

# **A LOOK AHEAD AT THE YEAR AHEAD**

**Four Wealth Management Strategies  
to Capitalize on Our  
Ten Investment Themes for 2008**

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**THE MDE GROUP, INC.**

Your family's most trusted advisor

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# A LOOK AHEAD AT THE YEAR AHEAD

## A Glance Back on the Year That Was

Before we can look forward to 2008, we feel it is only appropriate to assess the accuracy of our prior year predictions. As the title of this report indicates, our investment themes are more than cocktail party conversation. Rather they reflect our best thinking and ultimately are used to design investment strategies that may capitalize on these forecasts. We realize the inherent difficulty in making forecasts and fully expect to never be 100% correct. Nevertheless, we are pleased to report that eight of the ten forecasts we made last year, in our view, were assessed to be correct. The remaining two were partially correct according to our analysis.

Where did we go wrong in 2007? Residential real estate prices continued to fall nationally. Our forecast was for falling prices only in the regions that experienced the most rapid appreciation in recent years, such as Miami, Las Vegas, and some areas of California. This part of our forecast was correct, but prices fell in most regions across the country, not simply those that were previously the subject of speculation. Our second partially incorrect forecast was related to the performance of short-term or cash equivalent securities relative to long duration bonds. For the first half of the year, this forecast was spot on, but as the economy began to weaken and the Fed began to slash interest rates, long-term bonds surged ahead and outperformed over the course of the full year.

## Report Card for MDE's Investment Themes for 2007

Prediction	Assessment	Comments
1) No recession in 2007.	Correct	Real GDP increased 1.3% in the first quarter of 2007, 3.8% in the second quarter, and 4.9% in the third quarter. The fourth quarter GDP figure has not yet been released, but it is expected to be weakly positive.
2) The Fed will remain on hold for most of the year.	Correct	The Fed remained on hold for approximately the first 9 months of the year. Subsequently, on September 18 <sup>th</sup> it reduced the Federal Funds rate by 50 basis points, its first easing in 4 years.
3) Stock market returns will be below average for the 3 <sup>rd</sup> year of the Presidential Cycle, but still reasonably attractive due to an expanding P/E multiple, modest earnings growth and flow of funds away from real estate speculation.	Correct	The S&P 500 returned 5.5% for the calendar year. International stocks fared even better, with the MSCI Developed World Index (ex US) rising 12.4% in 2007. Although respectable, these returns are well below the 22.1% average experienced during prior 3 <sup>rd</sup> years of the US Presidential Cycle.
4) Real estate prices stop falling nationally, but continue to fall in some overdeveloped areas.	Partially Correct	Real estate prices continued to fall nationally, but especially in overdeveloped areas, such as portions of Florida, California, and Nevada.
5) Continued strong M&A / LBO activity due to strong corporate balance sheets, low interest rates, and large cash on hand of many corporations and private equity funds.	Correct	Worldwide M&A activity hit an all-time high of \$4.4 trillion in 2007, up 21 percent from \$3.6 trillion in 2006, despite the credit crunch that began in the latter half of the year.

6) The Dollar will be under further downward pressure as foreign central banks hike short-term rates and investors re-focus their attention on the U.S. trade and budget deficits.	Correct	In 2007, the Dollar fell 10.4% vs. the Euro, 5.7% vs. the Japanese Yen, and 14.7% vs. Canadian Dollar, to note a few examples. In fact, the Dollar fell relative to 14 of the 16 most actively traded currencies in 2007.
7) Opportunities continue to exist in overseas markets with lower valuations and higher yields compared to the U.S., but selectivity becomes critical.	Correct	The MSCI Developed World Index (ex US) outperformed the S&P 500 by 6.9%. Performance in emerging markets was far stronger, with the Shanghai Stock Index up 96.7% and India Bombay Index up 47.1% to note two prominent examples.
8) Fund flows into alternative investments will continue to increase, but at a decreasing rate due to the maturation of the asset class, investor dissatisfaction with high fees, lack of liquidity, limited transparency, and unspectacular returns.	Correct	Hedge fund assets under management increased to a record \$2 trillion in 2007. The 29% rate of increase was below that of the 39% increase realized in the prior year.
9) Cash and short-term money market instruments will continue to offer excellent investment merits relative to long duration bonds.	Partially Correct	Cash and short-term money market funds outperformed longer duration fixed income investments for the bulk of the year. However, long duration investments earned higher returns by the end of the year as the economy began to weaken in the fourth quarter, resulting in both lower short- and long-term interest rates.
10) Infrastructure investment opportunities will continue to emerge, reflected in both increased assets under management for this segment and in wider investment offerings.	Correct	Investments in infrastructure assets increased a healthy 33% in 2007 to \$106 billion as many government agencies sought to raise money by selling or leasing assets. The tragedy of the Minnesota bridge collapse, brought infrastructure into the minds of the public at large.

