



## Basic Questions on Strategy and the Economy

**Q. OK. Let's cut to the chase. How are you recommending clients invest their money right now?**

We are recommending that clients underweight equities and equity-like investments relative to their investment policy asset allocation. Within the fixed income portion of clients' portfolios, we are recommending investing primarily in very high quality municipal and corporate fixed income instruments. Within the equity area, we like growth stocks with strong business models that can prosper and endure a sustained period of poor to slow economic growth. We also see a number of special opportunities (more on this later).

**Q. What is your view on the economy?**

The economy is in bad shape and will get worse before it gets better. Most of the factors that got us into this contraction are still at the stage where they are either getting worse or not improving. Housing prices continue to fall, and the credit markets are still very unstable.

**Q. Are there any hopeful signs for the economy?**

A few have arisen recently; but, in aggregate, not many. The fact that credit market conditions are slightly better than late last year could be counted as a positive. Perhaps more importantly, housing prices are now getting down to a level where they should begin to level off. Housing prices are at their most affordable levels in close to forty years based on the Housing Affordability Index. The only problem with this is that buyers now, unlike the past few years, have to overcome some annoying requirements like making a down payment and proving that they have an income.

**Q. What will get us out of this economic contraction?**

This is the most severe economic contraction since the Great Depression of the 1930s. Unlike that period, policy makers have introduced massive amounts of fiscal and monetary stimulus into the economy. Most of these measures have been introduced relatively recently – less than six months ago – and should be given time to work.

**Q. When will the economy begin to recover?**

If monetary and fiscal stimulus is going to have an impact, it will probably not be until 2010.

**Detailed Questions on Economic Policy**

**Q. Things are so bad now. How do these policies turn the economy around?**

Let's take monetary stimulus first. The most common way to implement monetary stimulus is to cut interest rates. When you cut interest rates, people and corporations are more likely to borrow and either spend the money or invest in a business.

**Q. But the short-term interest rate that the government sets - the Fed Funds Rate - is now close to zero, and the economy is getting worse. Where do we go from here?**

I guess the answer would be Plan B, or to be more precise, Plan TARP, TALF, and something called quantitative easing. When Lehman Brothers collapsed last August and defaulted on its debt, the credit market seized up. The rates that banks began to demand to lend to each other and to customers went up, even though the Fed was cutting interest rates. As it became more expensive for banks to borrow funds, the value of the assets that the banks held on their balance sheets went down. This has left some banks in a position where lenders are worried that the value of the assets may be lower than the value of their liabilities.

**Q. But didn't we give the banks a whole lot of money through the TARP program to offset this problem?**

Maybe yes. Maybe no. The value of the assets that the banks hold is fairly uncertain. We simply don't know the value of the debt on their balance sheets because the markets are no longer pricing these securities based on their true economic value (i.e., the amount of money that will actually get paid back to the lenders). These securities are being discounted further because buyers have refrained from buying now in hopes of purchasing these assets at very steep discounts sometime in the future.

**Q. I don't see how this monetary stimulus is helping yet.**

Unfortunately, you are not alone. The market feels the same way. The Federal Reserve is stimulating the economy by making sure that the supply of deposits and money markets that the banks use to fund loans (the money supply) stays high. In contrast, during the Depression, when the government let banks fail, the money supply collapsed. At that time, the feeling prevailed that it was only fair that the people who had made bad business decisions should go out of business. The problem with this approach was that when the banks failed, they called in their loans. As a result, some businesses and individuals who were doing perfectly well now had a problem. They, in turn, had to withdraw the cash that they had in their accounts to survive. This, then,

reduced the money supply and caused more banks to run out of capital and call in their loans.

**Q. So are you saying that we should never let a bank fail?**

No, but you do want to stop the chain reaction before it goes too far. The possible solutions include finding a buyer for the failing bank or absorbing the bank into the FDIC, then selling the loans that are still OK. Unlike the Depression, the supply of deposits and money market assets that banks can use to fund loan growth has actually increased. This is known as the money supply or money stock. In the Depression, the money stock was allowed to shrink. From 1929 (when the stock market crashed) until 1933 (year one of Roosevelt's first term), the money stock was allowed to drop by about one third. Milton Friedman and Anna Schwartz wrote a book that convinced a large part of the economics community that the downturn that started in 1929 was lengthened and deepened by the fact that the money supply was allowed to contract so much. (Milton won a Nobel Prize for this work. Why not Anna? Good question.)

In contrast, money supply has risen by 7% (\$545 billion) over the last six months. This increase in deposits and money market accounts is just waiting to be invested. Increases in the money supply are eventually used for spending or investment, which results in a boost to the economy as the money finds its way back into the system.

