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FINANCIAL ADVISORS

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2008 Market and Economic Outlook: Weathering the Storm

A conversation with Garrett R. D'Alessandro, CFA, AIF®
Chief Executive Officer, President, and Director of Research

Highlights:

- We now see a recession in 2008 as more likely to occur than not, although we believe it will be moderate and short-lived. The severity and length of this downturn rests squarely with the Fed.
- The Fed should begin to cut rates immediately and significantly and continue to cut until 100,000 to 150,000 net new private sector jobs are created for three months in a row.
- During 2008, the full impact of the subprime housing crisis will become known, as resets from the 2006 peak of subprime loans occur.
- Although energy prices have risen significantly, because the U.S. is primarily a service-oriented society, energy prices have limited impact on the U.S. economy versus more significant inputs such as wages.
- We do not see evidence of inflation being a problem for our economy at this time.
- We continue to favor high dividend equities for reliable income and international equities for growth.
- As a defensive measure against stock market declines, we rely on stop loss and gain capture rules in client portfolios.
- To achieve increased diversification in their portfolios, we recommend clients become familiar with low volatility alternative investments that have low correlations to traditional asset classes.

The following discussion is moderated by John T. Buckley, CFA, Executive Vice President and Western Regional Director, of Rochdale Investment Management.

Q: Garrett, let's start by taking a look backwards. Could you take a few minutes to review how the economy and financial markets performed in 2007?

A: I think 2007 can be summarized by saying it exceeded the expectations of the consensus forecasts at the beginning of the year, which predicted a more meaningful slowdown than actually occurred during 2007. The best illustration is the 4.9% GDP growth in the third quarter, which was probably double what most people had expected.

In terms of the overall financial markets' performance, if I would have asked someone in January of 2007, "What do you think the stock market will do in terms of performance if oil goes to $100; if subprime causes $200 to $300 billion worth of write-offs; if the major money center banks in this country experience 30% declines; if the Iraq war continues, and all of the other things that I could mention," it would have been unusual for anyone to say that the stock market would have been up for the year. The reality is, the S&P and the NASDAQ finished the year positive. The various indices were mostly up between 5% and 10%. Some segments of the market were not up that much, but generally speaking, the financial markets did okay.

Starting in November, we saw a rather sour and downward-biased financial and stock market trend, which has continued into early 2008.

Q: Over the past month, the S&P 500 is down nearly 7%. There is a raging debate about whether there will be a recession, there will not be a recession, or we are already in a recession. Maybe you could comment a little bit about what your expectations are for the economy for 2008, and what aspects of the economy most concern you in 2008?

A: We just this week raised our expectations for a recession. Given the turn of events in the employment market, durable goods orders, manufacturing trends, and the ongoing negatives associated with housing, we now believe that the recession that has been widely forecasted and is the more likely outlook for at least the first half of 2008.

I want to distinguish our outlook from some of the other people who have a recession outlook, and I want to qualify this recession outlook as moderate. I do not see any indications of significant market imbalances. I do not see the stock market valuation as being significantly too high, so the correction or the recession in our economy we would put in the minus 1-1.5% range. We think if certain monetary and fiscal policies are implemented aggressively and quickly, it could be a three-quarter type of recession.

Q: Great, thanks for that lead-in on the Federal Reserve and interest rates. Maybe you can share your view of the Federal Reserve's behavior in light of the housing crisis and oil prices being at $100 a barrel, and their traditional need to balance economic growth with the prospects for inflation. What grade do you give the Federal Reserve going into 2008, what do you expect from them in 2008, and how would you differ if you were the Chairman of the Federal Reserve as we enter into this moderate recession?

A: Actually, thanks for giving me the opportunity to be the Fed chairman; I actually would like that job right now. Let me offer an op-ed comment here. I think Bernanke is particularly intelligent and very talented, as are several other members of the Fed. However, it is important to distinguish between their intelligence and their understanding of the role that they have today, particularly the chairman.

Coming from academia, it is my impression that Chairman Bernanke has turned a very real-world, very negative, potentially deflationary experience into an academic exercise. With the housing market, with the subprime loans, with the banking industry constriction, these very real-world issues require immediacy. In my mind I have this vision of Chairman Bernanke and the boys sitting around the club down in New York smoking a pipe and in tweed jackets, and it reminds me of one of those commercials where the guy is choking to death, and they all are theorizing about how to get the thing out of his throat.

