Madison
WEALTH MANAGEMENT

INSIGHT

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First Quarter 2008 – Market Review

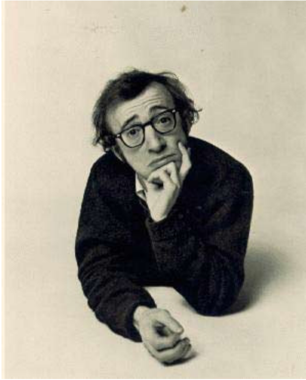
The first quarter of 2008 was rough for equity investors. The sub-prime mortgage meltdown turned into a full blown credit market crisis. This forced the Federal Reserve to take unprecedented action, drastically cutting short-term rates, injecting lots of money into the banking system and engineering a financial rescue of Bear Stearns. The deepening credit market woes filtered down into the economy, causing a slowdown (perhaps to recessionary levels) and declines in worldwide stock markets.

Just how bad was it? The first quarter decline of 9.5% in the S&P 500 Index ranks as the sixth worst first quarter since 1926. The other five periods were in 1933, 1935, 1938, 1939 and 2001. However, there may be some encouraging news. While past performance is never a guarantee of things to come, it can still be instructive. In three of those five periods (1933, 1935 & 1938) the stock market rose more than 60% in the subsequent nine months! In 1939, stocks rose more than 18% during the remainder of the year, while in the last nine months of 2001 stocks were flat. Although, we do not expect a 60% increase in stock prices between now and year-end, hopefully the worst of the market decline is behind us.

The table below displays core market benchmarks both before and after inflation. Interestingly, over the last ten years, investors have earned a higher real return in bonds and cash, than in stocks. This is not a normal situation. Over long periods of time stocks have posted about a 7% real return, not 0.7%. In our judgment, this situation will correct itself. This is how markets function, as investors price in all of their current concerns so as to earn an attractive future return.

At this juncture, it may be tempting to abandon an existing investment plan and go with something that's "working." As recently we've seen with real estate, periods of strong returns tend to be followed by weaker returns. Thus areas that are "working" today may not "work" tomorrow. Commodity prices simply can not continue to go up forever. There will be significant pullbacks in commodity prices, allowing other investment areas to shine. Investors that are well diversified don't have to be "right" all the time and can benefit as market conditions change without knowing when they will change.

Asset Class Returns - Before the Impact of Inflation						
	Investment Type (Index)	**1st Qtr**	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
Equity	Large Cap (S&P 500)	-9.4%	-5.1%	5.8%	11.3%	3.5%
	Broad-Market (Russell 3000)	-9.5%	-6.1%	6.1%	12.1%	3.9%
	Large Cap Growth (Russell 1000 Growth)	-10.2%	-0.8%	6.3%	10.0%	1.3%
	Large Cap Value (Russell 1000 Value)	-8.7%	-10.0%	6.0%	13.7%	5.5%
	Mid Cap (Russell Mid-Cap)	-10.0%	-8.9%	7.4%	16.3%	7.7%
	Small Cap (Russell 2000)	-9.9%	-13.0%	5.1%	14.9%	5.0%
	International Equities (MSCI EAFE)	-8.9%	-2.7%	13.3%	21.4%	6.2%
	Commodities (Dow Jones AIG)	9.6%	21.8%	12.1%	15.7%	10.4%
	Real Estate Investment Trusts (NAREIT)	1.4%	-17.4%	11.7%	18.3%	10.9%
Bonds	Gov't & Corporate Bonds (Lehman Gov/Credit)	2.5%	8.4%	5.6%	4.6%	6.1%
Cash	Cash (T-Bills)	0.7%	4.2%	4.2%	3.0%	3.6%
	Inflation (CPI)	1.2%	3.5%	3.2%	2.9%	2.8%
Asset Class Returns - After Inflation						
	Investment Type (Index)	**1st Qtr**	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
Equity	Large Cap (S&P 500)	-10.6%	-8.6%	2.6%	8.4%	0.7%
Bonds	Gov't & Corporate Bonds (Lehman Gov/Credit)	1.3%	4.8%	2.3%	1.7%	3.4%
Cash	Cash (T-Bills)	-0.5%	0.7%	1.0%	0.1%	0.8%



"More than any time in history, mankind faces a crossroads. One path leads to total despair and utter hopelessness. The other, to total extinction. Let us pray we have the wisdom to choose correctly."

Woody Allen in 1979

We are constantly reading and listening to many other investment managers. One professional who consistently offers valuable insight is Bill Nygren, the manager of the Oakmark Fund. Below are two paragraphs from his recent letter to fellow shareholders.

"There is a tremendous amount of fear in today's markets. Some portion is due to real economic events. The future for home prices is clearly not the straight upward march it used to be. With average home prices already down 10% from their peak and many homeowners having borrowed as much as their banks would allow, credit losses are certainly increasing. But are loss rates really going to be as high as the bond market is predicting? We normally like to use market prices as estimates for macro variables such as bond default rates, future inflation rates, or energy costs. We assume that those markets incorporate their specific experts' best thinking and that our time would be more productively spent analyzing individual companies. However, the magnitude of gaps we now see between price and value across many markets has made it imprudent to simply use current market prices for our forecasts."

"The financial media is painting a picture that is similar to the Woody Allen quote (above): If the Fed acts aggressively then we are doomed to a future of hyper-inflation and a permanently declining dollar. If the Fed doesn't act, then there is no bottom to the housing market and we are headed toward a depression. We hope they have the wisdom to choose correctly! As you might guess, our view is not so dire, and is in fact quite positive. We find it encouraging that the Fed is thinking outside the box and directly targeting the problem of financial market illiquidity. More importantly, we believe that the dividend yield of the S&P 500 now equaling the five-year Treasury yield is a significant sign of undervaluation. When the front page news is so negative, there is a high probability that the reality won't be as bad as feared."

Nygren goes on to discuss a 1995 book called The Craft of Investing by John Train. He cites a section of the book that describes a typical market bottom:

"At a major bottom, current business news is usually terrible and many authorities feel that things are likely to get even worse. There are several spectacular bankruptcies, of international importance. Unemployment is usually up. There is usually some grave unresolved national problem that is bothering everybody. The brokerage business itself is likely to be in the dumps, with many bankruptcies. Big "producers" of the up years have to cut back on their lifestyles. Wall Street's own desperation reinforces the syndrome. When in a market collapse everything finally caves in during a few catastrophic days and weeks, there is an almost audible flushing effect. Stocks are hurled into the abyss, like the cargo of a sinking ship that the crew is desperately trying to save. Value means nothing."

Nygren concludes; "To me, the Bear Stearns collapse was 'an almost audible flushing effect.' There is, of course, no guarantee that things won't get worse, but this environment seems to closely parallel Train's description of a bottom."

"Diamonds are nothing more than chunks of coal that stuck to their jobs." ***Malcolm Forbes***

Important Note: Past performance is no guarantee of future results. Please do not assume that any information contained in this Insight serves as the receipt of, or as a substitute for, personalized investment advice from Madison Wealth Management.