

November 6, 2008

TO: All clients and interested parties

FROM: Bob Kargenian

This quarter, we are skipping any planning type topics and focusing totally on the markets. To the closing low (thus far) on October 27, stock market indexes in the U.S. and around the world were down over 40% year-to-date, the greatest single calendar year decline since 1931.

As a result of this and a number of contributing factors, our portfolios, whether they be Conservative, Moderate or Aggressive, have declined in value more than we and clients have been accustomed to during negative environments, even with our risk management process in place.

In the pages that follow, we'll be examining what has happened, what we've done right, what we could have done better, and steps we're taking to be better in the future. There will also be a look at current conditions and valuations, and what to expect going forward.

In addition, we've enclosed two reprints with this letter, which include the thoughts of Steve Leuthold of The Leuthold Group and Dr. John Hussman on related topics. I touch on their comments below, and I highly encourage you to read them.

### **This Time It's Different (or This Has Never Happened Before)**

We've been hearing this refrain, or something similar, from a number of clients. With all due respect, that is simply wrong. As Leuthold points out in our excerpt from his October 2008 publication, View From the North Country, financial crises and government bailouts are nothing new. He says, "While the characteristics of each crisis are, in some respect, different from the others, one element stays the same: **They tend to produce exceptional buying opportunities.**"

Putting it a different way, Willaim Bernstein, author of "The Four Pillars of Investing," once said "Investing has always been, and will remain, an operation in which wealth is transferred from those without a working knowledge of financial history to those who have it."

### **What's Happened in 2008**

Stocks declined over 40% from 2000 to 2002, but that took place over nearly a three-year time period, while this decline has taken place in less than 10 months. That's different. In addition, bonds as measured by the Vanguard Total Bond Index gained at least 8% per annum in the 2000-2002 period, while the index is virtually flat this year. In addition, corporate bonds have declined anywhere from -8% to -25% (high yield), and at the lows several weeks ago, even high quality municipal bonds, which most investors consider to be relatively stable and safe, were down -15%.

In other words, diversification by itself has not worked. Investopedia describes diversification as a process which "strives to smooth out unsystematic risk events in a portfolio so that the positive performance of some investments will neutralize the negative performance of others. Therefore, the benefits of diversification will hold only if the securities in the portfolio are not perfectly correlated."

That hasn't happened in the past 10 months, as virtually all markets have declined together. This has confounded even the best minds on Wall Street, many of whom have suffered their worst year ever.

### **What We've Done Right**

Part of our commitment to clients, as well as ourselves, is following our systematic, disciplined risk management models for the various markets/asset classes. As you will see below, the models aren't perfect, but we believe our approach gives us an edge over virtually all of our competition. Why? Because we have a consistent set of rules to guide us, which have worked well in almost all environments.

We, as we always do, have followed our disciplines, but it has still led to losses at a level that we are not proud of. But, a number of things have worked well for us.

Within the gold stock fund area, we've been using two different models since late 2006, and we assign 50% of the capital allocated to this area to each model. In a Moderate risk account, we've allocated 5% to gold, which means that about 2.5% of capital would go on each model. One of the models has been on the sidelines since last year, and thus has totally avoided the carnage in gold stocks. I'm not even sure carnage is the best description—what do you call it when gold stocks decline over 70% from their peak in May to the bottom in October?

In any case, having half of our gold stock allocation on the sidelines has been a good thing. The "other" gold model has not fared so well, as you'll see in the next section. Presently, the gold model which has been on the sidelines for over 1 year is very close to moving to what we call a long term BUY signal. They are pretty rare, with only 10 since 1975. All but one has been profitable, with the lone loss at -10%.

One of the other areas that has continued to work well for us is our tactical pairs trading of high yield corporate bond funds coupled with government bond funds. Based on the readings of our models, we over and under-weight each area, typically in a ratio of 80%

to 20%, sometimes a bit less and other times a bit more. Below is a chart of the BlackRock High Yield Fund, one of the funds we use in client portfolios. In 2008, there has only been one time period where we've been overweight the high yield sector, that being from mid-April to late June, as shown. Since our "SELL" on June 25, the fund has declined 24%, as high yield bond funds have suffered their largest losses ever.



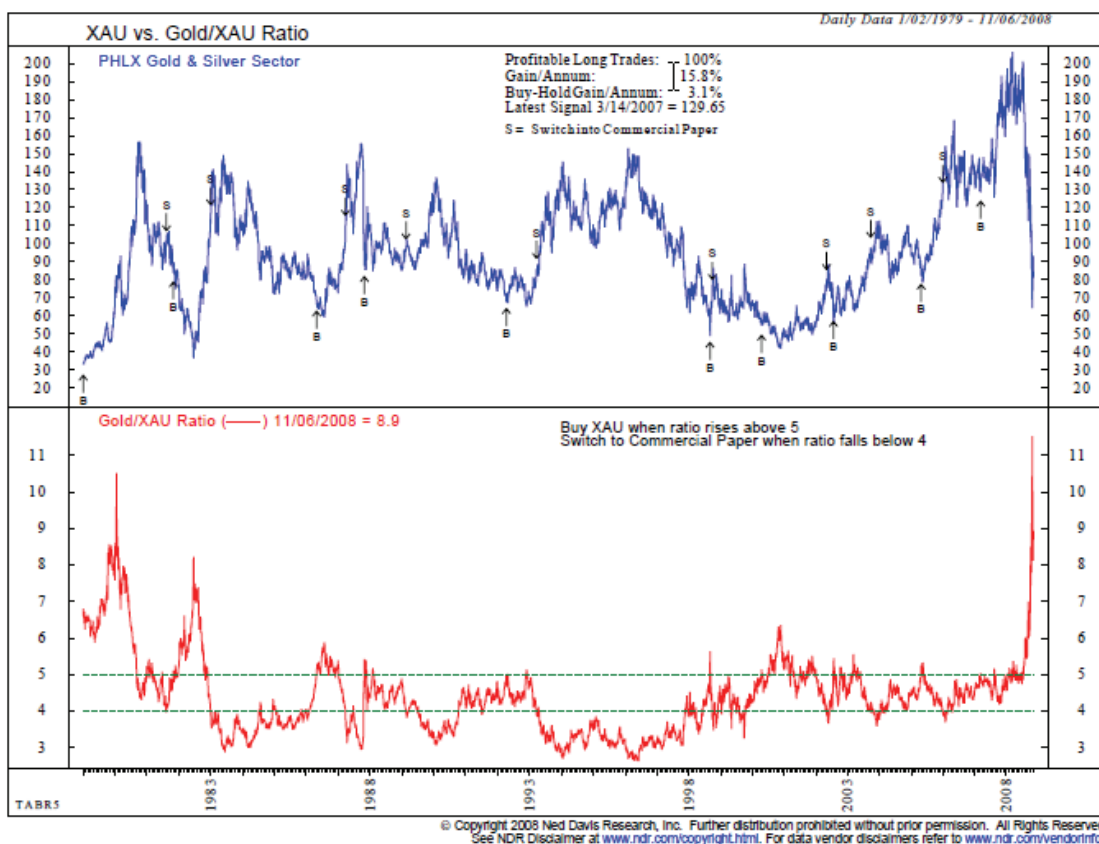
Finally, the last area that has mostly served us well in this environment has been our stock market risk models. Of the three, two have been negative since last November all but two weeks, and as a result, the average invested exposure of the hedged portion of our equity allocations has run between 30% and 50% the entire year. Unfortunately, with the severity of this year's decline, even sharply reduced allocations have been "too much."