## MDE's Ten Investment Themes for 2008

While we firmly believe that no one can know the unknowable or predict the unpredictable, we also realize that as wealth management advisors we are paid to deliver advice. So it is a core part of our job to analyze the world around us and to make investment recommendations based upon our best thinking. Our advice at MDE tends to be strategic and long-term in nature, but nimble enough to adapt to the ever-changing investment landscape.

With this in mind, we would like to share with you our thinking on some of the significant factors we believe will play an important role in the year that has just begun. Just as was the case last year, we can state with some confidence that some themes we offer for 2008 are likely to be correct, some incorrect, and some partially correct. We can also predict with great confidence that what will ultimately prove to be some of the major themes of 2008 are neither on our list, nor on anyone else's. With these important facts in mind, we humbly offer you our top ten investment themes of 2008.

- 1. Economic growth will be well below its long-term average of 3%, but if there is a recession it will be short lived.** Whether the U.S. is in a recession or close to it, is almost irrelevant, since it will be revealed in the "official statistics" well after the fact. The margin of error between 1% growth or 1% decline is quite small. What we can confidently say is that the economy has slowed considerably and is likely to remain sluggish over the near term. In our view, any possible recession will be relatively shallow and short lived due to aggressive action by the Fed, the correction of dysfunctional markets, and international exports.
- 2. The Fed will continue to cut interest rates in an effort to jump-start the economy.** Given the current slowdown in the US, the Fed has no near-term choice, except to cut interest rates. A fifty basis point cut is likely for the January 30<sup>th</sup> Fed meeting and others are likely to follow.

3. **High quality investments, on balance, will outperform low quality investments.** The slowing economy often creates panic and a flight to safety mentality among skittish investors. There is no universal definition of high quality, but it often maps into large cap, stable growth companies, with a long history of increasing earnings under various economic environments. On the flip side, small cap companies and those with erratic or negative earnings are likely to underperform, in our view.
4. **Real estate prices continue to fall nationally.** Not running from our partially incorrect prediction concerning real estate last year, we take another stab at projecting its direction this year. A huge inventory overhang, increasing job losses, rising credit spreads, and flight of speculative capital all combine to create a witches brew for home prices. Since real estate is not a national market, it is nearly impossible for all regions to fall simultaneously. Nevertheless, the confluence of forces listed above will likely result in falling residential real estate prices at an aggregate level in 2008.
5. **Asset flows into structured or planned returned investments will increase at double digit levels.** Planned returned investments increased 56% in 2007 to approximately \$100 billion. The combination of high volatility and the desire to avoid losses, creates a compelling opportunity to invest in this burgeoning asset class.
6. **Corporate default rates will rise substantially.** We have heard about the credit crunch, but have not yet seen the complete fallout. Many bad companies were propped up by the liquidity that flooded the market in recent years. The “easy money” plug has been pulled and speculative companies now face a very difficult environment to obtain financing. The net result will likely be a rise in the number of defaults vs. the 2007 level of 0.34%
7. **Total dividends paid by corporations will be reduced as firms attempt to conserve cash and shore up balance sheets in a slowing economy.** Financial firms were the hardest hit during the subprime crisis and generally have higher than market payout ratios. In order to shore up their Balance Sheets, financial firms such as Citigroup, Merrill Lynch, and Morgan Stanley have sought to raise capital. High dividends are a luxury, not a necessity, and are one of the first things to go during times of financial distress.
8. **Commodity prices will remain volatile and at elevated price levels.** Despite weakness in the U.S., commodity prices will continue to be strong, partially due to continued rapid growth in international markets. This overseas growth will offset tempered consumption in the US. The net result to consumers will *not* be a dramatic drop in prices at the pump or the supermarket, creating a double whammy of weak or negative economic growth and high prices.
9. **As dysfunctional markets become functional over the course of the year, there will be excellent opportunities in select distressed assets.** The slow motion train wreck that began with subprime, has not yet run its full course. As we write this review many markets, such as asset backed securities, are dysfunctional. They are too important to disappear entirely, and will eventually return to working order, albeit at possibly lower levels. In our view, those who patiently wait will ultimately be rewarded in some distressed sectors. To further clarify our views, the time for high quality assets is right now, while the time for distressed assets may emerge later in the year and with a dollar cost averaging approach to minimize the point of entry risk.
10. **IPO activity will decrease due to a reduction in investor appetite for riskier investments and a more challenging financing market.** IPO activity is cyclical by nature and largely driven by two factors, investor appetite and market valuations. Investors are currently engaged in a flight to quality and valuations are becoming relatively unattractive for strong privately held firms. The end result is an adverse selection bias, where the best private equity firms remain on the sidelines and wait for a better market, while the less attractive firms seek to go public in a bid to finance their expected growth or shore up shaky finances.

