

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

**Ten Investment Themes for 2009 and Our  
Four Strategic Wealth Management Themes  
to Capitalize on Them**

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**THE MDE GROUP, INC.**

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## A Glance Back on the Year That Was

Before we can look forward to 2009, 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. Although we had six predictions correct, one partially correct, and three incorrect in 2008, we view it as a pyrrhic or hollow victory given the dramatic decline in most assets over the course of the year.

Where did we go wrong in 2008? Although we forecasted below average economic growth in 2008, we did not foresee the recession that unfolded over the course of the year and accelerated towards the end of it. Similarly, the credit crisis that began in 2007 resulted in financial markets going from dysfunctional to frozen in the aftermath of the Lehman bankruptcy in October. The credit markets have modestly thawed as we begin 2009, but they remain far from normal. Our forecast for an increase in structured products was off slightly, with originations dropping from \$114 billion in 2007 to \$110 billion in 2008 as the credit worthiness of the product issuers was called into question. Lastly, we were partially correct on our commodities prediction. We forecasted volatile and high commodity prices over the course of 2008. The volatility occurred throughout the year, but prices moved in a “reverse V” shape with a sharp rise followed by an ever more dramatic decline. For example, oil began the year priced at \$96 per barrel, peaked at \$147 in July, and then ended the year at \$44 per barrel.

## Report Card for MDE's Investment Themes For 2008

Prediction	Assessment	Comments
1) Economic growth will be well below its long-term historical average of 3%, but if there is a recession it will be short lived.	Incorrect	Although economic growth was well below the historical figure of 3%, we did not foresee the deep recession that unfolded in 2008.
2) The Fed will continue to cut interest rates in an effort to jumpstart the economy.	Correct	The Fed cut interest rates dramatically, with the Federal Funds Rate falling from 4.25% at the start of the year to a range of 0% to 0.25% at the end of the year.
3) High quality investments, on balance, will outperform low quality investments.	Correct	The ultimate high quality investment – U.S Treasury securities – turned in the best performance of the year, relative to traditional assets. International and emerging market stocks were among the worst performers.
4) Real estate prices continue to fall nationally.	Correct	Real estate prices fell sharply with the S&P / Case-Shiller Index down approximately 18% over the course of the year.
5) Asset flows into structured or planned returned investments will increase at double digit levels.	Incorrect	Structured investments totaled approximately \$110 billion in 2008, a modest drop of 3.5% from the previous year's value of \$114 billion. Issuance slowed down in the latter half of the year as credit concerns about banks came to the forefront of investors' minds.

6) Corporate default rates will rise substantially.	Correct	Moody's Investors Service found the global speculative-grade default rate finished 2008 at 4.0%, more than quadruple the 2007 year end rate of 0.9%.
7) Total dividends paid by corporations will be reduced as firms attempt to conserve cash and shore up balance sheets in a slowing economy.	Correct	Dividends for S&P 500 stocks fell 2.3% in 2008, largely on the basis of turmoil in the financial sector. Financial firms are typically among the sectors that pay the most dividends, but were often forced to trim or eliminate dividends on common stock as a condition for accepting TARP funds.
8) Commodity prices will remain volatile and at elevated price levels.	Partially Correct	Prices rose sharply over the first half of the year, and then fell precipitously over the second half. For example, oil began the year at \$96 per barrel, peaked at \$147 in July, and ended the year at \$44 per barrel.
9) As dysfunctional markets become functional over the course of the year, there will be excellent opportunities in select distressed assets.	Incorrect	Credit markets went from dysfunctional to frozen in the aftermath of the Lehman Brothers bankruptcy. Distressed assets largely became even more distressed over the course of the year.
10) Democrats will win the 2008 Presidential Election, raising the risk of higher tax rates in 2009 and beyond.	Correct	Democrat Barack Obama was elected President of the United States and part of his platform is to increase taxes on corporations and the wealthy.