That brings to mind a lack of understanding of the need for intensity and immediacy. So while I think the Fed has the potential to be quite brilliant and quite excellent, I think the practical grade is probably a C– or maybe a C+.

What do I expect them to do? Let's go back for a moment and understand that we have never before in the history of our country had the confluence of events that exists today. In 1907 we had a bank panic. We've had debt crises in Latin

America. We've had the tech bubble and the Internet boom. We've had housing declines. We've had many individual experiences.

But we have not had the combination of oil shocks, housing depression, derivatives, subprime, leverage, etc. Because we have no prior experience with this combination of events, the Fed should cut rates; they should cut immediately, and they should continue to cut until they see the real economy generate 100,000 to 150,000 net new private-sector jobs for three months in a row. Then I'll know that they're at the right level of interest rate policy.

Now, someone is going to ask, what about inflation. In all things economic, as accounting, you have a debit and you have a credit, and you have to balance out the two. In economic terms, there is no such thing as a free lunch, but you have to address the level-one need first. If you try to balance out inflation against growth with the risk of deflation facing us, you can see the result by looking at what the stock market has done in November, December, and January. It's done nothing but continue to vote negatively about the current monetary federal policies. So I don't think, quite frankly, that inflation should be the concern. I don't think inflation is going to be a concern. Six months into a recession, I think inflation will not be an issue.

Q: Let's peel back the onion on the inflation issue a little bit. With oil prices at $100 a barrel, and energy prices generally being fairly high, why is that not in your mind a significant inflationary issue?

A: No more than 5% of the cost structure of our economy is related to oil or its inputs. Labor is about 60%, food and other consumables are about 10%, and a variety of other things are in between. So what we call the coefficient of inflation derived from oil is mid single digits, unlike 25 years ago where it was 10% or greater because we were more of an industrial or a manufacturing society.

Now that those industrial jobs have been taken on by other global economies, our economy runs basically on services. As a result of 60% or more of our economy being service-driven, the inflationary pulses that drive the U.S. inflation picture are mainly labor costs. As a result of a rising unemployment rate – I think it went up to 5% recently – lowering demand for labor going forward, we believe that wage inflation will not be more than say 3% nominally, and, after a percent or two of core inflation, will be very controllable overall.

We are not saying that oil and the feed-through of that isn't going to have some impact on headline inflation. We are not saying that food prices aren't going to have some impact. But if we go back to the 1970s when we had "stagflation," which we're hearing a lot about and if I remember correctly, we started that stagflation period with inflation rates at like 7.5%, and they rose to like 10% or 11%. Seven and a half is a lot different than 3% or 3.5%. So while inflation rates have gone from 2% to 3%, or 2.5% to 3.5%, the absolute level is still nowhere near where it started the stagflation in the 1970s.

Q: As I recall, 25 years ago in my economics courses, when an economy is approaching a recession or in a recession or in a contracted negative period, there are three sources of stimulus. One of those is the Federal Reserve, which you have addressed nicely. The other two are tax policy and fiscal stimulus, or increased government spending. And recently, the President has discussed – at least as I've seen on the news – the prospect for a fiscal stimulus package. Is that meaningful at all, or is this simply a situation that should be solved by the Federal Reserve?

A: Yes. The Keynesian side of the stimulus can benefit the economy, although it is maybe 20% to 25% less potent as compared to lowering interest rates. Between tax policy and fiscal stimulus, I would give more emphasis to the tax policy in terms of its ability to influence more directly and more timely.

Now, will either one of those stimulus drivers be relatively more important than the Fed? No. Quite frankly, we are of the view that the length and depth of the recession is heavily dependant upon what the Federal Reserve does with interest rate policy. To the extent that the Fed acts academically and cuts another 25 basis points in January, we're going to add another one to two quarters to the length of the recession.

They need to cut rates 50 basis points or more, and they need to keep cutting them until we have, as I said before, employment growth for three consecutive months. Our economy will do great as long as business executives – of big, medium, and small businesses – have confidence that the economy is going to be okay. Because if business executives have confidence that the economy is going to do okay, then they're going to seek to grow their business. That means jobs will be created. Once we see a consecutive number of months of job creation, then everybody – financial markets and economists – will know that the recession threat is behind us.