## MDE's Four Potential Wealth Management Strategies for 2008

Investment themes in and of themselves are interesting, but of little value. They must be actionable if they are to be valuable for our clients. Therefore, coupled with our Ten Investment Themes, we would like to offer Four Potential Wealth Management Strategies for 2008, along with specific techniques to implement them.

1. **High Quality Investments Provide Relative Safety In A Slowing Economy.** Former Fed Chairman Alan Greenspan has said there is a 50% chance of a U.S. recession. Bond guru Bill Gross and brokerage firm Merrill Lynch have stated we *are* in a recession. In a survival of the fittest economic environment we favor high quality companies.
  - ◆ We have moved from our traditional Value bias to one that more evenly balances Value and high quality Growth.
  - ◆ We have modestly increased our allocation to global and international managers whose portfolios may benefit from the superior growth prospects of many foreign companies and act as a hedge against a falling Dollar.
  - ◆ We have significantly reduced our allocation to merger related funds. As capital dries up due to the credit crunch, or is available at much higher rates, it may result in fewer deals and lower expected returns.
2. **Effective Risk Reduction Through Planned Return Investments.** Structured, or planned return investments, reduce downside risk at the cost of capping upside potential. Given the volatility in the market, in our view the risk/return equation makes planned returned investments a compelling investment opportunity.
  - ◆ We added planned return investments to our wealth management platform for the first time in 2007 and we foresee further expanding this allocation across client portfolios in 2008.
  - ◆ By covering the first ten percent of losses, planned returned investments provide significant downside protection in the event of a severe recession and bear market.
  - ◆ By multiplying the returns in the lower end of the return spectrum by a factor of three, the planned return strategy provides a higher probability of outperformance in relatively flat markets.
3. **Subprime Fallout Will Eventually Result in Excellent Opportunities For Distressed Assets.** We have been around long enough to know it is not wise to catch a falling knife, but believe when the dust settles there will be attractive investment opportunities in distressed assets.
  - ◆ We are researching credit related fixed income funds that are offering healthy yields and low default rates. Returns may be attractive, even after adjusting for an uptick in defaults.
  - ◆ Real estate related investments have had a dismal two years of performance and the worst may be yet to come for part or all of 2008. Nevertheless, while others are panicking, bargains may be found. Opportunities may not only exist domestically, but also globally given the non-synchronicity of the world economy.
4. **Falling Yields Create Need For Innovative Ways To Earn Income.** With the 90 day Treasury Bill and 10-Year Treasury Bond yielding 2.0% and 3.3%, respectively, it has created a challenging environment to earn adequate income through conventional fixed income portfolios.
  - ◆ We are studying the prospect of using planned return investments on the fixed income side of client portfolios, potentially resulting in higher returns and less correlated risk relative to traditional fixed income vehicles.

- ◆ Real estate and distressed assets, as noted above, provide attractive yields that may be worthwhile quasi-fixed income investments.
- ◆ We continue to favor select energy master limited partnerships (MLPs), despite recent volatility. The Alerian MLP index earned a total return of 12.7% last year, although all of its returns were achieved by the end of February. The index exhibited extreme volatility over the remainder of the year, due mainly to the turmoil in the financial markets, as opposed to weakening fundamentals. Business fundamentals for the MLP space remain strong; distributions are continuing to increase and yields remain strong with the spread to ten year Treasuries having withstood well beyond historical norms. While returns are likely to remain choppy over the first half of the year, MLPs should prove to provide higher single digit or low double digit returns over the course of the entire year.

Providing investment advice is at the heart of our wealth management business and we leave no stone unturned in our continual search to add value to our client portfolios. Often we add value through conventional equity and fixed income investments. But we often rise above our competitors during challenging market environments, since it allows us to uncover new investment opportunities, such as planned return investments, master limited partnerships, and transparent alternative investments. What appears to be a bold move for the benefit of our clients at the time, often turns into conventional wisdom years down the road. The collective wisdom of the entire MDE team is working hard for our clients each and every day. We at MDE look forward to the opportunity to discuss our Ten Investment Themes with you, as well as the ways in which our Four Potential Wealth Management Strategies can be custom tailored for your personal situation.