I'll touch more on this in the next section, but the one model that has been bullish since late January has clearly failed in this environment, and we are evaluating it since it is not a trend-following approach like our other models. Our safety net is that we are using multiple models, and are likely to add a fourth, all with equal weight.

Some of you may remember the 1990's, when we traded quite rapidly and were basically either all in or all out. That worked then, but it would not work now. In our view, having all your money on one approach, unless it is foolproof, can be hazardous to your wealth. Our friends at The Leuthold Group unfortunately have experienced that this year. Their Major Trend Model, which has been in use to guide their allocation decisions for over 30 years (and is not a trend following approach), turned bullish in August, two months too early (at least so far). As a result, their funds suffered a 40% drawdown, their worst drawdown ever by a factor of nearly 2 to 1.

### What We Could Have Done Better (or What We've Learned)

I mentioned above that one of our gold stock models had been on the sidelines all year. That was the good news. The bad news is that our other model has been invested all year, which was fine until about early July. As the chart below shows (courtesy of Ned Davis Research), gold stocks have declined nearly 70% from their peak.



This particular approach relies upon the relationship of the price of gold to that of gold stocks, as a valuation indicator. Since 1983, the ratio has typically ranged from 3 to 1 to as high as 6 to 1. Recently, the ratio climbed to over 11 to 1, the highest ever, exceeding the levels reached in 1980 and 1983. Reversals in the ratio from those peaks resulted in gold stocks gaining over 200% in the following year.

Here is our bottom line conclusion in regards to this model. Even though we have allocated only 2.5% of capital in moderate risk accounts to this approach, we feel that the historical drawdowns are just too much. We expect to eliminate the use of this model most probably sometime in 2009, but we are also expecting gold stocks to at least double from their current levels. For your information, the maximum drawdown historically of our other gold model has been -35%, compared to buying and holding of -82%. The ratio model above is too similar to buying and holding (at least in terms of risk), and that is not what TABR is all about when it comes to investment management.

The other areas where we could have done better include our trading in sector funds, the Loomis Sayles Bond Fund, and our overall equity exposure.

Regarding sector trading, this is our second full year of including this approach in client portfolios, with an approximate 5% weight in Moderate risk accounts. Along with gold stocks, this was our most productive area in 2007, and it was retaining that distinction through June 30 of this year as well.

Unlike our core equity funds which are hedged depending on the status of our stock market risk models, the sector approach is a fully invested relative strength based process. The drawdown we've experienced through October of -39% is actually better than that of some of the core funds we own. What we are examining is whether or not we should hedge these positions as well (when appropriate), or whether or not we should eliminate them altogether except when long term trend indicators are in a positive mode, since a fully invested approach would be more profitable in that environment.

That is the way we are currently leaning, but we are finishing some research to determine if there is enough added value in the approach to compensate for owning five extra positions along with the extra ridiculous prospectuses that Fidelity sends out despite our electronic mail delivery efforts.

With regards to the Loomis Sayles Bond Fund, our mistake was in using a risk management model that was too slow to change. Since its inception in 1992, its biggest drawdown was just under 10%. With the approach we adopted back in 2004, we held the position for nearly four years. With the first signal change, we cut our position in half in mid-September, and then sold more just two weeks later.

As a result, our losses have been approximately -14% compared to a -25.9% loss for the fund (as of 11-6-08), but for us, this is not acceptable in this category. I guess there is some good news in that, since we've done nearly 50% better than the fund, but we're also aware that with a quicker trigger, we could have minimized the downside even more.

Finally, in regards to equity exposure, back in 2007, we decided to establish a floor (a minimum amount of exposure at all times), based on research from The Leuthold Group. Basically, Leuthold found that it rarely paid to go to an almost all cash position, except when valuations were at historic extremes (such as year 2000).

Before this time period, if all of our stock market risk models were negative, we would hedge down to a 0-10% invested position. With the above approach, if all were negative, we would remain about 25-30% long. This was the position we were in from November 2007 to late January 2008. When one of our 3 models turned positive in late January, exposure was increased to about 50%, and has remained between 40-50% since then, with the exception of two weeks in September.

Through the end of August, this was not a problem, but given the sharp decline in September and October, having an extra 25% exposure has probably cost our portfolios about 4% to the bottom line.

As a researcher and money manager, I think it is important not to over-react to what has taken place here. Yes—stocks have experienced their worst calendar year decline in about 75 years, but that doesn't mean they are about to do it again. Yet, as we've noted, there are some things we think we can do better. My perfectionism will always be there, but I want to emphasize that even if we had done everything perfectly this year, even our conservative portfolios would be down about -10% this year. If you've found that your risk tolerance isn't what you thought it was, it's important that we have a discussion to see if changes are necessary. This bear market may be ending, but over the next 15 to 20 years, the remaining lifespan of many of our clients (and who knows, me?), history suggests there will be 3 to 4 bear markets. It is a fact of life, and it's our job to deal with them and minimize the downside.

### **What We're Doing**

We're already in the process of revamping parts of our portfolios. Some of this is subtle. On the equity side, we are giving more weight to conservative equity funds that have less volatility, which is something we can change when the longer term trend changes to the upside.

On the fixed income side, we've established core positions in Hussman Strategic Total Return across almost all accounts, and in Conservative portfolios, have been purchasing individual government agency bonds (Fannie Mae, Freddie Mac) with an approximate 9-year maturity and yields in the 5.4% range. To a lesser degree, these will also be placed in Moderate risk accounts, which we've yet to get to.

And, as noted above, there will likely be changes in our approach with gold funds and sector investing, but this will take place over a period of several months. In addition, the "floor" under equity exposure will likely be removed. Finally, for the past five years since moving to Fidelity as our custodian, we've used a passive approach for the many small accounts that are part of running a practice. That will be eliminated as well, and these small accounts (typically under \$50,000) will be managed with our more active, risk management approach just like our more typical, larger household relationships, which tend to average over \$500,000.