Q: Thank you for that. Let's dig a little deeper. We have long said to financial advisors and CPAs and clients that one of the key indicators or predictors of stock price performance is corporate profit growth. That is particularly true when valuations are fair and when price-to-earnings ratios are fair. Could you comment on expectations for corporate profit and as well, the condition of the consumer and their ability to contribute to corporate profit growth?

A: Sure. In 2008, we're looking at corporate profit growth of 5% to 8% for the entire year, minus the effects of the financial industry's losses and write-offs. If the financial industry's losses and write-offs were to be included, which is proper to do from a comprehensive accounting measure, then the first couple quarters will be low single digits. But when you invest with Rochdale, we are able to pick and choose those industries and sectors that we want to emphasize and those that we want to avoid, and we've been underweight banks. We've owned one or two of them, a couple we still like, one or two we've sold and are going to continue to sell.

Corporate profit growth is the fuel that gives the business executives the ability to invest in new jobs, plants, equipment, and other capital expenditures. Think of profits equaling cash flow, and if business executives have a lot of cash in their pockets, the tendency is to seek things to do with it, and as a business, the things that they tend to do with growing cash flows is invest it in growing their businesses.

In 40 years of history, the corporate sector's balance sheets have never been as strong as they are today. So quite frankly, corporations have the ability to invest in growing in their business, but they also have to be willing to do so.

You're not going to spend that cash flow if you believe it's not going to give you an adequate return, and that leads into your consumer question, which is, if I build it, if I create it, will they come? The business executive today is answering that question as: "I'm not sure. I don't know if I build a new set of technology widgets or gadgets or if I add some more services to my company or if I create some new types of videos, will they sell." So they're reluctant to make those capital expenditures and new-hire decisions because they're uncertain as to what the ability and willingness of the consumer will be to buy those services, and that gets back to the need for us to see employment growth resume.

Now, I'm absolutely clear that right now we are not expecting consumer spending to go negative. That's not our forecast. Growth in consumer spending will be low – 1%, give or take – but spending at a 1% or 1.5% level is not exciting for the business executive.

Why can't the consumer spend more than that 1% or 2%? Part of it is psychology. I don't know a person that I speak with that doesn't get a headache listening to all of the recession talk and all of the gloom and doom about subprime and all of the oil problems and all the housing problems. That just psychologically makes you a little less willing to be liberal with the money that you earn.

Secondarily, people have debts. They're not insurmountable for the 93% of people who don't have a subprime loan problem. 93% of all mortgages and consumers are not in this subprime problem, so they're okay. But they're sick and tired of seeing and hearing all the problems, so they're just going to pay down a little bit of debt or save a little bit more. Those consumers that do have a problem obviously are not going to be in as positive a spending pattern as they otherwise would have been a year or two ago.

Q: Would you care to weigh in on how high unemployment will go?

A: Yes. I was giving this thought the other day. Try to visualize the economy as an airplane. The airplane is flying at 25,000 feet in the third quarter. That's GDP growing at 4.9%, employment adding on average over 100,000 jobs during the third quarter, and it's flying at a nice altitude and it's doing great.

It then hits a little bit of turbulence in the fourth quarter, and instead of 25,000 feet, (October and November) it's at like 12,000 feet. Then in December we get actually a decline in the number of private-sector jobs. We get negative durable goods orders, we get slowing in the manufacturing sector, and now we're flying at maybe 5,000 feet.

We're entering the year 2008, and in 2008 we know for sure that we're going to be hitting turbulence for several quarters in terms of job losses continuing from the residential housing bust. We know we're going to see job losses from the follow-on of the weakness in the manufacturing sector, and we know we're going to see job losses from the financial sector because all of these bankers who don't know how to make a bona fide mortgage loan are going to cut tens of thousands of jobs – so we know we have a bunch of job losses in the first and second quarter, so the airplane now is not going to be able to keep up a positive altitude.

So we see unemployment rising at least to 5.5%, up from 5.0% presently. And when you start to see people lose jobs and the headlines, we encounter a feedback loop that causes reflexes by the consumer which I articulated before, which makes them a little less willing to spend, even those that do have a job.

Let me add one other point: The wage increases are quite good right now, so all of the people that have a job – and 95% of all the people that want a job have one – are getting 3% to 5% type of wage increases. That's a very powerful stimulus.

