

# SHARPER ♦ GRANITE

*Optimal Portfolio Management*



One year ago in our *Winter 2008* letter we wrote encouragingly in our research article: “Positive Returns Will Spring from Fear Factors.” At that time we expressed our bullish thoughts for most asset classes in 2009, the one exception being Treasuries which we singled out in “Treasury Bond Bubble” (see “2008 Quarter 4” under the Outlook & Research tab at [www.sharpergranite.com](http://www.sharpergranite.com)).

In 2009 the “ABT Strategy” (Anything But Treasuries) proved lucrative. U.S. and foreign stocks, bonds (non-treasury), real estate investment trusts, and commodities all performed well while long-term treasury bonds fell 21%.<sup>1</sup>

Recoveries like that in 2009 are common following deep recessions as the economic “rubber band” snaps back upward. The flight to safety backtracked as investors shifted money away from the safety of treasuries (and U.S. dollars) back into riskier assets. Now, as the economy emerges from the worst recession in eighty years, we offer our investment perspective for the next decade. Please read “2009 and the Decade Ahead for Stocks” below.

WINTER  
2009

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## Financial Markets Summary

The S&P 500 Index (with dividends added) ended the fourth quarter up 6.0%, and completed the year up 26.5%.<sup>2</sup> The Dow increased 18.9% for the year.<sup>2</sup> Sharper ♦ Granite portfolios also did well in 2009. Clients may read about their individual quarterly and annual performance in their 4Q09 reports.



The Dow hit its 2009 peak right at year-end on December 30<sup>th</sup>. Strange coincidence? Absolutely not. Sharper ♦ Granite research notes an incredible “December Effect.” It’s more than a Santa Claus rally. Since 1928 the Dow has hit its high for the year between December 27 – 31 an astonishing 21% of the time.<sup>3</sup>

Bonds of all types other than treasuries performed well during the rebound. The iBoxx Liquid Investment Grade Bond Index, which Sharper ♦ Granite uses as a high-quality bond benchmark, returned 0.3% for the quarter and 12.8% for the year.<sup>2</sup> Bonds rewarded investors who stayed put and refused to panic last year.

For 2009, the average investment return from all Sharper ♦ Granite portfolios was 22.3% (net of fees) at an estimated average risk level 38% less than that of the S&P 500.<sup>4</sup> The S&P 500 Index (with dividends added) and zero-risk 3-month treasury bills may be used to estimate fair market return at lower risk levels.<sup>4</sup> That fair market risk-adjusted return is 10.9%.<sup>4</sup> Thus, we estimate that the average of all Sharper ♦ Granite portfolios beat the S&P 500 Index on a risk-adjusted basis for 2009.<sup>4</sup>

Another way to look at 2009 Sharper ♦ Granite portfolio performance is that average client returns were similar to that of the Dow and S&P 500 indexes but with an estimated 38% less risk.<sup>4</sup>

## 2009 and the Decade Ahead for Stocks

The stock market opened the past year with one of the worst January performances in history and reached its nadir on March 9 with the S&P 500 Index descending to 676. The turnaround event appears to have been the March Fed announcement to pump \$1 trillion into the economy through the purchase of \$300 billion of long-term U.S. Treasury securities and an additional \$700 billion of Fannie Mae and Freddie Mac guaranteed mortgage-backed securities and other debt.<sup>5</sup>



The year 2009 ended with the S&P 500 Index recovering half of its 57% bear market plunge; it is now down about 28% from its all-time peak. Had the S&P 500 declined from its high of 1565 to its current level near 1115 in roughly a straight line, it would not have provoked nearly the investor despair that it did when it took its dip in March.

We preach that stocks are for long-term investors, and most agree. But when stocks fall, even those who will not touch their retirement savings for years, panic and flee the market, worsening their situation and increasing their risk of an insufficient retirement nest-egg.

Many have discussed how this past decade has been the worst in a century of stock market history. But we should understand that measuring decade performance today compares a bubble *peak* from ten years ago to the *trough* of today. The decade of the 1990's ended in the biggest stock market bubble in history and followed the 1980's which also produced near-record returns. Never before had investors experienced two back-to-back extraordinary decades. This spawned over-optimism and books such as *Dow 35,000*. The last ten years cancelled the excess returns of the 1990's and brought us back to reality.

