

Second Quarter 2009 – Market Review

Finally, a positive quarter to report! Although the financial markets began to stabilize during the second quarter, by no means did the economy show much improvement, unless you consider going from “grim” to “weak” a positive development. The fact that things did get “less bad” is a positive development and investors celebrated in turn. U.S. stock indexes rose from 15% to 20%. Stocks in foreign markets did even better, as international developed markets stocks rose by 25% and emerging markets collectively gained nearly 34%.

Bonds rated below investment grade also delivered very strong gains, up 23% during the quarter. On the other hand, the securities that experienced the biggest flight to safety during the market crisis, U.S. government bonds, lost between 1% and 7% during the quarter. While the gains from the indexes that rose last quarter are impressive, all have a long way to go before they make new highs. The economic and financial market recovery is just beginning and it may not be as rapid as hoped.

As Bill Nygren, portfolio manager of the Oakmark Fund, observed; “It seems that the analogy du jour is to compare the economy to gardening. Are we seeing evidence of green shoots? Will those shoots flourish and become a full blooming garden? Or, as sometimes happens in climates like Chicago’s, will they be hit by a late freeze and die? Nobody knows, but everyone seems anxious to share their opinions.” What we do know, is that the most productive thing investors can do is to position themselves for an eventual recovery, rather than spending energy on guessing when it will take place. As we have pointed out in a prior Insight, a recent study of stock returns from 1810 to 2008 by American Funds, showed that when stocks returned less than 2.5% per year over a 10-year period, they averaged over 13% for the next 10 years, within a 7% to 19% range. Of course, historical results do not guarantee future returns but do provide some solace as we position portfolios for the future.

Asset Class Returns - Before the Impact of Inflation						
	Investment Type (Index)	2nd Qtr	1 Yr	3 Yr	5 Yr	10 Yr
Equity	Large Cap (S&P 500)	15.9%	-26.2%	-8.1%	-2.2%	-2.2%
	Broad-Market (Russell 3000)	16.8%	-26.6%	-8.4%	-1.8%	-1.5%
	Large Cap Growth (Russell 1000 Growth)	16.3%	-24.5%	-5.5%	-1.8%	-4.2%
	Large Cap Value (Russell 1000 Value)	16.7%	-29.0%	-11.1%	-2.1%	-0.2%
	Mid Cap (Russell Mid-Cap)	20.8%	-30.4%	-9.3%	-0.1%	3.2%
	Small Cap (Russell 2000)	20.7%	-25.0%	-9.9%	-1.7%	2.4%
	International Equities (MSCI EAFE)	25.4%	-31.4%	-8.0%	2.3%	1.2%
	International Emerging Markets (MSCI EMF)	33.6%	-30.0%	0.6%	12.0%	6.3%
	Commodities (Dow Jones AIG)	11.7%	-47.1%	-8.3%	-0.2%	7.2%
	Real Estate Investment Trusts (NAREIT)	28.9%	-47.5%	-15.5%	-1.4%	5.8%
Bonds	Gov't & Corporate Bonds (Barclays Gov/Credit)	1.9%	5.3%	6.2%	4.8%	5.9%
Cash	Cash (T-Bills)	0.1%	0.8%	3.0%	3.0%	3.1%
	Inflation (CPI)	1.4%	-1.4%	2.1%	2.6%	2.7%
Asset Class Returns - After Inflation						
	Investment Type (Index)	2nd Qtr	1 Yr	3 Yr	5 Yr	10 Yr
Equity	Large Cap (S&P 500)	14.5%	-24.8%	-10.2%	-4.8%	-4.9%
Bonds	Gov't & Corporate Bonds (Barclays Gov/Credit)	0.5%	6.7%	4.1%	2.2%	3.3%
Cash	Cash (T-Bills)	-1.4%	2.2%	1.0%	0.4%	0.4%

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.

“An idealist is a person who helps other people to be prosperous.”

Henry Ford

Regrettably it appears the news headlines regarding the economy will continue to be negative for some time. A front-page headline in the July 3, 2009 edition of the *Wall Street Journal* blared; “Rising Job Losses Damp Hope of Recovery.” The article pointed out that the U.S. has lost about 6.5 million jobs since the recession began in December 2007, leaving total employment at its lowest level since August 2004. There is no doubt that the recession may be the worst we’ve seen in almost 30 years and that job losses (made much worse by the financial crisis) further stresses the economy. This is the harsh, painful reality of recessions; many good people lose their jobs and are forced to make a new life for themselves.

Interestingly, the collective actions of consumers and investors also made the economic situation worse. As consumers felt the impact of a slowing economy (perhaps some lost their jobs or worried about losing their jobs), many began to spend less and save more. But what’s right for one individual isn’t necessarily the best course of action for the entire population. This is known as the **Paradox of Thrift** or **Paradox of Saving**. It is a paradox of economics propounded by economist John Maynard Keynes. The paradox states that if everyone saves more money during times of recession, then economic activity will fall and will in turn lower total savings because of the decrease in consumption and economic growth. Although it makes sense for any one individual to save more and spend less, when everyone does it at the same time the effects can be very negative.



Compounding the effects of the Paradox of Thrift were the actions of many investors. As stock and bond prices in financial markets fell, it induced many investors to sell for fear of losing more. And, at various points during the crisis, a complete lack of access to capital (often referred to as a “liquidity crunch” - which for companies is akin to starving them of oxygen) forced companies to begin laying off workers and reducing expenditures. This certainly made what was otherwise shaping up to be a fairly mild recession much worse.

The good news is that once people reset their level of spending, the economy finds a new base from which it can begin growing again. And for the financial markets, once the forced selling and panic subsides, it

creates a new level from which the markets can begin posting positive returns. We hope that the second quarter was the beginning of that, but it is entirely possible that the economic recovery, at least in the U.S., will take longer than most of us would like. This said, when investing we know patience pays, and we have been positioning our clients’ portfolios for an eventual global economic recovery.

“It is a paradoxical but profoundly true and important principle of life that the most likely way to reach a goal is to be aiming not at that goal itself but at some more ambitious goal beyond it.”
Arnold Toynbee