**Q. How long are we going to have to wait for this to happen?**

A little patience might be wise here. Lehman collapsed less than six months ago. Individuals and businesses are still scared and have hesitated before rushing out and taking any risks. At some point, the businesses and individuals that have not been as severely hit by this problem are going to snap up homes and assets at good prices, hire people they couldn't hope to afford a few years ago, and expand their businesses. The cash is there.

**Q. But what if private individuals stay scared and keep their money in cash?**

That certainly seems to be the case right now, and is one of the problems that worried John Maynard Keynes. He recommended that governments 'prime the pump' by borrowing money and spending it when private individuals and companies were too scared to do anything more than sit in cash. This is fiscal stimulus. Roosevelt did not take Keynes' advice in the 1930s and actually tried to close the budget deficit.

**Q. So how do we know it really works?**

Proponents often cite two occasions where this worked. The first occurred during World War II when the government used deficit spending on a level similar to what we are seeing right now. The economy picked up quite well during this period. The other time is the early 1980s when the U.S. government ran very large deficits. Many people will argue that the boost that the economy got during this time period was attributable to two factors: 1) the supply-side nature of the tax cuts and 2) inflation was reduced to

more predictable levels. This is an interesting debate to have, but it may cloud the current situation.

The point here is that we have two very effective tools, monetary policy and fiscal policy. These have worked well in the past, but they were not employed effectively when we went through the recent tremendous credit contraction. We have not given either policy enough time to work. Our best guess is that they will begin to have an impact at some point over the next twelve months.

**Q. Don't these two policies both have significant downsides? If the money supply grows too fast, then you create inflation; and if you spend too much, the budget deficit will not return to normal levels.**

Let's take the policies, one at a time. Yes, a large increase in the money supply can cause inflation to rise. We are currently in a very deflationary cycle. Prices are much more likely to go up than down. If inflation picks up, we will see it coming and adjust our recommendations accordingly. This is a good reason to add to commodity/natural resource stock positions now.

Fiscal policy is harder to dismiss, and we suspect that part of the stock market's latest round of weakness has a lot to do with the budget proposals that the President recently announced. Tax increases on the wealthy were not a surprise. The surprise was that the President did not defer some fairly expensive programs until after the economy had begun to heal. Investors are concerned that the trillion dollar deficits forecast for this year and the next will not end in 2010.

The market is already having a very hard time envisioning how the credit and banking crises will be resolved while losses at Citibank and AIG continue to mount. Few are willing to give administration budget planners the benefit of the doubt and assume that some fairly ambitious spending plans will be covered with planned tax revenues at the same time as the deficits for Medicare and Social Security begin to grow. The cap and trade pollution permit system that has been proposed is also a huge unknown at a time when the market does not need another unknown.

### [More on Investment Strategy](#)

**Q. So what do you like right now?**

Corporate and municipal fixed income securities are trading at fairly attractive yields versus Treasury bonds. Our best guess is that government policy will be sufficient to allow companies to support their debt payments. It will take longer, however, for the economy to improve sufficiently to support earnings growth.

**Q. Do you like the High Yield Bond market?**

High yield bonds are very attractively priced right now. They are, at the end of the day, almost like equities in terms of price risk. They have the advantage, however, of carrying a higher yield. We have avoided this sector for most of the past six years. With yields at their current levels, we would invest in a starter position in these bonds. Over time, we would be tempted to increase our exposure to this area. Default rates will be climbing significantly from current levels, and as they rise to historical high levels, we will be tempted to add to our positions.

**Q. What sort of stocks would you invest in right now?**

Our bias is towards growth stocks, or to be more precise, GARP stocks (Growth at a Reasonable Price). These are companies with sustainable business models that can prosper through a period of slow growth. Some of the most interesting companies are in the technology sector where you can find numerous companies with a strong history of generating returns for shareholders and relatively strong balance sheets, selling at low prices.

**Q. What are your thoughts on international investments?**

We recently reduced our recommended weighting in international equity from 20% of total equity to 15%. While international stocks are trading at some fairly attractive valuations, we are worried about the stability of European currencies – in particular the euro. While the United States has spent the better part of the last two years coming clean about its financial problems, Europeans are still in the early stages. We are inclined to believe that this will put a fair amount of pressure on the euro. The euro has already retreated from fairly overvalued levels relative to the dollar. It now stands a little above fair value. Our best guess is that the euro may decline farther from here as the validity of the currency is challenged.