If everybody was in a neutral state of mind, then we would see consumer spending grow 3% or 4%, and that's 70% of the economy and we'd be fine. But for the reasons I've articulated, they're going to take some of those increased wages and they're going to put it against debt or they're going to save it rather than spend it.

Q: Can you quickly share with us your thoughts and predictions on energy prices?

A: With the emerging markets, other Asian markets, and Latin American markets remaining robust in their growth, we believe that energy consumption in the developed markets of Europe and U.S. will slow somewhat. Presently oil prices are $95 to $100. We see the fundamentals potentially bringing prices down $10, so we would probably see oil in the $80 range if our outlook for a moderate recession for two or three quarters occurs.

Q: Could you also address your expectations for the real estate market, broadly. Are we approaching a bottom?

In terms of real estate, I think where you are on West coast, where I am on the East coast, and the other four corners of Florida and Southern California, those markets have different dynamics than our good friends in Kansas City or Texas or Chicago or Minneapolis. So, while real estate as we know is local, I'll try to answer the question in general terms.

The biggest issue relating to real estate is the two million subprime adjustable rate mortgages – or ARMs. Let me make sure everybody understands that the only problem of importance with the mortgage industry are subprime ARMs. Fixed-rate loans are fine, prime loans are fine, jumbo loans are fine. They're all experiencing the normal rates of delinquencies. It's only the subprime ARMs, and that represents about 7% of total loans.

We know for a fact that several hundred thousand of these subprime ARM loans are going to reset each quarter, and in all of the areas where they're going to reset, it's expected that some amount of those resets won't be able to be afforded by the property owner. Those houses will go into some status of delinquency, foreclosure, and for sale, and that leads to price declines in those markets.

It's the price-decline continuation that we're referring to when we say that for at least the first half of 2008, the overall real estate prices – in aggregate – will still experience declines. As long as there are declines in the housing price market, buyers will naturally continue to be hesitant to buy because they think they can get it cheaper later on.

If all things work as expected – I think this is a nice way to think of it – we know at the end of 2008 the subprime situation will be known. It won't be done with, but we will know it. And what I mean by that is, the last vintage of subprime loans and ARM loans with no money down, no deposit, no income verification, were issued in 2006, and the majority of those have a two-year reset. So we're in the reset year for the last year of issuance, which was the most egregious.

Think of it – we're going to have 1/12th of the knowledge that we wish we had today as each month of the year passes. So by the time we get into the middle of the year, we're going to know the reality – we're not even going to have to estimate – we're going to know the reality of 50% of the entire subprime problem.

Once we get to that June-July period, we're going to then be able to pretty much look to the second half and say, okay, the first half, out of the million that came up, 200,000 had to be delinquent, 200,000 had to foreclose, the losses were X. Okay, I'm going to multiply that by two, put a fudge factor on it. I'm going to circle that amount and it's going to be $300 billion. Look at the banks, look at the economy – can we absorb that?

So about that time, I would hope that the housing market, the industry, the mortgage dilemma, all of those challenges will start to stabilize, and then from the middle of the year through the end, you'll start to see some erratic kind of percolation, a little bit up, a little bit down.

Q: All right. Then let's get into what everybody's interested in, which is your crystal ball on returns. What are your expectations for stock returns in '08, domestically and internationally.

I remember a couple months ago, where we had a call like this, and I was participating. I said there was a 50% chance that there would be a 10% or greater correction. I said that the correction was a prudent expectation to set, and the reasons were we didn't know what was going to happen with all of the other factors facing us.

The market went up after that, of course. Once I say that we might go down 10%, it does just the opposite. But over the last several weeks or months, I think we've gone down about 10%. So from today forward, it's more than reasonable to expect that the doom and gloomers – John, if I can use your trademark, the forces of darkness – they're in charge. The gloom and doomers on TV, the gloom and doomers writing magazines and newspaper articles, they're totally in charge, they're in full bloom. The forces of darkness will continue for the next several months at least and that should set our expectations for at least a 10% or 15% potential correction. I'm not predicting it's going to go down another 10%, but that is something that should not surprise everybody if it were to happen.

Now, the reason why I think that could be the extent of it, as compared with the most recent bear market we had where stock prices went down 44%, was and is one of the saving factors: the valuation of the overall stock market today is about 15 times earnings. Those are pretty good quality earnings with the exception of, of course, the banking industry, which – those are a falsehood. So valuations give us reason to be comfortable saying that this correction, if it's down 10%, it is probably overstated by 40% or 50% looking forward.