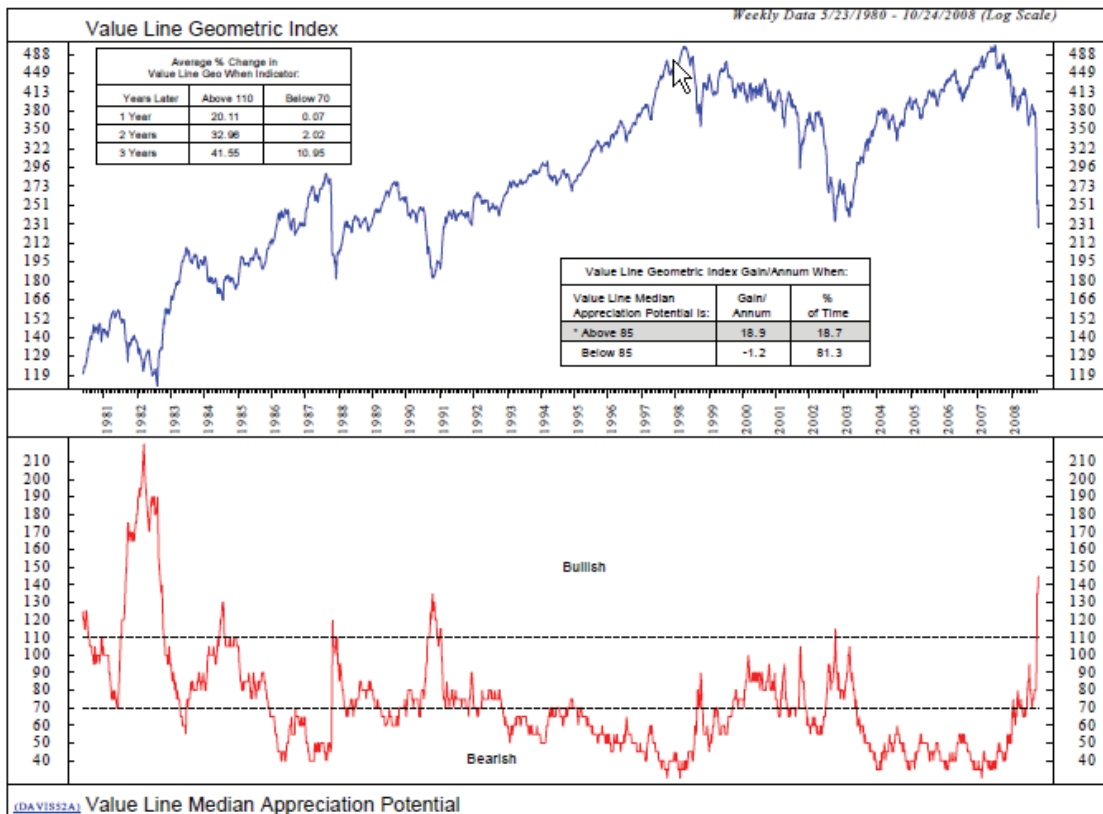
**The Outlook (and What To Expect)**

Earlier, I mentioned we were also enclosing a full reprint of the October 20, 2008 weekly comments from Dr. John Hussman, with his express permission. It’s titled, “Why Warren Buffett is Right (and Why Nobody Cares).” Though for brevity, I’ll summarize his conclusions, you cannot get the full tone of his work without reading the entire piece.

He says, “In 2000, we could confidently asset that stocks would most probably deliver negative total returns over the following 10-year period. Today, we can comfortably expect 8-10% total returns *even without* assuming any material increase in price-to-normalized-earnings multiples. Given a modest expansion in multiples, a passive investment in the S&P 500 can be expected to achieve total returns well in excess of 10% annually.”

This isn’t just an opinion. His work is based on observable conditions of the past, and their future outcomes. As its turned out, stocks have delivered negative total returns the past 9 years. And as has happened in the past, as the public is abandoning them, stocks are now priced to deliver compound returns over 2 ½ times that of a risk-free Treasury Note over the next 10 years.

But Hussman’s work isn’t the only reason to have some confidence about future returns. Below is a chart of the VLMAP (courtesy of Ned Davis Research), which stands for Value Line’s Median Appreciation Potential.



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This indicator is a single number that represents the median of the projections made by

Value Line’s analysts of where the 1,700 stocks they closely follow will be trading in three to five years’ time. The chart shows this number at 145%, and the most recent weekly reading has increased to 160%.

As you can see on the lower clip of the chart, this is the highest reading on the chart since 1982. Similar readings in the past over 110% have all led to substantial multi-year gains in stocks.

Though the long-term evidence for superior returns the next five to ten years is substantial, I want to stress that for those of you who are monitoring your accounts monthly or even more frequently, you are likely to be disappointed for awhile. Of the past 10 waterfall declines in market history as defined by Ned Davis Research, 7 made lower lows.

Right now, those lows are 839 for the S&P 500 and 7882 for the Dow Industrials on an intra-day basis, and 849 and 8175, respectively, on a closing basis. In other words, do not be surprised if the market eventually drops to the 700-750 range for the S&P, and the 7000-7500 range for the Dow, most probably after the first of the year.

Could stocks take off from current levels and not turn back? Absolutely—in the 3 of the above cases, that is what they did. But currently, our longer term trend indicators which would suggest a new bull market are not positive, and it would take substantial improvement in the tape before you would see us increasing equity exposure beyond 50% in client portfolios.

### **Third Quarter Performance**

Below is the performance, net of management fees, of four real-time portfolios we are tracking. These represent a majority of the strategies we are using in client accounts, but not all. The differences are mainly attributed to risk (example—moderate allocation versus conservative allocation or aggressive) and account size. The numbers are for the first nine months of 2008, through September 30.

<b>Type of Account/Strategy</b>	<b>YTD</b>	<b>Benchmark</b>
TABR Moderate Risk Account	-11.49%	-12.46%*
TABR D.A.L.I. Account	-20.14%	-12.46%*
TABR Passive Allocation	-21.98%	-12.46%*
TABR Bond Account	-8.98%	+0.65%***
Vanguard Total Stock Index		- 18.52%
Vanguard Total International Stock Index		-29.21%
Vanguard Total Bond Index		+ 0.65%

\*consists of 45% Vanguard Total Stock Index, 15% Vanguard Total International Stock Index and 40% Vanguard Total Bond Index

\*\*Vanguard Total Stock Index

\*\*\*Vanguard Total Bond Index

**Returns shown are net of management fees, and include reinvested dividends**

The approximate average invested exposure of our tactical equity allocations for the first nine months of 2008 was 51%.

### **In Closing**

It goes without saying this has been a difficult time for a majority of investors, our clients, and us. We've weathered this storm better than a large majority, but not quite up to my standards. But, we'll be better for this in the future, and at this time of Thanksgiving, we all still have much to be thankful for.

We've heard the following refrain from a few clients, and no doubt many investors feel this way and have acted by eliminating all equity exposure, more probably near the bottom.

