

GREEN INVESTMENT MANAGEMENT, INC.

309 W 7th Street • Suite 101 • Fort Worth, Texas 76102-6901
Toll Free (800)950-8004 • Phone (817)335-1178 • Fax (817)877-0741
Web Site: www.GIMlink.com

Volume 18, Issue 1

February 4, 2009

Market Commentary

A Review of the Markets and a Look into the Future

Stocks on Sale: 50% Off!!!

“In short, bad news is an investor’s best friend.

It lets you buy a slice of America’s future at a marked-down price.”

-Warren Buffett

Overview: Strategy Session

Investment markets are strange beasts. When prices soar to unbelievable heights, people clamor to buy whatever they can wrap their fists around. When prices fall into fire sale territory, the aisles are as empty as a ghost town. I wouldn’t mind owning a retail store that worked like that!

Over the past year, investment markets across the globe have declined into fire sale territory. Relative to its last high, the U.S. stock market is practically offering a buy-one-get-one-free deal. Most other asset classes (except Treasury bonds) have been in a similar free-fall, as Figure 1 illustrates.

It is rare for such a range of asset classes to decline by such a similar degree. In this environment, even well

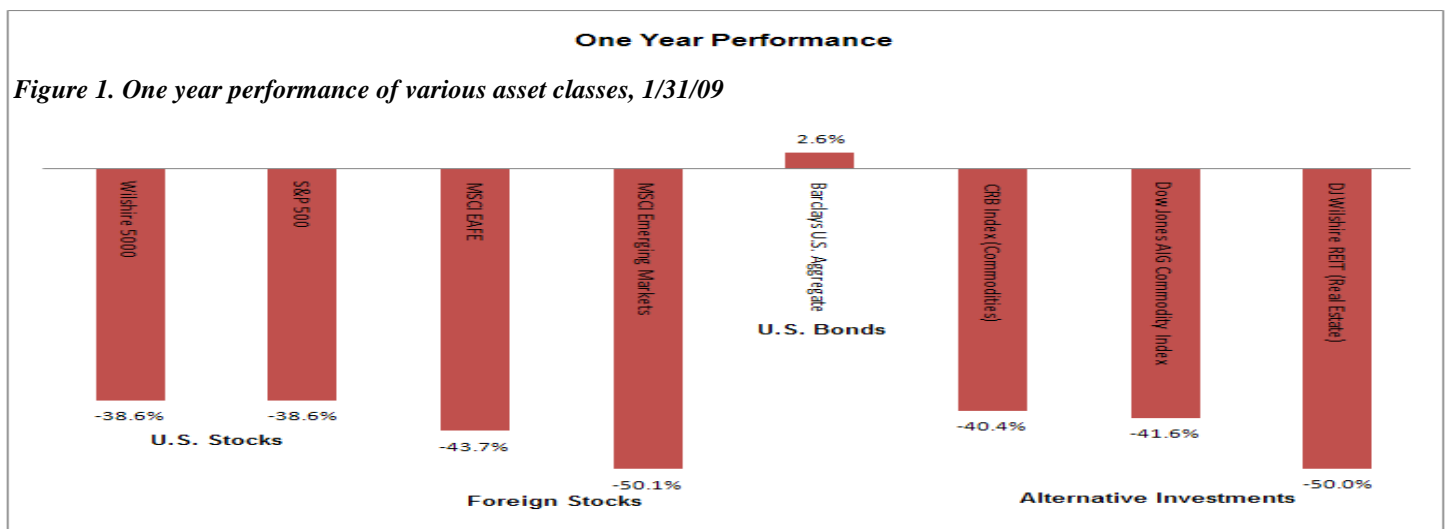
diversified portfolios have sustained large losses. Some of the industry’s most vaunted money managers, including those at huge endowment funds like Harvard’s and Princeton’s, have been left licking their wounds.

The common reaction of investors in this environment is to turn tail and run to cash. That is the self-reinforcing dynamic that has been driving the decline. But is it the best strategy?

Those who bail out of markets in the trough are often the ones who come back near the peak. It is not a winning strategy. To find a winning strategy you have to look to investors with a history of winning, like Warren Buffet. He summed up his strategy with this sentence: “Be fearful when others are greedy and be greedy when others are fearful.”

One Year Performance

Figure 1. One year performance of various asset classes, 1/31/09



Right now, others are definitely fearful. What reason is there not to take advantage of the fire sale by putting money into assets such as equities?

One reason would be to see how much further the decline can go, and try to buy at the very bottom. But unless you have a working crystal ball handy, this is hard to do. It is much easier to recognize an undervalued market than to time exactly when it will turn back up. The bottom of the trough is a function of human emotion, something beyond the reach of even the most sophisticated mathematical equations and computer models.

