



2008 Year End Commentary-1/16/09



The Year in Numbers: (Note: all performance figures include reinvested dividends and, if applicable, capital gains. Portfolio performance is monitored using Morningstar resources.)

Model Portfolio Returns:	<u>2008</u>	<u>End of Day 1/16/09:</u>
Modified:	-40.75%	-7.11%
Pure:	-39.82%	-7.26%
Model Trust:	-24.68%	-7.57%
Challenge:	-29.75%	-5.95%
S&P 500:	-37.22%	-6.47%
Bond Fund:	1.11%	1.81%

Market Sector Returns:	<u>2008</u>	<u>end of day 1/16/09</u>
Large Cap US Stocks	-37.22%	-6.47%
Mid Cap US Stocks	-36.77%	-5.01%
Small Cap US Stocks	-34.15%	-6.64%
Developed Market International	-41.04%	-10.10%
Emerging Market International	-48.89%	-7.89%
REIT Real Estate Invst Trst Index	-38.75%	-14.29%
DJ AIG Commodities Index	-43.33 %	-2.82%

2008 Comments: Don't want to wish the passage of time, but boy am I glad to see 2008 end--A difficult year by any metric. 2008 was the worst year for the U.S. stock market since 1931. As you can see by the charts above, there was nowhere in the global investment world to hide-- except for US Treasury Bonds. Looking back at 2007 EOY Commentary http://www.darecapital.com/news/080117_newsletter.pdf, I identified some storm clouds but was frankly not expecting anything like what we've just been through.

If I tried to mention every market moving event of 2008, this letter would be thirty pages long. Here's a few, however: Bear Stearns bailout, Oil hits \$147 a barrel and then drops to \$35 in five months, Washington Mutual seized by FDIC, Lehmann Brothers bankruptcy, Wachovia nearly bankrupted, Global credit markets freeze up, AIG/Fannie Mae/Freddie Mac bailouts, Car makers seek bailout, 10 year note yield hits low 2% yield, Bernard Madoff accused of \$50 Billion Ponzi scheme, etc., etc.

All of these were important, but a few stood out and deserve some extra discussion:

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Lehman Brothers Bankruptcy-this happened over the weekend of Sept. 13th. The company, one of Wall Street's old line investment banks, had been the subject of speculation as to its ongoing health after it was discovered that the bank's capital was leveraged something like 40 to 1 in 2007, and 30 to 1 as late as the end of September 2008. Though the company was cash flow positive (!) and denied all speculation about its viability, it was under attack. A band of short sellers were bidding up the company's credit default swaps, selling the company's common stock short, pulling money from the bank's prime brokerage unit and spreading negative stories about the company in the media, a practice that Jim Cramer termed "Kesselschlacht" after the German Army tactic of encirclement and annihilation. The excerpt below is from CNBC-TV's *Mad Money* on 10/14/08:

Cramer described the process in which short-sellers and hedge funds targeted banks and destroyed them. By using unregulated credit default swaps, short-sellers were able to create unsubstantiated fear in a stock. Once the fear took hold, the short-sellers would exacerbate the situation using naked shorts and puts to lower the stock price even further at very little cost to them. With stocks under heavy pressure, rating agencies were forced to lower ratings, causing media speculation and eventually banking customer panic. Cramer said the Securities and Exchange Commission's prior moves to ban short-selling on financials didn't go far enough to prevent the credit default swaps from being used to spread fear.

Why Lehman Brothers' bankruptcy especially matters is that the company had \$126 Billion in unsecured debt. When those investors (and they included German pension funds, Asian individual investors, you name it-many of whom thought they owned very conservative investments) realized that their investments were worthless, a group of them ran for the doors in unison, investor to investor trust and appetite for counterparty risk went out the window, and the global credit markets froze. The equity markets went straight south and are still trying to recover from this.

To state this again as clearly as I know how to, Lehman's failure is **THE** event that accelerated the crash last fall. To be sure, there were a lot of other issues, and letting Lehman fail felt right at the time ("Punish the arrogant greedy investment bankers who took on too much risk!"), but we as investors are collectively paying for that turn of events.

Historic Commodities Swing:

In the August letter http://www.darecapital.com/news/080802_newsletter.pdf I spent a fair bit of time talking about the run-up in oil and the fact that, while we wanted to own commodities exposure, the world economy would be hurt by continued high energy prices. At that time the fund that I use for commodities exposure was up something like 33% for the year. Well, that fund, the PIMCO Commodities Fund (PCRIX) ended up down 43% for the year, for a truly out of the ordinary 77% one year swing.

What's behind the move? Why did commodities go from being the hottest asset class to one of the coldest almost overnight? The weak global economy has something to do with it for sure, but I think the forced dissolution of a group of hedge funds who owned commodities had more to do with the amplitude of the second half 2008 drop. Pundits continually remarked how \$8 Billion of "smart money" had entered the commodities sector, tracking investors (like David Swenson of the Yale Endowment) who advocate commodities exposure. Those pundits continually called the capital inflows "a bubble" and suggested a multi-year collapse in the sector was imminent. I say, not so fast! For one thing, \$8 Billion across the whole commodities sector (Just to scratch the surface, consider the components of the Dow Jones-AIG Commodities Index: Natural gas, gold, oil, soybeans, corn, cattle, aluminum, sugar, wheat, copper, hogs, coffee, heating oil, silver, soybean oil, cotton, unleaded gasoline, zinc, and nickel) represents only the market capitalization of one midcap stock. In other words, not a big position when you think of the broader universe of investment capital and the global need for raw materials. I think the market has gotten this one wrong! See my 2009 outlook for more discussion regarding commodities.