“Some people say they want to wait for a clearer view of the future. But when the future is again clear, the present bargains will have vanished. In fact, does anyone think that today's prices will prevail once full confidence has been restored?”

That comment was made in May of 1932 by Dean Witter, just weeks before the end of the worst bear market in history. It is just as true today.

Best regards,



Bob Kargenian, CMT  
President

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Comparison of the TABR Model Portfolios to the Vanguard Total Stock Index Fund, the Vanguard Total International Stock Fund and the Vanguard Total Bond Index Fund is for illustrative purposes only and the volatility of the indices used for comparison may be materially different from the volatility of the TABR Model Portfolios due to varying degrees of diversification and/or other factors.

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## ***Why Warren Buffett is Right (and Why Nobody Cares)***

***October 20, 2008***

*John P. Hussman, Ph.D.*

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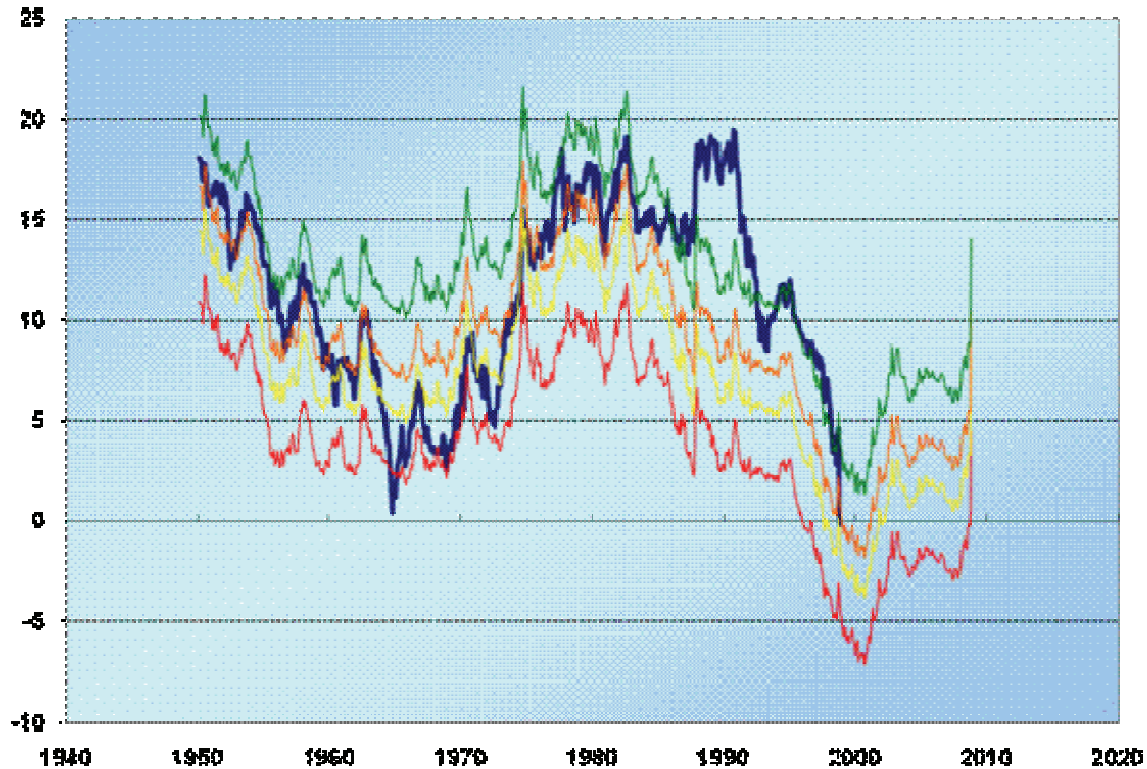
The best way to begin this comment is to reiterate that U.S. stocks are now undervalued. I realize how unusual that might sound, given my persistent assertions during the past decade that stocks were strenuously overvalued (with a brief exception in 2003). Still, it is important to understand that a price decline of over 40% (and even more in some indices) completely changes the game. Last week, we also observed early indications of an improvement in the quality of market action, and an easing of the upward pressure on risk premiums.

In 2000, we could confidently assert that stocks would most probably deliver negative total returns over the following 10-year period. Today, we can comfortably expect 8-10% total returns *even without* assuming any material increase in price-to-normalized-earnings multiples. Given a modest expansion in multiples, a passive investment in the S&P 500 can be expected to achieve total returns well in excess of 10% annually.

None of this is an argument that the market has necessarily registered either a near-term or a final bear market low. Regardless of whether or not the market has established a short-term trough, one would generally expect that a decline of the magnitude we've observed would be followed several months later by a secondary decline (which may or may not take stocks to lower levels). It is also not an argument for establishing an aggressive investment stance. We continue to hold index put option coverage under about 90% of our stockholdings, though primarily as a "stop loss" against any major continuation, rather than a defense against moderate declines. What is clear, however, is that after more than a decade of strenuous overvaluation, stocks are finally priced to deliver acceptably high *long-term* returns.

While it's true that the market established even deeper valuation troughs in 1974 and 1982 (near 7 times prior peak earnings, compared with the current multiple of about 11), it is important to remember that long-term Treasury yields were 8% in 1974, and 14% in 1982, compared with about 4% at present. While I've frequently argued that stock and bond yields are not related in anything near the 1-to-1 manner that the "Fed Model" suggests, it is already clear that a long-term investment in stocks here is likely to substantially outperform a long-term investment in Treasury securities over time. Even with very little adjustment for risk, U.S. stocks are likely to provide stronger long-term returns than the yields available on most corporate bonds as well.

This point is so important that I am again presenting our 10-year total return projections for the S&P 500 Index ( [standard methodology](#) ). The heavy line tracks actual 10-year total returns since 1950 (that line ends a decade ago for obvious reasons). The green, orange, yellow, and red lines represent the projected total returns for the S&P 500 assuming terminal valuation multiples of 20, 14 (average), 11 (median) and 7 times normalized earnings.



The reason we use a variety of methods to “normalize” earnings is that reported earnings are actually more volatile than stock prices themselves. In recessions, both earnings and stock prices decline, but stock prices nearly always bottom first. Year-over-year changes in reported earnings have virtually no correlation with year-over-year changes in stock prices. Despite all of that earnings volatility, long-term S&P 500 earnings can be nicely contained by a 6% growth trend connecting earnings peaks across economic cycles as far back as you care to look. Interestingly, even the enormous short-run variation in U.S. inflation rates over time has had very little impact on that long-term dynamic.

As for individual stocks (at least the stable, quality businesses), you don’t liquidate just because a recession may depress earnings next quarter, or even for a few years. The main use of quarterly earnings reports is as an information signal for businesses whose future can’t be adequately assessed otherwise. The better the business, the less attention you place on quarter-to-quarter earnings.