## **MDE's Ten Investment Themes for 2009**

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 2009 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 2009 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 2009.

1. **The recession will extend through the bulk of 2009.** The National Bureau of Economic Research (NBER) declared in late 2008 that the United States economy has been in a recession since December 2007. The average recession since World War II has lasted 11 months, but this recession is far from normal. It is the only recession, since The Great Depression, that has resulted in a significant drop in the stock, bond, and real estate markets. Hence, a recovery is not expected to be quick, especially in light of the continued difficult credit markets. In short, a recovery is not likely until the end of 2009 or sometime in 2010.
2. **Corporate defaults will continue to rise, but credit spreads will shrink from elevated levels.** Default rates often lag economic activity as distressed companies tap all sources (e.g. asset sales, credit lines, etc.) in an effort to

stave off an impending default. Defaults will inevitably rise in 2009. However, credit spreads are at extremely high levels, pricing in a Great Depression scenario. In our view, the number of defaults will increase as the economy continues to contract, but a continued thaw of the credit markets and investor realization that we are not in “Great Depression, Part 2” will shrink credit spreads.

3. **There will be a wave of bank mergers as strong banks merge with weak banks.** Weak banks, such as Wachovia and Washington Mutual were given a Hobson’s Choice by the Federal Government – merge at fire sale prices or go bankrupt. Many other banks face or will face a similar choice as the year unfolds, especially with the Obama administration indicating that the next \$350 billion of TARP funds will go towards activities that support consumers and municipalities, not banks.
4. **The number of hedge funds will contract in 2009.** Nearly all hedge funds have a “highwater mark” which forces them to recoup any losses before earning the incentive fees that are essential to their survival and growth. The HFR Global Hedge Funds Index fell 23% in 2008, placing many hedge fund companies in distress and the viability of their business in doubt. On the positive side, the turmoil in the hedge fund sector will likely accelerate the industry towards our longstanding vision of increased liquidity, transparency, and lower fees.
5. **Cash equivalent and U.S. Treasury securities are the next bubble, but if it unwinds it could have positive implications for riskier investments.** A bubble is typically defined as an asset that is trading at prices well in excess of their fundamental values. U.S. Treasury securities are selling at yields near their all-time lows, with the 30 Day Treasury Bill yielding 0.09% and the benchmark 10 Year Treasury yielding 2.3%. In the bond market, low yields result in high prices. Of course, yields have been driven down in large part by the “flight to quality” movement from risky securities to U.S. Treasuries. As fear subsides and the credit markets move from nearly frozen to functioning, money should move out of Treasuries and into more traditional investments, such as stocks as bonds.
6. **There will be increased government regulation of the financial markets and involvement with financial institutions.** It is clear that the government is playing a large role in high profile companies such as AIG, Fannie Mae, and Freddie Mac. Furthermore, those firms that accepted TARP funding have close ties to the federal government. In our view, the “money with strings attached” approach to helping distressed financial institutions will continue in some form. Additionally, as Congress eventually untangles the problems that resulted in the destruction of the modern investment and universal banking firms, it will enact a raft of new regulations that may reduce short-term risk, but raise the specter of unintended long-term consequences for our financial system.
7. **Unemployment will continue to increase for the bulk of 2009 and corporate earnings will be depressed.** Economic news appears to be going from bad to worse, as lower sales result in reduced corporate earnings, which in turn result in companies reducing headcount. This vicious cycle will eventually reverse, but unfortunately it appears that it still has a way to go. However, the financial markets usually rise 6 to 9 months ahead of the economic fundamentals, so it may not be prudent to move to an ultra conservative portfolio at this time.
8. **Consumers will reduce discretionary spending and increase savings rates.** Without a doubt, consumers are hurting, suffering from a triple whammy of less employment, wealth, and credit. The painful, but necessary choice of reduced spending and increased savings is practically the only way for consumers to repair their fractured balance sheets. This “Paradox of Thrift” is good for the individual consumer, but bad for the economy as a whole, since it typically results in falling retail sales and employment.
9. **Fundamentals will ultimately dictate security prices, as investors begin to discriminate between strong and weak companies.** The global bear market of 2008 resulted in indiscriminate selling across nearly all asset classes, as liquidity overwhelmed fundamentals – the proverbial baby was thrown out with the bathwater. As panic subsides, and markets gradually return to a functioning status, those firms that were unfairly punished will move towards their fundamental values. Quantitatively, we forecast a larger than normal gap between the returns of top and bottom quartile firms in most broad indexes.