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Government Involvement (or not) and the resulting consequences: This is a biggie, because the government has intervened in the operation of banks, insurance companies, and automakers, and (in)famously not in the case of Lehman Brothers. In the case of the TARP bank rescue plan, Treasury Secretary Paulson appeared to waffle and apply inconsistent direction to the plan in November, causing the market to hit new lows on a crescendo of selling based on his perceived inconsistency and lack of strong focus/vision.



Banking analysts have observed that the Financial Accounting Standards Board's 2007 changes to mark-to-market accounting rules have exacerbated the downdraft in asset write-downs by financial institutions, forcing companies to continually reprice illiquid securities in a market that is temporarily frozen.

The Securities and Exchange Commission (SEC) also has an outsized influence on the markets' workings, again in what could be considered a lax or inconsistent manner. Market observers feel that the SEC under Christopher Cox has been one of the biggest contributors to market instability by:

1. Repealing the uptick rule on short selling in July of 2007.
2. Allowing the proliferation of double and triple leveraged exchange traded funds (ETF's), which have caused great instability and wild swings in the markets due to the leverage they employ.
3. Allowing an unregulated market to trade in credit default swaps, in effect allowing investors to buy insurance on a company that they did not own, then destroy it and be paid for their efforts. (Think of it like buying homeowner's insurance on a house that you do not own, then burning the house to the ground and collecting a check.)
4. Allowing naked shorting of a stock-that is, selling the stock without having to locate the actual shares to borrow.

It should also be noted that the SEC received several calls over the years suggesting that something wasn't quite right with a Mr. Bernie Madoff's suspiciously predictable portfolio returns. The SEC apparently investigated the calls and found no evidence of wrongdoing, even as Mr. Madoff was allegedly propagating a multibillion dollar Ponzi scheme right under their noses.

Atonement: Owning Up to mistakes, missteps and other general hardheadedness

- A. **Trying to find value and stay long the market-** Guilty. I am no great market timer, the market has looked cheap to me for some time, and I think investors with more than a five year time horizon should maintain market exposure. In retrospect it may have been a better call on my part to tell clients to take the year off and go travelling or something. For what it's worth, a year like we've just been through can't help but offer incredible opportunity for value seekers in any but the most dire economic environments.
- B. **Contrarian stance-** Guilty. I do not mind sticking my nose in places where I think the market has overreacted. I have to be willing to be wrong for a while as the market realizes that it has overreacted, and in a year like 2008 this approach can cause some short/medium term pain.

- C. **Not Selling the Financials**—Guilty. We are still not overweight this sector, but Goldman Sachs, Ameritrade, and BBT are broadly owned favorites. We were hurt by Washington Mutual, and to a lesser extent Wells Fargo, Wachovia, and Bank of America. The market is currently trading these as if the whole sector is in danger of disappearing—stay tuned for how it will ultimately play out.

Trends for 2009:

As my fellow planner and mentor Ron Pearson wrote in his year end letter to clients, the most severe recessions since the Great Depression have been 16 months long ('73-74 and '81-82). We "officially" entered this recession in December 2007, showing how difficult it is to determine when recessions start or stop. We are thirteen months into this one, but right now it seems Bear-er than most. Will it end in a few months? No one knows. To me, the one indicator to watch is inflation versus deflation--all else is secondary.

Deflation is a condition marked by the systemic loss of value in almost every asset class in an economy, reduced spending by government and individuals, and perhaps an increase in unemployment. Economic deflation hardly ever occurs but is the hardest condition to remedy—think Japan in the 1990's. Fear of deflation is also behind the unprecedented fiscal and monetary stimulus packages that global central banks have injected into the world's economies.

Fear of deflation has played out recently in a flight to US Treasury Bonds. Treasuries are trading at such historic high prices and low yields that James Grant, publisher of *Grant's Interest Rate Observer* called them "Return-free risk" at current levels in an article which appeared in the Jan 10, 2009 issue of *The Economist*.

On the other hand, inflation is a condition marked by higher input costs and higher valuations for everything except money. Bonds tend to do poorly in inflationary times. The traditional hedges against inflation are real estate, commodities, and common stocks.

There are undeniably a lot of moving parts to the current economic situation, and we may be in for more rough sledding. I just can't help but think that the stimulus the Fed and global central banks have thrown at the world economy will be inflationary at some point in the future. The \$64 trillion dollar question is "When will that occur?"

From a more granular perspective, I also think it is worth owning oil at \$37 a barrel. Bluntly, I think the day will come when we will look back at sub-\$40 oil as a gift we should have taken advantage of. I plan to do just that.

Finally, my wish for 2009 is for an end to the relentless media negativity and breathless reportage of all that is bad or dysfunctional in the world; for a society wide "circular filing", if you will, of action verb pornography, of "Plunges, Slashings, and Dives" which make things seem worse than they are and which pander to the perceived need for intelligent people to be brutally and systemically desensitized by a group of hired gun jackals with word processors, secretly afraid for their own futures; and, most of all, for a return to a kinder, gentler, more honest America, where one's words and deeds do indeed mean something. I invite you to join me in this quest.

Good investing, Will W. Woodard, III, CFP®

Will Woodard is president of Dare Capital Management LLC, a Registered Investment Advisor firm in the State of North Carolina. Learn more about the firm at www.darecapital.com Will and/or clients of Dare Capital Management LLC may own the investments mentioned herein.

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