Domestically we should not be surprised if we go down 10% the first half and we kind of come back 10% the second half. We end up the year flat. That wouldn't surprise me. It wouldn't surprise me if we finished the year down 5% or 10%, nor would it surprise me if we finished the year up 5% or 10%.

Now, why am I giving those three? It is impossible to know what probabilities are until we see the monetary policy response. If someone were to say the Fed's going to cut, they're going to cut just as you want them to, then I would say that the stock market will end the year positive, mid to high single digits, and the reason for that is simple. The lagged effect of interest rates, which started a month or two ago, plus further interest rate cuts – good, solid 50-basis-point cuts, timely, and kept according to my plan – would give us six months of recession spotting. Then the market in the middle of the year will start to look ahead and start to see the interest rates starting to buffet and bring up the rest of the economy

and consumers and mitigate the housing market, and stock prices will then start to appreciate because corporate profits will be growing 7% to 8%.

The Fed's agenda could be to keep this as an academic exercise, resisting what we think is essential in terms of reduced cuts and try to wring out all of the immoral behavior of the subprime industry and all of the crazy leverage in the system. The Fed could very well say, we're not going to be the "Bernanke put regime;" we're going to put this thing into a recession, we're going to wring out all of this leverage, we're going to stop all of this indebtedness – then there's no reason why the stock market wouldn't be down for the year.

Q: Can you address international markets?

A: There is a thesis being submitted by many: the notion of decoupling. In essence, the theory is that the impact of a slowdown in the United States and Europe won't affect those countries such as China, India, and Asia. There is a partial truth to that but it's not a complete truth.

Five years ago, China shipped, in terms of exports, more of their goods to the United States and Europe than they do today, so China, as well as India and Brazil, rely less on the U.S. economy than they used to for economic growth. We do expect China, India, and Brazil to continue to grow at robust levels, down, though, from the very high levels which they are experiencing now. That takes into account what I would say is a 20% or 30% kind of connection between the slowdown in the U.S. and what's going to happen in those countries. So we expect better returns with commensurate volatility for the international stock markets.

Q: Let's peel back the onion on that a little bit. Currency has an effect, so – two questions: How do you see the currency effect in terms of international markets? It has been our view for some time to overweight international versus let's call it a normalized portfolio. Is it still your view that we will recommend overweighting international relative to a normalized portfolio?

A: We are currently overweight international as an allocation positioning. I would remain as we are rather than increase the international allocation, so if a normal allocation is 12% in international, we are probably at 15% to 20%. That's fine to keep, and we would not increase it. As some people are saying, if the U.S. isn't going to do great, why don't I put more of my money abroad?

The first thing that we pay attention to always is the volatility budget, or the tolerance for fluctuation of principal in every client's portfolio. Taking money out of any developed U.S. market and moving it to any international or emerging markets raises the volatility, and that would probably exceed a volatility budget. That's the reason why we wouldn't drastically increase international allocations, despite the fact that with higher risk you might gain higher return, and we think the odds of that are good. So, we'd remain overweight to the extent that you are.

The currency, again, is very dependent upon what the Fed does. To have confidence with what the currencies will do is hard to say. But in my scenario, there's no reason to believe that the dollar would not continue to weaken, as the trading countries have better economic growth, more stable patterns macro-economically, than we do. They don't have a need to cut interest rates, and in fact China is continuing to increase them to kind of stem the overgrowth that's going on there. So I would not be necessarily betting that the U.S. dollar is going to go up a whole lot next year. But there's a very big positive to that, and that is the export growth in our economy, which we hope will continue.

Q: Okay. We have a relatively high percentage of clients who rely on their portfolios for cash distributions, for income. The sources of that income have been allocations to bonds, which we've been generally underweight, and allocations to high-dividend stocks, which we've been generally overweight, with the high-dividend stocks having done exceedingly well up until last year. Could you comment on best sources of income generation for 2008 for these types of clients, and what your expectation is for high-dividend-paying stocks?

A: The high-dividend income allocation has been a consistent theme of ours for several years, and the average

annualized return, including I believe through this year, is still at our expected long-term rate of return, approximately 8%. It could be higher for some, but generally going into this year, it was double digits for the last three or four years, and this year those dividend-paying stocks are flat to down slightly, depending upon the mix and the yield that you have.