The table is now set for normal or better market returns in the next decade. We believe stocks will return to their long-term, after-inflation average of 6% to 7% annual returns (real returns) over the next ten years. This long-term, after-tax average for stocks is better than that of bonds, real estate (unleveraged), and commodities, especially gold.<sup>6</sup>

Current stock market valuations are reasonable. Soon, earnings on the S&P 500 will surpass their high of \$92 per share reached during the last expansion. Even if earnings take five full years to hit \$100 per share, the market would then be valued at 1500 with a conservative 15 P-E ratio. That is 38% above the current market and an 8% annual return (with dividends). Moreover, that return is tax-advantaged relative to real estate, bond, and private equity returns. Stocks should be a core holding moving into the next century.<sup>7</sup>

### A Great Year to Die

Congress failed to pass expected legislation preventing the 2010 single-year elimination of the estate tax. As of now, for deaths occurring in 2010, estates of any size will pass estate-tax free to heirs.

Coupled with this change, however, is the assessment of a 15% capital-gains tax on assets sold, with the gains reckoned from the time the decedent purchased them.<sup>8</sup>

Congress could pass a law retroactively in 2010 to correct this bizarre situation.

For 2011 and beyond, Congress is expected to pass legislation similar to that which passed the house in December: an estate-tax exclusion of the first \$3.5 million per person (\$7 million per couple) with a 45% tax on amounts above that.<sup>9</sup>

If you are concerned about how this turn of events could affect your estate planning, please contact your Sharper ♦ Granite advisor.

The financial meltdown that ignited this economic crisis rattled all investors to some degree. Many changed their investing processes – some for better, many for worse. Several types of risk are present in our world, and market declines such as we just experienced are not as rare as we believe.

Professor Barry Eichengreen at the University of California, Berkeley has found that financial crises are becoming more and more common. Along with Professor Michael Bordo of Rutgers University, he identified 139 financial crises between 1973 and 1997, 44 of which occurred in high-income countries, compared with only 38 between 1945 and 1971. All in all, they found that financial crises are twice as likely today as 50 years ago.<sup>10</sup>

Economic crises will happen again. We should use this time to reflect on our financial goals and risk tolerance to fine tune our investment strategy. Let us prepare, be balanced in our investments as in life, and rest easy.

### Fourth Quarter 2009 Economy Review

The overall trend for the economy remains encouraging as the economic data reports of 4Q09 were generally strong.<sup>11</sup> Our leading indicators below now primarily flash positive. The Conference Board's Leading Economic Index confirms this, showing a spike into positive territory this quarter.<sup>12</sup>

Global economic factors are improving as well. European and especially emerging-nation stock markets fared well.<sup>1</sup> The U.S. trade deficit declined more than expected this quarter.<sup>11</sup> Even the maligned U.S. dollar rebounded this quarter. While a weaker dollar helps U.S. companies' overseas profits, the stock market actually performs better during periods of dollar strength.<sup>13</sup>



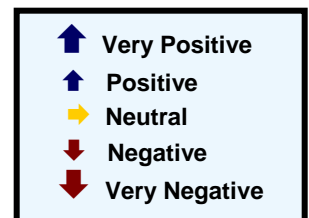
### Leading Economic Indicator Summary

↑ **Calendar Cycle:** Looking forward, the first quarter of each year tends to be strong, powered by January which has been the third strongest of the months for the S&P 500 since World War II.<sup>6</sup>

January is a good month -- especially for small caps and international stocks. Small caps have averaged a phenomenal 4.8% return in the month of January since 1925.<sup>6</sup> In foreign countries January returns account for an astonishing 30% of the total annual return on average.<sup>6</sup>

Since 1900 there have been 100 rolling ten-year periods, 21 of which have had negative returns such as the one we just experienced. Following these negative decades, the market was higher 70% of the time over the following one, three, and five-year periods, and was higher 100% of the time over the following decade. Additionally, all these time periods had above-average returns.<sup>14</sup> This “reversion to the mean” effect when reviewing ten-year periods has been echoed by studies at the Wharton School of Business.<sup>7</sup>

↑ **Interest Rate Stimulus:** Interest rate direction is the most significant short-term influence on stock prices.<sup>6</sup> Both long and short interest rates continue to sit at extremely low values by historical standards. Low inflation will keep short-term rates near zero for at least another two quarters. Low treasury yields are helpful to stocks in that they provide little competition for investment dollars.



↓ **Political Cycle:** We are moving into the second year of President Barack Obama’s term. Traditionally, the second year in the presidential cycle is the weakest for the stock market, averaging 7% returns under Democratic presidents and 8% overall since 1888.<sup>6</sup>

In addition to the macro-political cycle, the recent fiscal spending has created challenges that Washington will need to address in 2010 perhaps with higher taxes or other economically restrictive measures. Protectionist legislation also looms as a threat to U.S. and global growth.

↑ **GDP Growth:** Gross Domestic Product (GDP) is the official measure of the U.S. economy, tallying all goods and services produced in the United States. 3Q09 GDP rose 2.2%, following four straight negative growth quarters.<sup>15</sup>

This is a solid GDP growth rate, and near the “sweet spot” for stock market performance. Stocks actually perform better in weak GDP growth periods than in strong ones.<sup>11</sup> This may be due to the high interest rates that accompany periods of hot growth. In those times high bond yields prove worthy competition for investor money.

