

# KFS February Update

This past weekend we diligently prepared an educational update on the stock market. However, we ultimately opted to table the update because at this point we have a feeling that no amount of educational information is going to make you feel better about what's happening in the financial markets, your portfolio, and the economy. Yes, we can provide all sorts of rational reasons for staying fully invested - and - we can provide you with lots of excellent data and reasons for optimism going forward. But at the end of the day, none of it will ease the short term pain we're all feeling right now. Frankly, it's okay to be nervous. At this point, who isn't?

So rather than tell you what we know about situations like this, we'd rather focus on our solutions. And rather than tell you that maintaining focus on the long-term is critical at times like this (even though it is), we'll tell you that in a market like this nearly everyone eventually loses focus on the long-term. It's inevitable. We're all hardwired a certain way and at some point fear trumps everything and all the education in the world no longer matters. We get that. However, our full focus is on how to best advise each of our clients in the midst of the worst investment environment any of us have ever seen. We're here for you, we have your best interests at heart, and we're not going away.

## **Being Pro-active**

Even though we are concerned, frustrated, and maybe even a little sick to our stomachs over what has happened in the stock market, we remain ever diligent in our efforts to learn as much as possible about the current economic situation. On a daily basis, we pore over many types of information, including academic studies, reports from the Federal Reserve, the new stimulus bill (all 1,000+ pages of it), commentary from economists or financial analysts, Warren Buffett's recent letter to shareholders, and the many articles forwarded to us by our clients each week. We contemplate all of it and take much of it into consideration when assessing what we're doing well and what we could do better.

Recently, however, we've also been gathering valuable information directly from you. As you might expect, markets like this one elicit a large number of concerned calls (and e-mails) to our offices. And as the markets have continued to deteriorate, these

contacts have increased in number. We understand and we hear you. In fact, we're concerned too—only our biggest concern is not what the stock market is doing. Yes, the stock market concerns us, but what concerns us even more is the behavior of our clients in relation to the market. We've talked a lot about fear and the flight response in the past, and we've discussed how damaging it can be for investors who cut and run after large declines like this one. We've also documented the dangers of market timing and have demonstrated that by virtually any measure, today's markets are awash in undervalued securities. But at some point, none of that matters anymore because fear, the most powerful of all emotions, reaches a level where logic, reason and rational discourse no longer resonate.

If this includes you, we understand—and we want you to know it's not your fault! It's how we're all genetically wired to react. On the other hand, our job is to come up with solutions beyond education that will help alleviate your fears without sacrificing the upside potential of your portfolio. To this end, we have been proactively rebalancing portfolios for quite some time to help reduce portfolio volatility. In addition, we have also uncovered a few opportunities that fall in line with our long term investment strategies (one of which we have already shared with you). These are the focus of today's update.

### **Strategy #1: Own investment Grade Corporate Bonds**

We believe there are still excellent opportunities in domestic investment grade corporate bonds. (You'll remember we discussed investment grade bonds at our client dinners, our year-end newsletter, and in our recent three-part email update). Although we know the stock market will eventually bounce back, at this juncture we think it makes sense to own high quality corporate bonds as well. We believe that corporate bond prices have been beaten down due to a crisis with the bond buyers (hedge funds, insurance companies, investment banks, and commercial banks) that forced them to sell off assets in order to raise cash in the midst of the recent mortgage crisis. This has led to a unique opportunity in corporate bonds, the likes of which we've never seen. As a result, we have been proactively rebalancing portfolios into Loomis Sayles Strategic Bond Fund (NEFZX), a broad-based bond fund that invests primarily in domestic corporate bonds.