**Q. Are there any other interesting strategies or opportunities out there now?**

When the world's economies recover, we are inclined to think that a lot of the growth will come out of Asia. China and India have the capacity not only to grow by exporting goods but also by creating demand within their own economies. It also may make sense to allocate more money to commodities, particularly companies involved in commodity production. Many commodity prices, including oil, have returned to their inflation-adjusted historical norms. This strikes us a good time to invest.

**Q. Anything else?**

Convertibles appear to be mis-priced relative to their fair value because many convertible arbitrage hedge funds had to de-leverage last year and dump shares into the market. MLPs (master limited partnerships) involved in natural gas delivery are also mis-priced thanks to a similar situation. (Note: MLPs have extremely complex tax structures and may not be for every investor.)

**Q. Keep going. There has been so much carnage. There must be more.**

Oh yes. Writing covered calls on a portion of your equity portfolio may be extremely advantageous right now. In the simplest strategy, you can buy an S&P 500 Index ETF and sell a covered call on top of that position. You receive an income payment for making this transaction, but you do give up much of the upside if the market goes up. Why is this attractive? The amount that you receive right now for writing a call – the premium – is very high. Even Warren Buffet, a frequent critic of derivatives, has executed a variant of this strategy for his company.

**Q. Anything else? Which sectors of the stock market do you like?**

If we had to pick one sector, it would be Technology. Technology companies are fairly cash rich and offer some of the better prospects for future growth. At some point, we are going to become interested in consumer cyclical companies, but not just yet.

Also, Glenmede manages a variety of quantitatively run equity management strategies. While these are not for everyone, we would be remiss if we did not point out that they are holding stocks with extremely attractive valuation discounts.

**Q. Valuation discounts?**

A valuation discount is calculated by estimating the P/E or Free Cash Flow Yield for the portfolio and comparing it to a similar figure to the overall market. Right now, there is a very big gap between the two numbers. There is also a gap between the profitability levels of the companies in our quant portfolios versus the profitability of the companies in the index. In other words, you can buy a portfolio of companies, which are more profitable than the index, at much cheaper prices.

**Q. Aren't quant portfolios just black boxes?**

Running a quantitative portfolio is almost as much an art as a science. The art part comes in terms of choosing which sort of factors or attributes you would like to emphasize. The science part derives from the program used to invest dispassionately in the attributes that the PM chose to emphasize. Emotion, a sometimes unhelpful quality in investing, is muted through this second step. Val de Vassal and Paul Sullivan have been successfully managing quantitative portfolios for over ten years. In the process, they have done a good job of beating the market.

**Q. Why not get out of the stock market completely until the economy recovers?**

Market timing carries some real risks. The stock market leads rather than lags economic events. In all probability, the data that confirms that the economy has turned will not be available until after the market has rebounded. The market may rebound because investors are just finished selling. A reason is usually invented later by market historians. When rallies occur, they usually happen very quickly. The majority of stock market gains

occur during the first year of a recovery. (Average 47%; Median 38%, according to Leuthold.)

**Q. You speak about underweighting equities. How much should I/we have in equities to start?**

That depends a lot on the circumstances of the individual or family. If you have not had a financial plan done lately, we would strongly recommend that you update it with us or someone else. A financial plan is the best way to determine how much risk you should take.

**Q. I don't have time to do that. Aren't there some basic rules of thumb?**

Yes. Generally if you have a longer-term time horizon or you only spend your income from your investments, you can afford to take the risk and hold more in equities. Spending only income and never touching principal is an old-fashioned concept, but it is not a bad guide. The income payment from a diversified portfolio of stocks and bonds generally stays fairly stable over the short and intermediate terms, even during bad times. If you spend only income, you can, in essence, allow the principal value of your assets to fluctuate and not let it affect your lifestyle.

**Q. But I'm not in that position. I need to be able to spend principal and appreciation.**

This is where a financial plan can be very helpful. As part of this process, we can project the value of assets after spending under a variety of different market scenarios and estimate the probability that you will be able to live off of your assets or stay above a certain asset value.

**Q. Is there anything else I should consider?**

There are many other people that recommend keeping two years' worth of spending in cash or short-term fixed income. This is not the worst idea in the world. The problem, of course, is that the short-term money will not appreciate as much as the stock market in a rally. Still, if you are going to spend the money within two years, a little certainty would not be the worst thing in the world.

This dialogue could certainly continue for pages, but I am going to stop here. If you do have more questions, please don't hesitate to e-mail them to me at [gordon.fowler@glenmede.com](mailto:gordon.fowler@glenmede.com).

All the best.

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