Another reason would be to wait for demonstrated proof of a recovery before buying back in. This sounds like a low risk strategy. But it actually contains a great deal of risk – opportunity risk. This is the risk of missing out on exceptional gains. The investors fleeing their “risky” investments into Treasury bonds and bills may be a prime example of people facing opportunity risk.

Take a look at the Bonds section beginning on page 3 of the newsletter to see how yields have fallen over the past six months. If that is not a strong measure of investor fear, I don’t know what is.

With all of this fear in the air, has Warren Buffet gotten greedy yet? In an October 16, 2008 New York Times op-ed entitled, “Buy American, I Am” he made the following comment:

“I’ve been buying American stocks. This is my personal account I’m talking about, in which I previously owned nothing but United States government bonds. (This description leaves aside my Berkshire Hathaway holdings, which are all committed to philanthropy.) If prices keep looking attractive, my non-Berkshire net worth will soon be 100 percent in United States equities.”

He made similarly definitive comments in a Forbes article on November 1, 1974. Stock returns had been

abysmal. The Dow Jones Industrial Average was below 600. Buffet said “Now is the time to invest and get rich.” The gains he reaped from that decision made him the richest person in the world.

Economy: The Great Depression, Revisited?

One argument against the current stock market being the buying opportunity of a lifetime is the idea that we are in for an extraordinarily long, deep recession. Some commentators have even likened this recession to the Great Depression, which lasted a decade, and might have gone longer had World War II not intervened.

Are we really in the midst of something like the Great Depression? Let’s compare the two periods side-by-side, refer to *Table 1* below. Based on these measures, the Current Recession has a long, long way to go before it can aspire to “Greatness.” The current market decline, however, does bear some similarities to that of the Depression. In both cases, there was massive deleveraging and a loss of confidence in the financial system. But the government response has been very different.

Some say the biggest single mistake made during the Great Depression was the government failing to curtail widespread bank failures. In this recession, the government has made Herculean efforts to support the banking industry. The same is true for most foreign governments.

In the Depression, the government did not understand the horrific ramifications for the economy of letting the money supply shrink as shown in Table 1. In this recession, the Federal Reserve has proven itself more than willing to use expansionary monetary policy to battle the downturn.

Additionally, we are seeing nothing like the massive deflationary spiral the economy fell into during the Depression. Many key commodity prices that declined early in the current recession have already stabilized.

Table 1. Great Depression vs. Current Recession

Measurement	Great Depression	Current Recession
Unemployment	25%	7.2% (projected to rise to 9%)
Real GDP	-26%	-.2% (year-over-year 2008)
Inflation	-26%	2% expected for 2009
Bank Failures	7,000+	25
Money Supply Growth	-25%	7.2%

The main problem now appears to be a lack of confidence. The markets seem to have discounted the fundamental state of the economy and then some. Over time confidence will return, and as usually happens we expect the market to rebound ahead of the economy. When it does, watch out above.

Stocks: Still looking like a bargain

Stocks have now endured two severe bear markets in a span of nine years. The first one began in 2000 when the technology bubble burst. It lasted 2½ years and brought grossly overvalued prices down to earth. When it was over, the U.S. stock market had fallen 49%. The current bear market began in October 2007 from valuation levels that were more reasonable. Nonetheless, this decline has exceeded all others since the Great Depression, with a 52% fall. These severe back-to-back declines produced a negative total return for the S&P 500 for a whole decade.

We call these markets bears, but of course they have nothing to do with the furry animals that romp through forests. They have everything to do with human beings, and their capacity for irrational emotion. The emotion dictating things now is fear.

We believe this fear will gradually dissipate, as it always has, and evolve into an appetite for risk and gain. The patient investor who came in low will be rewarded when this happens. Current price-to-earnings ratios are low. This creates the potential for gains much higher than earnings growth alone would dictate.

As to the timing of a market recovery, much of the fear in the markets is related to the state of the economy. The current recession is fast approaching its 14 month birthday. The longest life span of any recession since the great one is 16 months. There is no guarantee we won't exceed that record, but strong government stimulus gives us optimism that this recession may at least be in its old age.

It should also be remembered that equity markets look forward. They generally recover while the economy is still having problems. In a recent MarketWatch article, Mark Hulbert notes that over the last 60 years, stocks have performed better when the unemployment rate was higher rather than lower. Citing a study by Ned Davis Research, Hulbert writes:

“...the S&P 500 produced an average annualized gain of 13.5% when the unemployment rate was above 6%, in contrast to just 2.1% when it was at or below 4.3%. When the unemployment rate was

between 4.3% and 6%, the S&P 500 produced an average annualized gain of 5.2%.”