This positive quarter should confirm the end of the recession. Current estimates for 4Q09 GDP are 3.5% to 4.0%.<sup>11</sup>

### GDP vs. S&P 500<sup>16</sup>

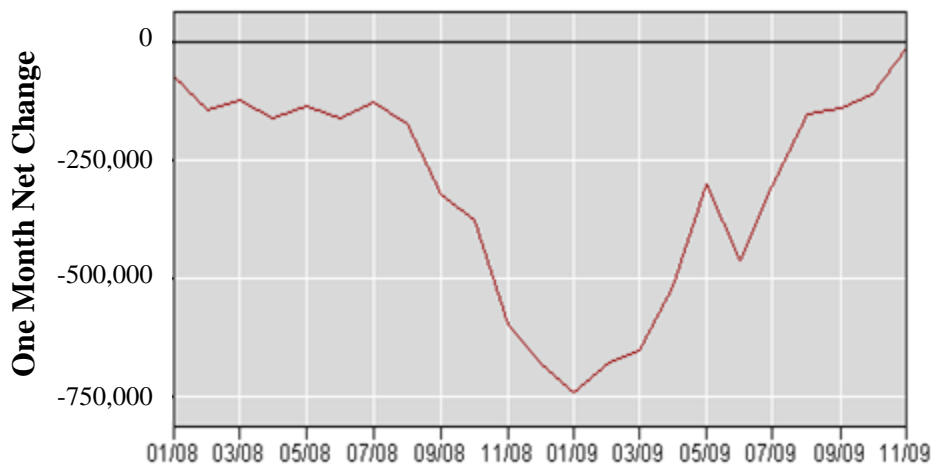
GDP Growth Rate	S&P 500 Annualized Gain
> 6.0%	-4.6%
0.5 to 6.0%	7.1%
< 0.5%	9.6%

↑ **Employment Momentum:** Employment conditions continue to dominate much of the conversation in the media and in Washington. The most frequently mentioned metric, the unemployment rate, is a lagging indicator, typically improving six months or so after recessions end.<sup>11</sup> While static job indicators such as the unemployment rate are dismal, the *forward-looking* job indicators are strong. They include the non-farm payroll and initial unemployment claims, which are showing momentum.

November saw an 11,000 decline in non-farm payrolls from the previous month,<sup>17</sup> the 22nd straight month of non-farm payroll decline; however, the rate of decline is *rapidly decreasing* (see chart), and December may actually show job *additions*. Initial unemployment claims have also decreased sharply.<sup>11</sup>

Job losses tend to reach a nadir one quarter following the steepest GDP contraction.<sup>18</sup> 4Q08 was likely the steepest quarter of GDP contraction, and job losses likely peaked in 1Q09.

### Non-farm Payrolls, Month-over-month Change<sup>17</sup>



➔ **Home Price Trends:** The Standard & Poor's/Case-Shiller Index signals a steeply *decreasing rate* of price decline. That is, home prices are still falling but less so each month. The San Francisco market, where many of our clients reside, is especially encouraging. Average year-over-year home prices there declined only 2.6% in October (most recent data), and may actually have turned positive by now. In Los Angeles, home prices declined 6.3% over the previous year and may be only a quarter away from turning positive.<sup>19</sup>

⬆️ **Stock Market:** Of all economic forward-looking indicators, the stock market is one of the best. In the short-term (days and weeks) the stock market moves unpredictably. Over several months and years, its purposeful trends are revealed. During recessions, the stock market quite consistently predicts the end of the recession five to six months in advance.<sup>7</sup> The S&P 500 Index made a low on March 9<sup>th</sup> and has since rallied 65%.<sup>20</sup>

⬆️ **Purchasing and Manufacturing:** The Institute of Supply Management (ISM) Index, the key manufacturing indicator, trended upwards again this quarter, showing continuing economic expansion for the fifth consecutive month through December.<sup>21</sup> Encouragingly, the New Orders component of the index showed the most strength.<sup>21</sup>

⬆️ **Inflation Control:** The most widely accepted measurement of inflation is the Consumer Price Index (CPI). The CPI and almost all future inflation indicators remain tame. As of November, the CPI was running at 1.8% year-over-year. This closed out the first 12-month period of positive inflation since February.<sup>17</sup>

The more-important Core CPI, which excludes the volatile food and energy components, rested at 1.5%, its lowest level since 2004 and well below the Fed's stated tolerable level of 2%.<sup>17</sup>

Inflation typically continues to decline for at least a year into recoveries.<sup>17</sup> We continue to see little threat of inflation during 2010.