### Why Warren Buffett is right, and why nobody cares

On Friday, Warren Buffett published an editorial in the New York Times titled “Buy American. I Am.” In that piece, Buffett noted “ I’ve been buying American stocks. This is my personal account I’m talking about, in which I previously owned nothing but United States government bonds. (This description leaves aside my Berkshire Hathaway holdings, which are all committed to philanthropy.) If prices keep looking attractive, my non-Berkshire net worth will soon be 100 percent in United States equities. Equities will almost certainly outperform cash over the next decade, probably by a substantial degree. Those investors who cling now to cash are betting they can efficiently time their

move away from it later. In waiting for the comfort of good news, they are ignoring Wayne Gretzky's advice: 'I skate to where the puck is going to be, not to where it has been.'

The most interesting thing about that op-ed piece wasn't Buffett's opinion about stock valuations. He's absolutely right, in my view. Rather, it was fascinating how quick many investors were to dismiss Buffett's advice, saying either that he didn't understand how bad the economy was going to get, that he preferred to "get in early," or that he was "talking his book" and trying to bid up the value of his own investments.

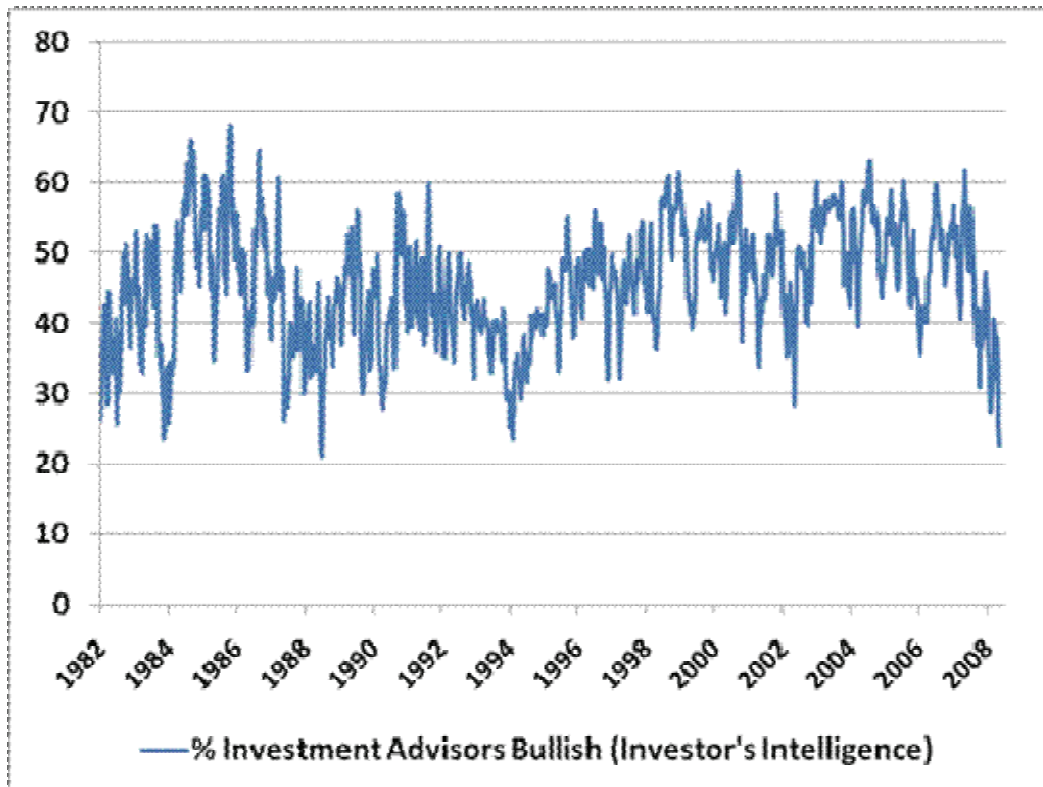
Look. Buffett doesn't need the money. Virtually everything he has is now or will ultimately be committed to philanthropy. My impression is that Buffett honestly doesn't like to see investors making decisions that will damage their financial security over time. Also, a good part of his own self-concept centers on being a good allocator of capital. If he didn't like his investment positions, he wouldn't try to talk them up. He would liquidate them. If he thought he could postpone his purchases without a high probability of missed returns from waiting, he would have waited. My guess is that Buffett is very excited about the values he has been buying up, but doesn't get wrapped up in the day-to-day fluctuations that weaken the judgment of less disciplined investors.

The most expensive resource on Wall Street is short-term comfort. Investors who constantly seek comfort over the short-term ultimately give up a fortune over the long-term. In a market economy, the most reliable source of long-term gains is to provide scarce and useful resources to others when those resources are most in demand. At present, the most probable source of long-term returns is the willingness to provide liquidity (holding out willing bids at depressed prices in a panicked market), risk-bearing (taking on the market risk being liquidated by fearful or distressed sellers), and information (through the proper assessment of value). In my view, Buffett's willingness (and our own) to accept market risk here does all three.

Though Buffett doesn't easily show his hand regarding individual purchases or the details of his calculations, he has always been very clear about what drives his assessment of value: stocks should be valued as if you were purchasing the whole business. The way you (properly) value a business is to *weigh the price against the long-term stream of cash flows that you expect that business to deliver* into your hands over time.

I'll say that again. The real object of interest is the *long-term stream of cash flows* that the company will *deliver* into the hands of shareholders over time (beware of companies that quietly dispose of their reported earnings through grants of stock and options to management and employees). Nearly all of the value of a stock is loaded into the "tail" of that stream – 5, 10, 20 years out and beyond. As Buffett notes "fears regarding the long-term prosperity of the nation's many sound companies make no sense. These businesses will indeed suffer earnings hiccups, as they always have. But most major companies will be setting new profit records 5, 10 and 20 years from now."

The rush to dismiss Buffett's advice underscores the extreme level of bearishness among investors here. According to [Investors Intelligence](#), just 22.4% of investment advisors are presently bullish. This matches the lowest extremes we've seen in decades. Extreme negativity of investors has generally been a useful contrary indicator of stock market prospects. That doesn't ensure that stocks have registered their final lows, but it contributes to a set of historically favorable conditions here.



At present, we observe not only undervaluation coupled with negative sentiment, but also extreme volatility that has historically accompanied important market troughs. Similar spikes in actual (e.g. 44-day) volatility were observed in July 1962, June 1970, October 1974, December 1982, December 1987, October 1998, and September 2002, all which were associated with important market lows.

The argument for gradually increasing our stock market exposure in the past couple of weeks is not that some flag has gone up that provides certainty about a bottom. Rather, our investment discipline is to gradually increase our investment exposure *in proportion* to the expected return/risk profile associated with *prevailing* conditions of valuation and market action. Scaling our positions *in proportion* to the market's expected return/risk profile, based on *prevailing* conditions (rather than trying to forecast market turns), is the essential practice.