For those of you who are retired and receive income from your portfolios, we have a simple rule that we have followed for years. For every 1% you take out of your

portfolio annually, we usually keep 10% of the portfolio in bonds and cash equivalents...with a few exceptions. In other words, if you withdraw 5% of your portfolio value annually we typically will hold 50% of your portfolio in bonds and cash equivalents. Given the stability of bonds and cash, this affords retirees a minimum buffer of ten years before needing to tap into any stock holdings. We hold bonds for our retirees because we assume downturns will occur, and the array of bonds we utilize consists of a well-diversified mix of domestic corporate bonds, U.S. Treasuries, and foreign bonds. This strategy has served us well. However, as a result of investor panic and a rush to buy highly liquid, low-risk investments, government bonds have become overvalued. Thus, we have begun moving out of Treasuries into high quality corporate bonds instead. We could go into the various reasons why we've come to this decision, but Warren Buffett likely says it better and more succinctly than we could:

*"A few years ago, it would have seemed unthinkable that yields like today's could have been obtained on good-grade municipal or corporate bonds even while risk-free governments offered near-zero returns on short-term bonds and no better than a pittance on long-terms. When the financial history of this decade is written, it will surely speak of the Internet bubble of the late 1990s and the housing bubble of the early 2000s. But the U.S. Treasury bond bubble of late 2008 may be regarded as almost equally extraordinary. Clinging to cash equivalents or long-term government bonds at present yields is almost certainly a terrible policy if continued for long."*

That's good enough for us.

## **Strategy #2: Own Convertible Bond Funds**

We have been looking for a good convertible bond fund for years, and for years there has been just one convertible fund we really liked. Unfortunately, the fund was closed to new investors...until now! Recently, Calamos Convertible (CCVIX), a convertible bond fund, reopened to new investors after being closed since 2003. For those who may not be familiar with them, convertible bonds are a hybrid security that provide the downside protection of bonds with the upside potential of common stock. And we think convertible bonds are especially attractive right now because they're selling at deep discounts to their true values, similar to what we've seen with corporate bonds. So, we can purchase convertible bonds at greatly reduced prices, collecting interest along the way, and wait for the bond price to recover. However, it's the potential conversion from bond to stock that makes these bonds so desirable.

The unique feature of convertible bonds is they can be converted to shares of common stock above a pre-specified “convert price.” This means investors in convertible bonds stand to benefit from the appreciation of a company’s stock price much like the firm’s stockholders do. When stock prices are low, as they are now, the interest payments on convertibles cause them to act like traditional bonds, providing excellent downside protection for investors. As the stock price increases, convertible bond holders can convert their bonds into stock...and share in unlimited upside. And as a result of the dramatic selloff in all non-government bonds, CCVIX has reopened to new investors and we’re very excited about being able to take advantage of the opportunity for our clients.

### **Strategy #3: Corporate Stocks**

We certainly don’t want to give the impression that we’ve given up on stocks or the stock market—we haven’t. It is important for investors to remember that “stock price” and “true value” of a company is not always the same. We believe stock prices today are well below true or intrinsic value and offer significant opportunities. However, we also recognize fear and forced selling can continue to push them even lower for some time. And since no one knows when the bottom will occur, market timing not only won’t work, it provides a potential recipe for disaster by locking in large losses and then causing investors to miss out on the subsequent recovery. But out of chaos and confusion comes opportunity, and we believe there are ways to limit the downside risk of our client stock portfolios while still providing excellent upside potential once the market does turn around. They are:

1. Buy severely discounted investment grade bonds, which is similar to buying severely discounted stocks, but with far less downside risk. As the economy turns, so will bond prices.
2. Buy severely discounted convertible bonds, which is very similar to buying severely discounted stocks. Both convertible securities and stock prices go up as the economy recovers. However, there is far less risk and less volatility associated with convertible bonds. They are basically corporate bonds with an equity kicker!

The strategy of using stocks, corporate bonds, and convertible bonds in combination helps mitigate the effects of further declines in the stock market. In addition, it also provides excellent upside potential once the stock market turns around. And that's exactly what we're trying to accomplish: Risk minimization with excellent upside.