Looking out a decade, the best predictor of 10-year average inflation is the 10-year TIP-Treasury spread, the difference in yield between the 10-year Treasury and the 10-year Inflation-protected Treasury. This spread is now 2.1%, indicating that the market is betting on *only 2.1% average annual inflation average over the next 10 years*.<sup>11</sup>

⬇️ **Oil Price Control:** We continue to watch the price of oil carefully and consider it one the most significant threats to the recovery. After rebounding 33% in 2Q09, oil price volatility calmed, climbing a modest 6% over the final six months of 2009.<sup>1</sup>

⬆️ **Consumer Spending:** Retail sales improved with a 1.3% year-over-year growth rate in November, twice the expectation.<sup>22</sup> Excluding the most volatile components (autos, gasoline and building materials), sales were up 1.2% and have jumped at a 5.6% annual pace during the past three months.<sup>11</sup> Retail inventories rose 0.2% in October, the first increase since the trouble ignited in August, 2008.<sup>22</sup>

Meanwhile, the University of Michigan Consumer Sentiment Index jumped meaningfully from 67 to 73 in November, though it remains below the long-term average of 86.<sup>23</sup> Its trend since February has been steadily upward.

⬆️ **Business Capital Spending:** The Business Roundtable's CEO Economic Outlook Survey Index, which takes the temperature of 160 member companies, made a sharp V-shaped recovery, rising back to the pre-crash levels of early 2008. Two-thirds of corporate executives surveyed expect their company's sales to increase in the next six months.<sup>24</sup>

Businesses also added to the hours of existing employees and added more temp workers, actions which usually precede permanent hiring.<sup>25</sup>

Finally, corporations may finally be rebuilding inventories. Inventories at factories and wholesalers rose in October for the first time in 14 months.<sup>26</sup>

- ↓ **Investor Sentiment:** The major sentiment indicators that we track continued into the optimistic zone this quarter as investors gained confidence from the stock market surge.<sup>27,28</sup> We prefer to see sentiment more pessimistic, which would imply that investors still have not yet pushed their money into the market.
- ↑ **Corporate Earnings:** The percentage of companies beating earnings estimates has steadily increased from 4Q08 through 3Q09 with 80% beating estimates in 3Q09.<sup>29</sup>
- ↓ **Insider Trading:** This continues to be one of our weakest economic indicators. Significant insider selling implies that executives have negative information about their companies' outlooks. Insider buying remained weak, below \$10 million/day for most of 4Q09.<sup>30</sup> TrimTabs, InsiderScore and Insidercow all confirm significant insider selling.<sup>31</sup>
- ↑ **Merger and Acquisition Activity:** Available cash and ready lending are igniting IPO (initial public offering) and M&A (merger and acquisition) deals, which is a boon to the stock market. "The IPO window is open," declared Bill Hurley of Benchmark Capital in November.<sup>32</sup> Globally, deal-making is recovering. The pace of announced M&A deals is now almost double the lows from last summer.<sup>33</sup>

#### Notes and Acknowledgements:

- Indexes used: BlackRock's S&P Europe (IEV), Vanguard's REIT Index (VNQ), BlackRock Morgan Stanley's Hong Kong Index (EWH), BlackRock's Goldman Sachs Oil Index (OIL), BlackRock's Lehman 20+ Treasury (TLT) as a proxy for long treasuries (-25% capital change + 4% yield = 21%)
- Index data from BlackRock
- Sharper ♦ Granite research and Dow Jones data
- Global Investment Performance Standard's (GIPS) Original Dietz Method used to calculate returns. Arithmetic average used for return measurement. Performance is net of fees and may include assets tracked for clients that lie outside Sharper ♦ Granite direct management. Such assets total less than 4% of total assets. All client portfolios weighted equally in calculation of average client performance. S&P 500 Index returns include dividends. Past performance does not guarantee future results. Normalization to similar risk as S&P 500 uses weighted average beta of all client portfolio assets, then normalizes to beta = 1.0 (S&P 500 Index beta) using the Securities Market Line (SML). The SML is constructed as a line on the beta-return chart between two points, A and B: A is the point representing "risk free" at beta = 0, return = 3 month return of the 90-day Treasury Bill rate on the last day of the quarter as posted in the *Wall Street Journal*. B is the point representing the "market return" at beta = 1, return = 3 month total return (including dividends) of the S&P 500 Index. Beta (asset) = covariance (asset monthly price %Δ vs. S&P 500 Index monthly price change) / variance (asset monthly price %Δ) using Yahoo! Finance historical price data. "Risk" as used here means market beta risk.
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- Insidercow, December 30, 2009
- TrimTabs shows \$40 of insider stock sold for every \$1 in September, 2009. InsiderScore shows \$63 of insider stock sold for every \$1 in 3Q09
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