Clearly the dividend-paying stocks represent a sustainable, durable, reliable, predictable component of all of our clients' cash flow from their portfolio. I want to distinguish and separate the stock prices from the cash distributions, the dividend income. We know that these are stocks, they are common stocks, and they have 70% of the fluctuation of regular common stocks, and we've seen that fluctuation occur this year. It's been within our expectation, but at the high end of our zone.

That naturally disappoints and frustrates us. It does not distract from the cash flow yield, which has been consistent, almost no volatility and upward biasing tendencies, which we believe will continue for many years going forward. If you have a dividend stock portfolio that's generating $50,000 in income, the income is gradually going to grow over time, and the volatility of the common stock is not going to affect your overall dividends. So we still subscribe to the notion that dividend-paying stocks are a bona fide source of cash flows at better-than-average yields today as compared to fixed income and Treasury bonds, which have probably the worst valuation for a long-term investor.

To give your money to the government for five or ten years and get 3.5% to 4%, when inflation is going to be no less than 2%, 2.5% or 3%, you're probably not going to earn a whole lot in real terms. While that investment in government bonds is perceived to be the safest area – we agree – it's not for the best interest of an investment portfolio's total long-term return, and everybody on this call understands why the price or yield of those government bonds has fallen to very unattractive levels; it's because everybody's fleeing for safety. It's understandable.

As it relates to what we expect going forward, this is essential. As we have articulated, the recession is our likely expectation, for at least two or three quarters, and as a consequence of that, stock prices have a tendency to go down. That does not change the fundamentals of the businesses over the long term. It could change the stock prices over the short term. To the extent that volatility is not within a client's tolerance, then we would be comfortable listening and reallocating from some dividends into not Treasury bonds or government bonds, but other sources of fixed income, although that's not necessarily what we're advocating.

The better strategy to reduce volatility in the portfolio is to look at your small-cap stocks, growth or value, or some of your larger-cap more cyclical stocks, and pull those down with some gain capture or some stop-loss limits – rather than changing your dividend portfolio. Quite frankly, the dividend stocks are more attractive than they were six months ago, not less attractive; the reason they're more attractive is because of the present volatility. We've had four or five consecutive years of very low volatility in all stocks. The volatility that we're experiencing now is more normal, if you would; but because we haven't experienced it in five years, it's very discomforting, and we're very sensitive to that volatility. We worry about that for a living. But our observations and analysis on these companies indicate to us that these dividends are going to continue to grow and continue to be solid for many years ahead.

Q: Thank you, that was outstanding. Final point: We have available to us and to our clients these things called alternative investments. And the second that one uses the phrase "alternative investments," there is instantaneous change in the listener's body language, relating to the press on alternative investments and the difficulty that some alternative investments have experienced.

There certainly has been a proliferation of alternative investments, and the availability of them to increasingly smaller investors is on the rise. I'm wondering if you could address the issue of the growth of alternative investments and the appropriate positioning of alternative investments as entities in clients' investment portfolios.

A: Yes. Let me take up an important point that you mentioned, which is, what is the purpose and what is the objective of alternative investments? Everything that we do has to be viewed within the context of a client's entire portfolio. The basic job that we have, in very simple terms, is to gain the maximum diversification within a client's portfolio at the best rate of

potential return. That fundamental objective cannot be achieved as well as it could be if you use moderate or lower-volatility-type, non-correlated strategies.

Let me give you an example. For most clients, we know 90-something percent of all individual clients do not have any alternative investment exposure. They'll have large-cap growth, mid-cap growth, some dividend stocks, some international stocks, and some fixed income. All of those equity asset classes are connected in a way that when they zig, they all zig, and when they zag, they all zag.

Those connections, or those correlations, have become increasingly connected. The intensity of the connections is rising. That makes our responsible objective to gain diversification and to search out other asset classes that don't have the same connection with these traditional asset classes, which leads us to finding appropriate alternative investments or alternative strategies, as compared to the traditional strategies with which everybody is comfortable.

We believe that the world has come to recognize that the innovations in financial applications are becoming commonplace. An example that comes to mind is technology for cars. We have not always had antilock breaks, but now you probably would not buy a car without them.

The financial landscape has many different techniques and innovations now, and those are called alternatives. When you know how to apply those alternatives, you can create a hedged asset class. We recommend that every client learn about what this is, and learn how it benefits their portfolio by bringing about better diversification, much lower downside declines than the regular stock market – I can give you an example.