10. **Commodity prices will bottom and gold will experience renewed interest due to investor concerns about the federal budget deficit, government policy, and the threat of long-term inflation.** Like equities, commodity prices also dramatically declined as the second half of the year unfolded. A material portion of the decline may be attributed to forced selling by hedge funds, in addition to the global economic slowdown. In our view, the drop in commodity prices was overdone, as there remains a fundamental imbalance in the long-term supply / demand relationship across most segments. Additionally, investors will ultimately shift their myopic focus from deflation to the inflation that will likely emerge over the longer term in the wake of persistent federal budget deficits. We believe gold will benefit as this longer-term view comes into focus.

## **MDE's Four Strategic Wealth Management Themes for 2009**

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 Strategic Wealth Management Themes for 2009, along with specific techniques to implement them. In some cases, there is overlap among the recommended action points to each theme, but we view this as a positive since it demonstrates consistency in our thinking.

1. **Buy Yield and Get Paid to Wait.** The global credit crisis has resulted in mass selling across the board in virtually all investments other than U.S. Treasury securities and cash equivalents. Accordingly, many yield oriented investments are selling well above their long-term historical averages. Investors have the opportunity to earn attractive current yields and also have the prospect of earning a capital gain “kicker” if yields revert in the direction of their long-term averages. Specific investments that may capitalize on this theme, and their corresponding yields include. \*

◆ **Breckinridge Municipal Bond Strategy (4.62% yield):**

- Core muni bond manager that focuses on high quality issues.
- Muni yields are trading at 170% of Treasuries, much greater than its long-term relationship of approximately 80%.

◆ **Loomis Sayles Bond Fund (9.4% yield):**

- “Go anywhere” bond fund with exposure to corporate and agency bonds.
- Likely to benefit from contraction of credit spreads.

◆ **Nuveen High Yield Municipal Bond Fund (15.8% yield):**

- The Obama Administration is likely to support municipalities, resulting in lower than expected defaults.
- Any improvement in the liquidity of non-rated bonds will provide a significant boost to the fund’s returns.

◆ **Kayne Anderson/Direct MLP Investments (12.3%yield):**

- Prices do not reflect the good long-term fundamentals of the Energy sector.
- Historical yield of this closed end fund is approximately 6%.

◆ **Lazard Emerging Income (11% yield):**

- Actively managed investment in sovereign debt of emerging market countries, with low chance of default.
- The fund has multiple country dependent return drivers and acts as a potential hedge against a falling U.S. dollar.

◆ **Stonebridge Preferred Stock Strategy (8.7% Yield):**

- TARP preferred investments are generally pari passu with existing preferred investments, resulting in an unwarranted divergence in yield between the public and government's preferred shares.
- Stonebridge has customized their core strategy for MDE to include fewer financial issues and deliver greater industry diversification.

◆ **Schafer Cullen High Dividend Equity (4.6% yield):**

- Focus is on solid companies, with the ability to grow dividends.
- Attractive yield, with equity kicker if stock markets rebound.

\* Yields are pre-tax; tax exempt yields are grossed up assuming a 35% rate for taxable fixed income securities.

