



About Bob Andres

Bob is the President and Chief Investment Strategist of Andres Capital Management. He regularly communicates economic viewpoints and investment strategies to the marketplace. Bob serves as a source of insight and perspective to advisors and their clients. He regularly engages with advisors in support of their client meetings, presentations and conference calls.

His business pedigree includes:

- President of Merrill Lynch Mortgage Capital Corporation
- Vice President and Manager of Merrill's secondary corporate bond trading division
- President and Co-Founder of Martindale Andres & Company, a firm that managed in excess of \$2 billion in assets

Bob has been featured in Barron's, Institutional Investor and a broad array of financial publications throughout his career.

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A Few Topical Questions

Today's environment has elicited a multitude of questions from advisors and clients alike. We have posed a number of these challenging questions to Investment Strategist, Bob Andres. We appreciate Bob's comments and hope to provide our advisors with insight that is both relevant and constructive.

How long can this economic crisis last? What's it going to take to turn it around? Historically, we have heard that the market rebound precedes an economic rebound. Do those lessons still apply today? Can we put what's happening presently in any context?

The crisis may last for a decade moving from one set of problems to another. Debt deflation is causing a massive destruction of wealth, reducing employment, income and spending. Irving Fisher, the renowned American economist, suggests that extreme indebtedness significantly limits the effectiveness of both monetary and fiscal policies as neither approach will enhance money velocity. Traditional monetary policy is designed to begin a new lending and borrowing cycle. This is not occurring as lenders don't want to lend and borrowers don't want to borrow. More importantly, the Administration does not seem to have a clear understanding of history and the factors that brought us this crisis. During the 2000s, the Fed took the fed funds rate down to 1%

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and left it there even though GDP was running above 5%. The Administration swapped fiscal surpluses for massive deficits and did nothing to support the declining dollar. This aggressive reflation worked for a while - the 2001 recession was mild and the equity market bottomed in 2002. However, as the analysts at BCA (Bank Credit Analyst) point out, this good news came with unintended consequences as the massive stimulus led to the debt-fueled housing bubble and the current crisis. It is naïve to think that we can spend our way out of the current mess without incurring negative consequences down the road.

Markets normally rebound around 4 to 5 months prior to an economic turnaround. I believe that those assumptions remain valid. However, I don't expect a real economic turnaround in 2009. We can get a bear market rally from these depressed levels if any positive sign of stabilization materializes.

Is the economic crisis facing the world different this time? Should we throw out historical models and assumptions? Is this a point of inflection where the old rules don't apply?

In the October 28, 2008 edition of *Perspective*, I stated, "I believe we are on the threshold of a broad 'financial inflection zone.'" The noted author, Peter Bernstein, has suggested that this implies "The future will share few features of the past, and after passing through a point of inflection the world will no longer obey the same rules it has been obeying."

Investors, currently occupied by the pain of wealth destruction, need to manage their expectations in the context of a changing political and economic environment. The future is not necessarily an extension of the past. We are clearly not in the same world as yesterday. I believe we are already in a transition and the changes will be potentially exacerbated by politics, current economics and developing long-term trends (aging baby boomers). The immediate and primary goal should be navigating the current transition period in an effort to protect capital and subsequently rebuild one's capital base.

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Michael Barone wrote back in September: “You can sum up much of the 20th century history by saying that in the 1930s Americans decided that markets didn’t work and government did, and that in the 1970s Americans decided that government didn’t work and markets did. The protracted and painful experiences of those decades changed public attitudes on the balance between government and markets, between regulation and enterprise, between government aid programs and self-reliance. The breadlines and depression of the 1930s moved Americans in one direction; the gas lines and stagflation of the 1970s moved them in another.” Today’s history is about to be written.

Is our government in over its head or do they have the capability and tools to navigate through this crisis? What critical steps are still missing from their plan? Does it need to be more of a global plan?

I believe events have made it difficult for policy makers to make rational and coordinated policy initiatives. Under the category of unrealistic expectations, we are expecting the people who did not see this coming to design policies to end the crisis. It is hard to lead with your hands behind your back and your fingers crossed.

I am convinced that both the Fed and the Bush Administration underestimated the magnitude and depth of the problems that grew out of the deflationary housing market that began in 2006. They were unable to connect the dots between housing deflation and its impact on the broad structured products market. The Fed has functioned from behind the curve for most of the last year. This phenomenon has led to declining confidence and enhanced volatility. I believe they are fighting a twenty-first century problem with twentieth century tools. Congress and their politicizing of the debate have exacerbated the problem. Remember, the genesis of our current problems was housing deflation in 2006, which led to declining valuations of mortgage-backed securities owned by the banks. Policy makers need to purchase distressed debt from the banks, which would bring back liquidity and functionality to the mortgage-backed securities market. In addition, policy makers need to stabilize housing prices, which would help reduce the backload of

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unsold houses, and in turn, would be supportive of lower mortgage rates and a re-growth in consumer spending.