Buffett notes, "Let me be clear on one point: I can't predict the short-term movements of the stock market. I haven't the faintest idea as to whether stocks will be higher or lower a month — or a year — from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over."

I have no idea whether the market will be higher or lower a month or a year from now either, but I think I differ from Buffett on the reasons for this. Buffett's reason is that he largely disregards short-term fluctuations, understanding that the market will improve before visible fundamentals do. My reason is that our market allocation is proportionate to the favorable expected return/risk profile of the *prevailing* Market Climate, and I have no way of knowing when that Climate will shift. When it does, we'll change our allocation. As I've said before, you don't have to forecast the future direction of the wind – you just need to regularly adjust the sails as the evidence changes.

## Early measures of market action turn favorable

Notably, last week we observed a measurable reversal in risk premium pressures, coupled with a clear “breadth reversal” across a wide range of industries. As I've stated frequently over the years, the most important feature of market action is not the extent or duration of market movements, but their quality and uniformity. These measures can change very quickly, and long before “trend following” signals such as moving-average crossings occur. Last week, our most sensitive measures of market action clearly reversed to a favorable condition. These don't “whipsaw” very often because they come into consideration only when market action is unusually compressed. Presently, in addition to undervaluation and extreme sentiment, we already have the beginnings of favorable market action.

That said, we don't yet have enough evidence to simply remove our hedges. The prevailing evidence is consistent with a high expected return/risk profile for stocks, but the still “early” improvement in market action and the unusual nature of the current downturn suggest that we maintain something of a “stop loss” in the form of continued put option coverage, with strike prices within a few percent below current levels. That is the position that we have established here.

The recent panic is frequently described as the “worst” since the Great Depression, but this does not imply that the outlook is similar. One of the clearest contributors to the Depression was the failure of the monetary base to expand at anywhere near the demand for base money. At present, governments have made a concerted effort to put the world awash in base money.

Neither the crisis in financials or the current recession are surprising, but Depression talk is hyperbole. About the only surprise in recent weeks was that the broad recognition of a U.S. recession emerged at the same time as the peak of the financial crisis. That compressed what should have been two separate down-legs of a bear market into a single swan-dive. This downturn is certainly extreme, but the conditions that amplified the downward spiral in the Great Depression are largely absent here. Both at market peaks and at market troughs, investors allow their imaginations to run, almost always to their detriment.

I'll repeat what I wrote during the 2000-2002 bear market: at meaningful market lows, “the tenor of news reports has always been something to the effect that 'conditions are bad, expected to get worse, and there is no end in sight.' When the news reports are uncontroversial in reporting that the U.S. is in recession, when they suggest that there is worse news ahead, and when they indicate that nothing seems to be helping, that is when the market is likely to register its low.”

This is also a good time to reiterate our standard “anti-marketing” message: The Strategic Growth Fund is not a “market timing” fund. Nor is it a “bear” fund or a “market neutral” fund. Strategic Growth is a *risk-managed growth fund* that is intended to accept exposure to U.S. stocks over the full market cycle, but with smaller periodic losses than a passive buy-and-hold approach. We gradually scale our investment exposure *in proportion* to the average return/risk profile that stocks have provided under similar conditions (primarily defined by valuation and market action). We make no attempt to track short-term market fluctuations. We leave “buy signals” and attempts to forecast short-term market direction to other investors, preferring to align our investment positions with the prevailing evidence about the Market Climate.

My *opinion* is that while there is still risk that the market will decline even further, investors may be underestimating the potential for a rapid 20-25% spike higher in U.S. stocks as risk aversion collapses. That opinion doesn't drive our investment stance. Rather, both my opinion *and* our investment stance are driven by the objective evidence we have in hand about valuations and market action. At present, the evidence indicates that it is appropriate to accept market risk, but with

something of a “stop” in the form of put option coverage close to (or a few percent below) current levels.

I won't sugar-coat the fact that we are accepting some amount of market risk here, and that this exposes us to some amount of potential loss if the market continues lower. Again, however, we continue to have a put option defense below about 90% of our stock holdings with strike prices within a few percent of current levels, which should relieve any concern about unacceptably large downside exposure. Equally important, in the event that stocks were to decline from here, I expect that there would be a strong likelihood of recovering *at least* to current levels on a subsequent advance. From that perspective, I expect that whatever downside we might experience as a result of a further market selloff would probably be temporary.

With the Strategic Growth Fund less than 10% below its record high, we now observe a loss of 40% or more in the major indices, extreme bearish sentiment and volatility consistent with important market lows, and a clear though still “early” improvement in our measures of market internals. It is impossible to be a successful equity investor without the willingness to accept some amount of market risk when conditions appear frightening. If anything should be clear from the bubbles of recent years, the greatest risks are *not* when prices are depressed, the economy is weak, and investors are frightened, but rather when prices are elevated and an unendingly positive outlook for technology, or housing, or global growth, or private equity, or emerging markets, or commodities seems all but certain.

### Treasury gets it right

Last week, the Treasury finally got it right, announcing that it would directly provide capital to troubled financial institutions by purchasing senior preferred equity stakes. As I argued in [An Open Letter to Congress Regarding the Current Financial Crisis](#) and [You Can't Rescue the Financial System if You Can't Read a Balance Sheet](#), this is exactly the right approach, since it operates on the liability (capital) side of the balance sheet, which is where the trouble has been. I would have preferred the Treasury to follow Bagehot's Rule (lend freely but at a high rate of interest) as opposed to the “favorable” terms that were offered. This would have encouraged these financial companies to get off of the public's dime as soon as possible. Even so, as long as the yield on the preferred is higher than the Treasury's funding costs, the favorable terms will represent an insufficient risk premium but not a loss to the public.

Still, some amount of patience is needed, lest investors frighten themselves that this capital infusion is not working. As I wrote in a note to shareholders in the Fund News section of the website on October 15, “Investors appear frantic to observe a reduction in LIBOR and other measures of credit strain, but such impatience is not reasonable given that the Treasury has not yet actually executed the announced transactions to provide capital to U.S. financials. Sellers at these levels may find themselves scrambling to repurchase stock as that occurs, particularly in view of current valuations (even adjusted for the impact of an ongoing recession). On nearly every measure - sentiment, valuation, volatility, oversold conditions, and others, we are observing extremes associated with strong expected return/risk profiles, on average.”