If on average the stock market goes down 15% over the next six months, and you have a well-constructed, high quality, low volatility, non-correlated alternative investment – I'm not picking anybody's name – that investment is probably going to go down 50% less than the stock market. So you have a lot of buffering going on there. On the upside capture, a well constructed, multiple strategy, multiple manager non-correlated alternative investment will likely capture 60% to 70% of the upside. So you have a favorable downside capture versus upside capture, in addition to the diversification and the low correlation. So that's for everybody to learn more about and to figure out if such a product meets their investment objectives for their overall portfolio.

Q: Where do these non-correlated alternative investments that have made money during market declines invest?

A: They use techniques like shorting. One of our alternative investments actually shorted the subprime, so they made money. Another one is arbitraging interest rates. But without getting into the nitty-gritty, these are the important questions that any prospective investor in any alternative strategy needs to ask. As investors come to understand what's involved, they'll have an appreciation that these are different techniques that are not correlated with the current techniques that we use in large-cap, mid-cap and international, and that's why when you add 10% of a properly constructed non-correlated alternative investment, it brings about great diversification benefits to clients' portfolios.

Q: Garrett, I was wondering if you could address one issue that we haven't yet talked about today, in that I've been reading that high-yield bonds and specifically muni high-yields have become attractive. What I was curious about is, relative to the current posture of the recession that you're now forecasting, even though a limited recession, would that impact the possibility of higher defaults on junk bonds, as well as how would that impact high yield muni bonds?

A: Thanks for that point, and it's a relevant topic. The initials "CDS" will become the next financial calamity that we'll start to hear about, and that stands for credit default swaps. Whenever you have innovation, you have good innovation and you have not-so-good innovation. Subprime adjustable rate mortgages were not a good innovation, nor were credit default swaps. CDS products allowed municipalities to borrow on very skinny terms or covenants. The question is, are there municipal bonds or municipalities that are not well financially positioned, that the high yield municipal bonds might look attractive, but might end up going south.

The answer is absolutely, and what makes it very important to know the municipality's sources of revenue and credit – is the fact that even insured munis are insured by companies that are having their own financial strains – such as Ambac or MBIA. So while we find that area attractive, it's not a blanket recommendation to just go buy a bunch of munis, because while it is true that the interest rates on those munis relative to other fixed income are quite attractive, you have to do your homework on each of the individual credit ratings and not rely on a rating agency. As we've come to know, they don't know anything.

Q: Can you give a recommended allocation among large-cap growth and value, mid-cap growth and value, dividend and income, and international? Just an idea of how you would allocate in the current market for clients in their 50s to 60s and a few of them are retired already.

A: At the great risk of not knowing their volatility budget and their cash flow needs, here is a very, very wide set of assumptions. We favor growth companies over value companies as a matter of investment strategy. We favor large over medium as an investment strategy. We favor cash flow-generating securities over non-cash flow-generating securities – so dividends or fixed income over non-dividend payers or others. We like international markets over domestic markets.

Let's say the typical average normal client allocation is 60% equity, 40% fixed income, and you have a 10% range around those two categories. You want to be at the lower end of your equity allocation, so if it's 60% and you could go as low as 50%, you should be towards 50%, and that would have you up towards 50% on the fixed income bond. You'd be at the lower end of your more volatile asset classes.

Also, how you look at high dividend equities is important. For simplicity, you should consider high dividend equities as 50% in the equity allocation and 50% in the fixed income allocation. It's not actually how we do it internally, but as an example, if you have 20% in dividend-paying stocks and you want to think in the two-dimensional world, you'd put 10% up into the equity class and 10% to the fixed income class.

Now, more important than anything, I haven't addressed, what we really do breaks into four dimensions: equity, dividend and income securities, fixed income, and alternative investments. Everything we do is modeled on four asset allocations, and in that composition, we would be favoring the lower volatility alternative strategies over any of the equity strategies at this time.

Q: I have a two-part question. Now that we're on the cusp of earnings season, do you feel that as the earnings unfold, some of the earnings announcements will at least stem these losses? And more importantly, if the Fed does the right thing at the end of the month, would we see the market kind of have a little bump here?