In terms of a global context, each country needs to deal with its specific set of problems and weaknesses. However, the G-20 countries need to put in place a global plan to avoid the growing threat of protectionism. The World Bank reported that 17 of the G-20 countries have introduced restrictive trade policies since mid-November. These realities will cause world trade to decline further if left unresolved.

How do we evaluate performance of managers and funds right now when almost everybody is down substantially? When is it the right time to replace a manager? And how do you find the right replacement?

Perhaps the time has arrived for the industry to evaluate managers on a ratio of risk taken to return achieved. The goal of most managers today is to outperform a given benchmark. Risk to these managers is underperforming their benchmark and, as a result, everything is reduced to relative performance.

Benjamin Graham suggested, "The essence of investment management is the management of risk, not the management of returns." He believed that because of the harm that losses inflict on wealth accumulation, investors should start by focusing on how much they can lose, not how much they can gain. Risk he believed was something that should be actively managed. Bull markets have created a system where relative performance has become the norm while risk management capabilities have declined precipitously. This phenomenon is true for both equity and bond management.

It is my belief that the emphasis on benchmarks and style boxes within the asset management industry has reached a peak. Asset managers will be required to deliver returns that emphasize capital preservation and active risk management. They will be measured less by how they do against a benchmark and more by the risk-adjusted returns delivered.

I believe advisors and their clients need to understand that this recession is not a typical post-war recession and will in all likelihood impact investing for years.

What are the potentially disastrous mistakes that investors can make now?

Investors need to avoid compounding the mistakes of 2008. The concept of *winning by not losing* is even more important today after the devastating losses incurred during the past year. The effect of large losses on long-term wealth accumulation is significant. Break-even analysis makes it clear that returns of 50% to 100% will be required to offset equity declines in 2008.

Investors need to employ strategies that focus on capital preservation and patience. They need to understand their options and it is critical that advisors communicate these options to their clients. Advisors also need to explain the potential consequence of each option in an attempt to avoid unintended surprises. I believe the prudent path to rebuilding wealth is not unlike building wealth in the first place. It is a process of multiplication or compounding over time. It is normally not the outgrowth of a one-time surge in market valuations.

I believe advisors and their clients need to understand that this recession is not a typical post-war recession and will in all likelihood impact investing for years. If one accepts this premise, it becomes essential to think outside of the box in building strategies for success.

Are there any hopeful signs out there that we can take solace in? What are the positive indicators out there, if any?

Yes, but we need to understand that we are in a war of attrition. A quick resolution should not be expected. Policy makers are attacking the crisis on two fronts. The Fed's focus is on rebuilding the credibility and functionality of the financial system. The Administration is utilizing fiscal policies in an attempt to stimulate economic growth. We can take some level of solace knowing that both the Fed and the Administration are fully engaged. The Fed's announced intention to purchase up to \$300 billion in long treasuries (quantitative easing) is a plus and will lower interest rates along the entire yield curve. This will reduce debt-service pressures for consumers and businesses, and cause mortgage rates to decline to approximately 4.0%. Monday's announcement that the

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government finally recognizes the need to purchase distressed debt from the banks is a step in the right direction. The plan appears reasonably complex and calls into question how fair market value will be determined and how due diligence will be managed. One may also wonder how many private organizations will want to partner with the government after the AIG bonus flop.

The declines in the equity market through March 6 put the S&P closer to fair market value in my opinion. The S&P had declined more than 60% since January of 2008. Assuming forward earnings of \$55.00 for 2010 and assigning a historic equity trough P/E of 12x, values the S&P 500 at 660. The S&P closed at 683 on March 6 setting the stage for a bear market rally that we have enjoyed subsequently. However, two conditions exist which could limit the downside and actually provide the opportunity for additional bear market rallies. The first is that there is plenty of money on the sidelines. The second is that I suspect many pension plans will need to rebalance their portfolios toward equities. However, the issue of sustainability will remain until we see progress in the following areas:

- The ratio of household debt to disposable income.
- The rate of change in both unemployment and non-farm payroll data.
- A reduction in the inventory of unsold homes from its current 11-month supply down to a workable 8-month supply.
- An initial sign that the banking system is functioning in its traditional role of lending.
- A reduction in corporate spreads and indications that capital markets are beginning to function normally.



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