With respect to the economy as a whole, I continue to believe that allowing what I've called a “property appreciation right” (PAR) would be the single best legislative change to decouple the mortgage crisis from the broader economy:

Congress can efficiently mute the impact of the mortgage crisis on “Main Street” by allowing a small change in foreclosure law. Specifically, in foreclosure proceedings, judges should have the ability to reduce the amount of principal on a mortgage loan, provided that the original mortgage lender receives a “Property Appreciation Right” or “PAR” from the homeowner. The PAR would be an obligation to repay the mortgage lender out of future appreciation on the home (including property subsequently purchased, until the obligation was relieved). Payment would occur either when the home was sold, or through an equity-extraction refinancing at some later date. In that way, homeowners would surrender some amount of future appreciation in return for an equivalent reduction in the mortgage principal. This would result in an immediate lowering of mortgage payments, yet the original mortgage lender would still stand to be made whole. To account for time-value, the amount of the PAR obligation could be allowed to increase at a small rate of interest. The homeowner would be able to keep the house. Importantly, there would be no need to continue major write-downs on mortgage securities, since only the character of the payments, not the value of the mortgage obligation itself, would change.

(Readers who believe this approach should be included in discussion are encouraged to forward the above paragraph to their representatives in Congress.)

## Market Climate

As of last week, the Market Climate for stocks was characterized by favorable valuations and early evidence of favorable market action. The improved character of market action is not evident from standard “trend following” evidence such as moving-average crossings and so forth. Rather, last week we observed a very broad reversal in breadth and risk premiums. When this has occurred in the context of favorable valuations, compressed price trends, and bearish sentiment, such early reversals have often resulted in double-digit market gains over a period of weeks. At the same time, we are maintaining something of a “stop loss” a few percent below current levels in the form of put option coverage for about 90% of our stock holdings. In doing so, we are balancing the improvement in our quantitative measures, as well as our qualitative analysis, against our tolerance for risk (we prefer investment positions that allow us to be dead wrong about everything and still not experience intolerable losses). I expect that we'll maintain some amount of put coverage at least until we observe confirming evidence from high trading volume and improvement of more conventional market internals.

Generally speaking, an intolerable loss is one that requires a heroic recovery simply to break even. From my perspective, the S&P 500 has experienced an intolerable loss, since a 42% loss requires a 70% gain just to recover. The typical market loss of about 32% in an average bear market requires a 47% gain in order to break even, leaving only bull market returns beyond that amount to contribute toward long-term progress. Downside risk should always be assessed in relation to upside potential: a 10% loss is recovered by an 11% gain, a 15% loss is recovered by an 18% gain, and a painful 20% loss is recovered by a 25% gain. Such losses in say, a short-term money market fund, would be cause for panic because gains of 18%-25% are indeed heroic propositions. In the equity markets - particularly for strategies that can be partially or fully exposed to market fluctuations - such recoveries are reasonable and even commonplace (within a matter of weeks or months) once the market has become deeply depressed.

In bonds, the fear about Depression gripping the markets had a striking result last week, as investors priced inflation-protected bonds as if the rate of inflation would be essentially zero for the next 5 years or more. Now, from the standpoint of immediate inflation risk, I have long argued that widening credit spreads have a very strong effect in suppressing inflation. At the same time, however, the

enormous increase in government liabilities stemming from an ongoing budget deficit and huge financial rescue efforts is likely to result in normal if not elevated levels of inflation as the economy recovers.

As investors suddenly adopted a “deflation mindset,” they dumped their inflation-protected securities with little regard to price or longer-term inflation prospects. TIPS yields soared to over 3%. From a historical perspective, it has been rare for U.S. Treasury securities to provide real yields much over about 2% annually. In the Strategic Total Return Fund, we shifted about 25% of the Fund into Treasury Inflation Protected Securities with a variety of maturities. We may accumulate more if real yields press even higher. As always, you scale in proportionately as the expected return/risk profile becomes favorable.

Back in April, when commodities were still advancing to new highs, I noted that “at the point where real interest rates become positive and trend higher, we may observe a softening in commodities. Presently, we don’t observe that, but it is important to keep in mind that the strength in commodities largely mirrors a persistent decline in U.S. real interest rates, and in the value of the U.S. dollar. As the downward pressure on real interest rates abates, so most probably will the upward pressure on commodity prices.” Having closed our TIPS positions when real interest rates fell to negative levels, we closed the bulk of our precious metals positions shortly thereafter when gold soared over \$1000 an ounce. It is not typical for the Fund to have the majority of its assets in Treasury bills, but that was the case through much of the summer.

The weakness in commodities now having largely played itself out, the entire analysis above could now be reversed. Specifically, at the point where real interest rates stabilize or trend lower, we may observe a strengthening in commodities. The weakness in commodities we’ve seen lately mirrors the surge in U.S. real interest rates and in the value of the U.S. dollar. As that upward pressure on real interest rates abates, so most probably will the downward pressure on commodity prices (as well as the upward pressure on the U.S. dollar). In addition to the Total Return Fund’s positions in TIPS and short-dated Treasury securities, the Fund continues to hold about 30% of assets in a diversified group of precious metals shares, utility shares, and foreign currencies. With these markets sharply down from their highs, I believe it is appropriate for the Strategic Total Return Fund to again hold a moderate, diversified portfolio of TIPS, short-dated Treasury securities (awaiting higher real or nominal yields to invest in longer-dated securities), precious metals shares, utilities, and foreign currencies.

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Prospectuses for the Hussman Strategic Growth Fund and the Hussman Strategic Total Return Fund, as well as Fund reports and other information, are available by clicking “The Funds” menu button from any page of this website.

# View from the North Country

## by Steve Leuthold

##Financial crises and government bailouts are nothing new.

...An updated timeline of U.S. Financial crises dating back to 1792.

...Names have changed but economic and emotional responses are not random, nor case-specific.

##Status of various benchmarks currently supporting the case for a bullish stance: Volatility Levels, Economic Time Clock, Valuation Levels, Median Bear Market Declines, and Insider Activity.

##Three keys to Leuthold's long-time survival in this business. (It is not because he is always right.)

##Editorial Rant: Incompetence at the SEC; new leadership is needed.



### I REMAIN BULLISH.....AND WRONG

A month ago it appeared to me that the stock market was in the process of bottoming out. Then in September, the S&P 500 fell an additional 9% with the MSCI measure of foreign markets down 12%. The markets have continued to decline. I have been in the investment management business for over four decades, managing mutual funds for over three decades...**this is certainly not the first time I have been wrong.** A client once asked me how in the world I had survived and prospered for so long in a business notorious for performance flame-outs and involuntary early retirements. This was a tough question, but later in this issue I will reveal the three key secrets to survival. All three are now in play and all three are interconnected.

### Current Outlook: Market Lows Close At Hand

Obviously I was wrong a month ago in thinking a rolling stock market bottom "was in", but I do believe the bear market lows are close at hand. (I was going to write "the end is near" rather than "close at hand", but quickly reconsidered.)

## **Today the level of investor pessimism is the blackest since 1974.** Back then I recall an *Economist* stock market cover story: "The World's Stock Markets Going Straight To Hell". Now again, investors are so negative that, for a contrarian, this has become a strong stock market positive. Today with the public, institutional investors and hedge funds so negative, we can assume most of these investors have drawn down equity exposure, reflecting their pessimism, or are in the process of doing so. The result will be a sold out market.