### **The Numbers: Some Perspective**

As a gentle reminder to everyone, we'd like to review the stock index levels between October and today. At mid-day on October 10, 2008, the DJIA bottomed at **7,773**, the S&P 500 hit **839**, and the Russell 2000 traded at **468**. (These numbers probably look familiar because we've covered them a number of times.) Within three days, all three indexes were trading 20% higher than those low points. Over the next few weeks, the markets were beset with extreme volatility and new lows were set during the trading day of **November 20, 2008**. On that day, the DJIA traded at **7,392**, the S&P 500 at **740** and the Russell 2000 at **371**. From that point through the first week in January, the DJIA increased 20%+, the S&P 500 increased 25%+ and the Russell 2000 increased 35%. In other words, two new lows were set in late 2008 and both were followed with significant market rallies. Unfortunately, neither lasted...

When the stock market closed for trading at the week of February 13, 2009, the DJIA was at **7,811**, the S&P 500 at **840** (both above their October 10 levels) while the Russell 2000 closed at **448**. Remember, this was just two weeks ago! So, although there was a great deal of volatility in the market...very little had changed through February 13, 2009.

### **So What Changed?**

The only major piece of "new" news over the last two weeks is the passage and signing of the stimulus bill—and continued sales of individual stocks across all areas of the market. The economic data has obviously not been good, but it's actually been a bit better than many expected. In fact, we can go down the list of economic indicators and find all sorts of positive signs. Real earnings, retail sales and the index of leading indicators all rose last month, for example. In addition, we can look at any of the other financial markets and see many signs of healing. For example, the investment grade corporate bond market had its biggest month for IPO's ever! Yes, ever in January!

Finding signs of economic life is not that hard to do, but with fear gripping the markets on a daily basis, everyone is fixated on the negative rather than the positive. So it appears any signs of healing are not going to help, at least not in the short run.

On February 20, 2009 (a week ago Friday) the DJIA breached its previous low. Then, on February 26, 2009 (Thursday of last week) the S&P 500 breached its previous low. And yesterday the Russell 2000 finally breached its previous low by a single point. We point this out to provide perspective. The last two weeks have been miserable, no doubt, but we have set lows before, and in each case the market rallied.

### **The Markets Going Forward**

No one knows what's going to happen over the short run in the stock market, which is nothing new. The frustrating part from our perspective is that stocks are already significantly underpriced. Yet, this fact seems to provide no impediment to fear and forced selling, which drives prices even lower. In one last attempt to help alleviate some of your anxiety, we'd like to leave you with a few thoughts.

First, in the last few weeks a number of well known analysts have examined and valued most of the stock market based future earnings and cash flow projections (which incorporate a massive economic slowdown). The process takes expected future cash flows, which we all agree will be much lower going forward, and discounts them back to today. What the analysts have determined is that current stock prices are up to 30% below fair value. And these calculations are conservative!

Second, over the weekend Warren Buffet published his most recent letter to shareholders. When describing the opportunities in stocks he said he felt like a "mosquito in a nudist colony." He went on to say that there are so many companies selling at such extreme discounts that it would be hard not to make money long term no matter what you buy. Of course, even he said he could not predict when a turnaround in stock prices will occur. But he did say the stock market will turn long before the economy does and noted, "America's best days are ahead".

Finally, there are hundreds of companies selling for less than the cash they have on hand—which makes absolutely no sense! In addition, half of the companies in the S&P 500 are currently selling for less than the book value of their assets. If you're an accountant, that last statistic should really leave you scratching your head.

## **Thank You**

We recognize this is a very difficult time and we know you are nervous. Who isn't? That said, prices are irrationally low right now and they will eventually adjust. We don't want you to miss the eventual bounce back when it occurs. But at the same time, no one has any idea what will happen over the next six to twelve months. This is why we are proactively making changes we think will benefit us all in the short and long run.

As usual, if you have any questions or concerns about your portfolio, the stock market, the economy or these updates, you can contact us directly via phone or email (see the numbers and email addresses provided below). Thank you for your continued confidence in our firm. We remain wholly committed to your financial wellbeing!

Have a good week....

**~Joe and the Gang at KFS**