A: I mean, that's what we all want to happen – we want to feel happy – and when we have, I don't know, eight out of the last ten or 10 out of the last 12 or some number of days down, down, down, it gets very uncomfortable. I think we all have to accept a couple things: We have had a 5-year bull market. If I quizzed anybody on this phone call that after five consecutive up years, would you expect the market to always be up in the sixth or the seventh year? I'd bet you 80% or 90% of the people would say the possibility is the market could be down. We have become so conditioned to going up that the notion of going down is just very unappealing.

We were speaking with a client today. They were not depressed, but the forces of darkness were getting to them. It gets to me. It keeps me up at night. The best thing I can say is because I'm worrying about it and David Abella is worrying about it and John Buckley is worrying about it, you and the clients shouldn't also worry. We both don't need to be doing the worrying.

That doesn't mean that things are going to turn around tomorrow. I legitimately believe that the fundamentals of the stock market are solid, demonstrated by a 15 P/E ratio. With the exception of this totally dumb banking situation, there was absolutely clear sailing in 2007 and 2008. Let's stop and remember that an artificial exogenous shock, subprime stupidity, has caused this problem. It wasn't the market was trading at a 27 P/E; it wasn't that we were in fairyland – there was no disequilibrium there. Housing was obviously the problem.

It takes time to work through this calamity— we want it to be over tomorrow; we want to wake up after the weekend, and on Monday it's up. But it's going to take a couple quarters. Instead of us fighting the forces of darkness being in charge now, the forces of light have been in charge for five years. We have to just kind of grin and bear this and accept it, because the long-term average returns of our dividend stocks and our international stocks will equate to what we have set out in our many discussions with clients and advisors.

More specifically to the question, I do not think there is any reason to be optimistic nor pessimistic because of earnings season. I think there is going to be the normal – some companies are going to show good signs, some companies are going to show not-so-good signs, and some companies are going to be clunkers. I own a bunch of clunkers, from dividend-paying stocks and large-cap stocks – they are going down every day for ten days in a row. They are not going to go out of business; they are not going to stop paying their dividend. It's going to take a couple quarters, and we just have to accept that because of one segment of our economy doing a really dumb thing, the rest of the economy is suffering right now.

I wish the Fed wouldn't wait until January 20-something to cut rates. There is no reason to wait. They should come out tomorrow and cut 50 basis points, and then they should say they're going to cut two or four weeks later, and they're going to keep cutting until employment starts growing. Then I would be saying that this recession is going to be over pretty quickly, say in six months.

Q: You're saying all eyes are on the Fed.

A: It's all up to the Fed. Look, if you have a head cold and you don't go into a steam, sauna, or whatever you do to get rid of it, it's going to take longer than if you take the right medicines and do the right things. The Fed knows the prescription, and it's just not giving it to us.

Q: So just tactically, with all these variables, you're saying we just have to stay the course?

A: No, no. What we are saying is, on every single stock that we have, we have a stop-loss limit or a gain-capture limit. As the market drives these stocks up to or below those limits, we sell the stock, and take the loss or take the gain. We are not going to sit here idly while the people are pushing the stock market around. These limits are in our systems. Our analysts are watching them. I think in every single client's case, you've seen some selling go on in December, and you've seen some selling go on in January.

That doesn't mean that the fundamentals of these businesses are necessarily bad; it's just, in order to be proactive and keep the volatility within manageable levels, you trim a few stocks and you put that in the cash account for a little while.

We are selling some stocks that are going down, and it doesn't indicate that the business is doing poorly; it just means that the forces of selling are overpowering that stock, and we're just going to step aside. We can buy it back a day later, a week later, a month later, and in two, three, four months. Whether it's May, June, July, August – these dividend stocks, I hope they're all yielding 9%. I would buy 100% dividend-paying stocks at 9%. I don't think they're ever going to get there. But they've gone from 6% to 7%, because the stock price has gone down 10%, and it feels very uncomfortable.

But the reality is, over a four-year period, those dividend-paying portfolios are doing exactly what we want, which is yield 7% to 9%. They were at around 10% at the beginning of the year, and now they're all back at 7% or 8%, and that's right where we're supposed to be.

Q: And you would include REITs in that class too?

A: Yes. And it's important to note that the Real Estate Investment Trusts (REITs) we own are not the REITs of the South Beach condos that are 98% vacant. These are bona fide, leased up, and solidly managed types of REITs.

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