This is another example of how the stock market is a leading indicator. Just when everyone is feeling the worst about the economy and their investment accounts, the markets shift their focus to the much more pleasant road ahead. Investing based on macroeconomic data can be like trying to drive your car while looking in the rear-view mirror.

Doug Sandler, Chief Equity Officer at RiverFront Investment Group, notes that bear markets end at the point when distrust of financial institutions and even markets themselves becomes universal. One of the signs of this is minimal valuation premiums for the best issues versus the worst. “America’s great companies,” Sandler says, “those with the strongest balance sheets and most resilient earnings growth – now sell for a 20% premium to average companies. It’s a market structure that is not seen very often and rarely lasts very long. This environment would be analogous to walking onto a used car lot where almost every car was selling for between \$10,000 and \$14,000. In this scenario a Mercedes or BMW would sell for only \$4,000 more than a Kia or a Hyundai, and vehicles in good shape with all the options would command little premium over those with high mileage and no ‘bells and whistles’.”

According to recent research from Goldman Sachs, Compustat and Bloomberg covering bear markets from 1929 to present, after a trough the S&P 500 typically bounces quickly, gaining 22% in first 3 months and 45% in 12 months.

All of this wisdom highlights the fact that you should not be caught on the sidelines when stocks recover. Trying to jump in the game late can carry a large cost. Think of it this way, with just an average 12 month bear market rebound of 45%, an investor could make in one year what it would take many, many years to make on money parked in risk-free Treasuries.

To conclude, we expect U.S. stocks to stage the strongest recovery of all the major asset classes. We believe foreign equity markets are also undervalued. But due to early and strong policy responses in the U.S., we expect their performance will lag the domestic market.

Bonds: Public or Private, which is best?

All of the cash that left equity markets had to go somewhere. Much of it sought the safety of U.S. government securities. These securities have benefited

from:

- Liquidations from other investments
- A massive flight to quality induced by investor fear
- Strong inflows from foreign buyers
- Purchases driven by fear of a deflationary environment caused by commodity price declines
- Expectation the Fed will buy long Treasuries as part of its current monetary policy stance
- Improvement in the still-tight credit markets for corporations
- Home price stabilization
- Declines in financial write-down's

The Bottom Line: Is your shopping bag empty?

Many of us remember telling our kids that if they work hard and do their homework good things would come to them. That doesn't necessarily mean if you work hard today good things will come tomorrow, but eventually they will come. Taking the lesson to heart requires patience.

Sometimes as adults it is good to remember these lessons for ourselves. Many of the best investment opportunities require patience. The markets may recover this month, or the next or the next. No one can say for sure. But they will recover. When they do, it will likely happen quickly. Don't be caught with your shopping bag empty when the big sale on equities ends.

We know these are volatile times, and we will continue watching the situation closely here at Green Investment Management in order to respond quickly to any changes in outlook. As always, we send thanks to those of you that are our clients. We appreciate the trust you have placed in our firm to manage your money and we sincerely appreciate your business. If you have any questions or concerns, please don't hesitate to give us a call. 🐾

All of this buying has bid up prices on ten-year government bonds such that yields have fallen from 3.98% six months ago to 2.89% today. Three-month treasury-bill yields have dropped from 1.75% six months ago to .32% now. This makes Treasury bonds our least favorite investment at the moment.

Corporate bonds, on the other hand, have yield spreads over Treasuries that are at very high levels. So we expect to see opportunities for impressive gains in corporate bonds, especially the high yield variety.

Some General Thoughts and Expectations

The housing market's bubble provided the genesis for the array of troubles we now face. So improvement in housing will be a key to the recovery of the overall economy. There is good news in that volatility appears to be rolling over. We expect falling mortgage rates and other efforts to gain traction and create a recovery in housing, but a gradual one.

We expect the efforts of the Federal Reserve, the U.S. Treasury and the U.S. government to exert a positive influence on the markets and the economy. Lower energy prices, easy monetary policy and a large fiscal stimulus will create a good likelihood that the recession will end in mid-2009. Economic growth coming out of the recession could be low, but still sufficient to spark an impressive market recovery.

Internationally, our trading partners have also been aggressive in providing the liquidity their economies and markets need. This has helped support commodity prices and limit deflationary pressures.

Key positive (or negative) signs to watch for:

- Passage of a fiscal stimulus package—President's Day is the target

The views expressed are those of Byron Green as of February 4, 2009 and are subject to change. The information contained herein does not constitute investment advice or take into account any investor's particular investment objectives, strategies, tax status or investment horizon. Additionally, this publication is not intended as an endorsement of any specific investment. Information contained herein is derived from proprietary and non-proprietary sources. We encourage you to consult with your tax or financial advisor.