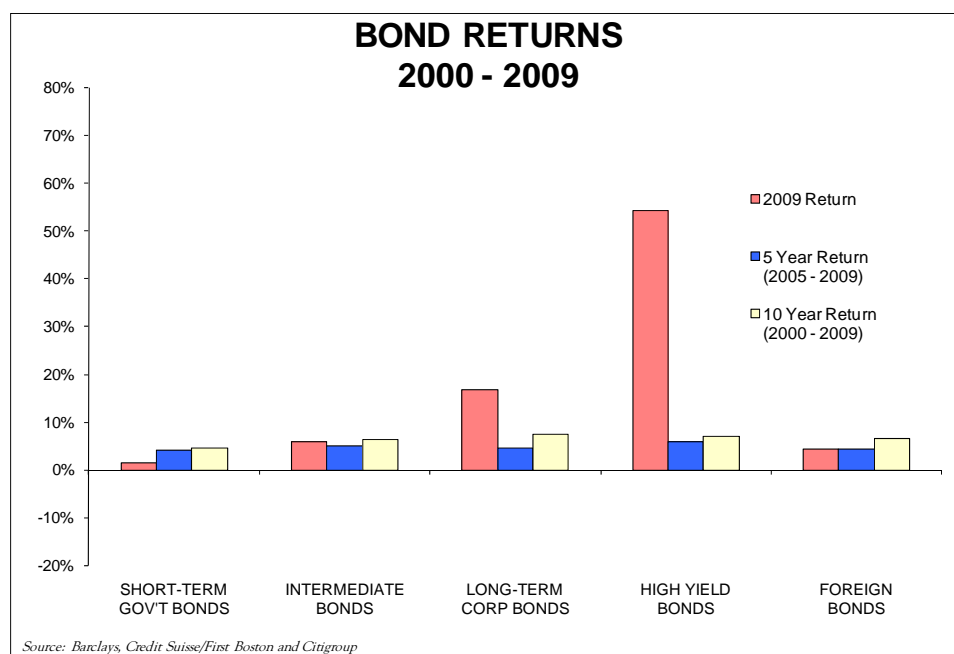
Going forward, the Fed's navigation between the dual goals of price stability and economic growth is going to be difficult. All eyes are peeled for signs of inflation and the effects of an overly accommodative monetary policy. Although the risk of deflation will remain until the economy clearly shows that it is recovering well, inflation holds the most significant threat long-term. Bond investors are wary, and those who bulked up on bonds late after being frightened out of the equity markets may be in for a doubly negative surprise. Then there is the looming effect of unprecedented government spending (measured as a percentage of GDP), which represents a huge headwind to future productivity and wealth creation. These last aspects, inflation and fiscal policy, are probably the great demons that we confront over the next several years.

In Conclusion

We hope this letter and the enclosed charts are instructive. Thank you again for your trust in our efforts on your behalf. May we meet the challenges of the next ten years with clear eyes and good judgment.

CAPITAL MARKETS REVIEW





TOTAL RETURNS (annualized)

	1 year (2009)	5 years (2005-2009)	10 years (2000-2009)	COMMENTS
EQUITIES				
US LARGE-CAPITALIZED GROWTH COMPANIES	37.2%	1.6%	-4.0%	The high returns in stocks in 2009 were tilted significantly toward growth as investors bid strongly for shares of companies thought to grow in a tough economy. Over the last ten years, however, US large-cap growth stocks ended the decade with a -4% average annual loss, showing the lingering devastation of the dot-com crash.
US LARGE-CAPITALIZED VALUE COMPANIES	19.7%	-.03%	2.5%	Value stocks lagged growth stocks by a wide margin in 2009, but measured over a full decade that includes the bust in large-cap growth stocks in the beginning of the decade, large-cap value stocks were the winners by 6.5% per year.
US SMALL-CAPITALIZED GROWTH COMPANIES	41.7%	2.0%	-0.2%	Small cap-growth stocks were the largest beneficiary of investors' preference for riskier stocks in 2009 with a return of about double their value stock counterparts. Still, for the full decade small-cap growth stocks lagged small-cap value stocks due to the lingering effect of the dot-com crash.

**TOTAL RETURNS
(annualized)**

1 year 5 years 10 years
(2009) (2005-2009) (2000-2009)

COMMENTS

EQUITIES

US SMALL-CAPITALIZED VALUE COMPANIES	20.6%	-0.1%	8.3%	Small-cap value stocks performed strongly in 2009, but were far outpaced by small-cap growth stocks. For the decade, small-cap value stocks were the best performing part of the US stock market.
FOREIGN STOCKS	27.8%	0.9%	-1.1%	Developed country foreign stocks significantly underperformed the US stock market in local currency terms in 2009, but roughly matched the US stock market after factoring in the decline in the US dollar.
EMERGING MARKET STOCKS	74.5%	12.8%	7.3%	After falling 54% in 2008, emerging market stocks had a spectacular comeback in 2009. Returns were also enhanced by currency tail winds as the dollar declined. And despite a rough 2008, the ten-year returns for this volatile asset class were a quite respectable 7.3% annualized return.

ALTERNATIVE INVESTMENTS

REAL ESTATE (REITS & EQUITIES)	28.6%	-0.1%	10.7%	Real estate equities captured the highest ten-year total return of any traditional investment class. However, volatility in the asset class was far worse than US stocks overall.
GLOBAL HEDGE FUNDS	13.4%	0.4%	4.4%	Despite higher than normal correlations to stocks late in the decade, global hedge funds outperformed most equity classes for the decade with lower volatility. Despite global hedge funds' solid return of 13.4%, in a recovery year like 2009, stocks far outpaced global hedge funds.
COMMODITIES	18.9%	2.0%	7.1%	Commodities experienced rising prices over the decade in response to growing global demand for production inputs. Late in the decade, commodities experienced a sell-off and rebound similar to stocks in the 2008-2009 period.

CASH EQUIVALENTS

CASH – MONEY FUNDS	0.1%	2.2%	2.9%	Combating the credit panic by flooding the market with liquidity, the Federal Reserve maintained a near zero rate policy in 2009 and consequently cash and money market fund investments had virtually no return.
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TOTAL RETURNS
(annualized)

	1 year (2009)	5 years (2005-2009)	10 years (2000-2009)	COMMENTS
BONDS				
SHORT-TERM GOVERNMENT BONDS	1.4%	4.2%	4.7%	Consistent pressure by the Fed to keep interest rates low resulted in a low return for short-term government bonds.
INTERMEDIATE BONDS	5.9%	5.0%	6.3%	The Barclays Aggregate Bond Index holds a variety of government, corporate, mortgage and government agency bonds. In 2008, spectacular government bond returns counterbalanced the corporate bond rout driven by panicked investors. In a reversal of those influences in 2009, intermediate government bonds lost ground, and corporate bonds benefited from the dramatic market recovery resulting in an overall return of 5.9% for 2009.
LONG-TERM CORPORATE BONDS	16.8%	4.5%	7.5%	Recovering from the panic, long-term corporate bonds rebounded significantly more than the modest -3.9% loss they experienced in 2008.
HIGH-YIELD BONDS	54.2%	6.0%	7.1%	Similar to long-term corporate bonds, in 2009 high-yield bonds more than recovered their -26% loss from the prior year as investors bet that high yields on the bonds would more than pay for losses on defaults.
FOREIGN BONDS	4.4%	4.5%	6.6%	Although the beginning of the decade was challenging for owners of foreign bonds, this asset class delivered 10% in 2008 and another 4.4% in 2009.