2. **Be a Partner with the Government.** The complete price tag has yet to be determined, but government investment designed to limit the recession and restore credit to the financial markets will certainly be measured in the trillions of dollars. The \$750 billion allocated to TARP is merely a down payment and targeted only at financial oriented firms. Infrastructure, education, and healthcare are among the industries likely to receive priority spending from the Obama administration. In our view, it makes sense to partner with the government since it is incented to do everything in its power to demonstrate success. The following investments may be beneficiaries of this theme:

◆ **Planned Return Strategies (PRS)**

- Although MDE is exploring the use of designing our own planned return strategies via exchange traded options, the federal government's significant investments in large financial institutions materially reduces the credit risk in notes issued by these firms.

◆ **Municipal, Agency Debt, and Preferred Securities**

- As discussed previously, we believe the Obama administration will provide financial support for municipalities. Strategies and funds managed by Breckenridge, Nuveen, Loomis Sayles, and Stonebridge should benefit from this capital infusion.

◆ **Infrastructure Investments**

- Infrastructure is a broad term that spans many industries, including construction, materials, energy, utilities, education, and healthcare.
- MDE is analyzing investments that are explicitly focused on infrastructure, as well as broader equity managers with a material allocation to infrastructure oriented equities.

3. **Purchase Investments with Different Return Drivers to Further Reduce Risk.** History never completely repeats itself; hence it is difficult to precisely reduce risk on a forward-looking basis. MDE proactively reduced portfolio risk throughout 2008, but underestimated the destruction of wealth across nearly all asset classes. Investments that held up relatively well in the 2000-2002 bear market – hedge funds, master limited partnerships, municipal bonds, and value stocks – did poorly in the current bear market. Nevertheless, we have completed substantial due diligence on the investments below and believe they are poised to capitalize on this theme over the short- and long-term.

- ◆ Planned Return Strategies (PRS) with a larger buffer that would provide very strong downside protection in the event of a drop in the stock market of 30% or less.
  - Since we are no longer concerned with long-term capital gain treatment, due to recent market losses, we have greater flexibility in how we structure future PRS investments.

- ◆ Cash utilized to a greater extent as a tactical asset. We made incremental moves in this direction in the last half of 2008 and expect to become more tactical if market conditions warrant it. It is important to make the distinction between market timing, which we *do not* recommend, and moving to cash oriented investments when risk is heightened and the market is not behaving rationally.
- ◆ Gold oriented investments, Real Estate and Treasury Inflation Protected Securities (TIPS) in the event that government monetary and fiscal policies lead to high inflation over the *long-term*.

However, we must note that if the financial markets remain frozen, diversification strategies, other than moving to cash, are not likely to provide significant benefits over the short-term.

4. **High Quality Investments Continue to Provide Relative Safety In a Recessionary Economy.** It is difficult to define “quality” when even venerable firms, such as General Electric and Bank of America, are in the midst of financial distress. However, we define “quality” as investments that have a high probability of conserving capital, as well as providing reasonable prospects for growth. Accordingly, we would consider the following investments, in aggregate, to be part of our high quality theme, despite the fact they may experience losses during times of market distress.

- ◆ The Breckenridge, Loomis Sayles, and Stonebridge strategies for yield oriented investors.
- ◆ The Alternative Fund, Titan, and our basket of five hedged mutual funds in the alternative investments asset class.
- ◆ Schafer Cullen, Harding Loevner, Manning & Napier, and Planned Return Strategies (PRS) for those investments with some or complete equity market exposure.

In recent times we have often been asked the question, “Why not structure the portfolio to hold primarily U.S. Treasuries and cash equivalents during this volatile time in the market?” We fully realize that these are historic times in the financial markets and that risk remains at heightened levels. However, we are also cognizant that no one knows exactly when the market will return to a more normally functioning status. Historically, a substantial portion of the market rebound after a bear market occurs in the first year of recovery. Hence, we believe it is important to maintain a diversified, tactical portfolio across many asset classes. 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 Strategic Wealth Management Themes can be custom tailored for your personal situation.