## **FINANCIAL CRISES AND GOVERNMENT BAILOUTS...Nothing New**

Although some policymakers and members of Congress would have us believe otherwise, **the current financial crisis has not led the U.S. into uncharted waters.** Herein is an updated Leuthold timeline of U.S. financial crises dating back to 1792.

We came away from several days of reviewing past crises more reassured than before the exercise. Names have changed, but the economic and emotional responses are not random nor case-specific, but patterned in some loose way. The **human** element tends to outweigh the structural ones, no matter how formidable the latter superficially appear. The following are some observations that tie together the crises we have studied:

### **The Bulk Of Asset Price Declines Occur BEFORE The Crisis Hits**

The chart on the following page shows that most crises occur near the end of significant stock market declines, and **only rarely touch off further additional losses in stocks and real assets.** This is true even when the crisis translates into a severe economic downturn (with the Great Crash of 1929 an obvious exception). The Great Panic of 1907—halted by J.P. Morgan’s famed intervention—coincided with a major bear market low in November 1907, even though real GDP would decline by almost 9% in the following year. Big declines in stocks and commodities exposed those who were “swimming naked” when the tide was high. Again, the crisis is generally the **result** of these declines, not the cause of additional ones.

### **Government Intervention Is Almost Inevitable**

Financial crises have brought on interventions from even the most laissez faire of governments. Responses range from brilliant to bizarre, and many if not most are counterproductive. For instance, the response to the Wildcat Bank Panic of 1837 was to raise tariffs; the Panic of 1857 caused government to lower them. The Glass-Steagall separation of commercial and investment banking activities and the FDIC arose from the Emergency Banking Act of 1933. The panicky response to an especially severe crisis was to establish an Orwellian “Office of Financial Stability” (as provided for in the **Emergency Economic Stabilization Act of 2008**... we’re not kidding).

### **“Cooler Heads” Will Not Prevail...They Will Roll**

Officials that avoid the pressure to “do something” don’t last very long. Imagine Herbert Hoover’s Treasury Secretary, Andrew Mellon, at the helm in the today’s crisis. It was Mellon who felt that the post-1929 panic was best left to play out on its own:

*“It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people.”*

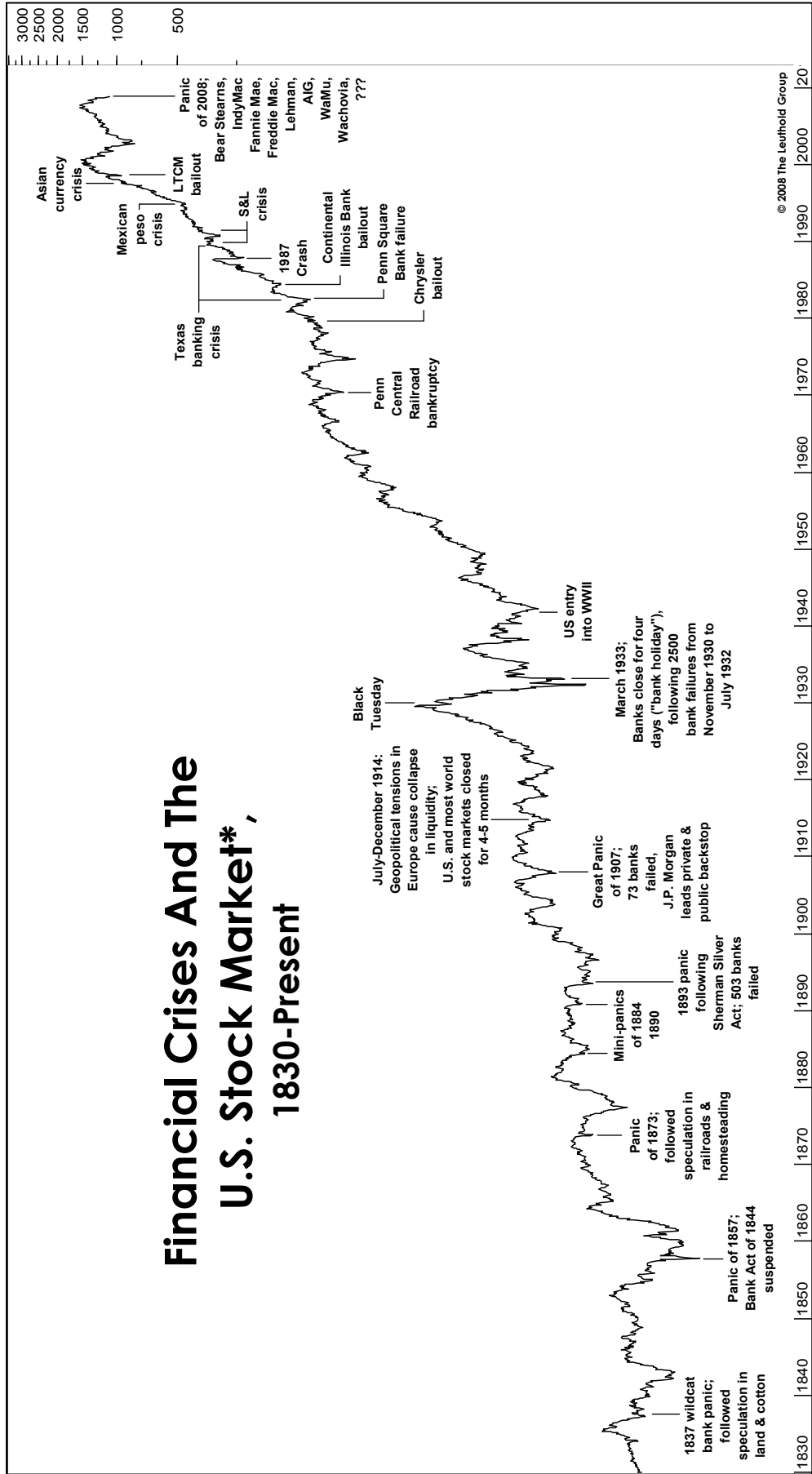
The cooler heads among **investment professionals** are also at risk. The investment merits of owning a AAA-rated, general obligation muni bond yielding 6% versus a T-bill at 1% (or recently, **0.1%**) may not outweigh the short-term career risks of having the muni appear on a quarterly statement.

### **Psychology Overrides Economics**

The underlying economic viability or desirability of any government intervention becomes secondary to the immediate objective of restoring confidence. (Very important to keep this in mind while reviewing some of the outlandish earmarks attached to the current bailout bill.) Ironically, resuscitating “greed” is the goal—although the wording is more likely to be “rekindling animal spirits”.

Regarding the last point, we just finished reading an apocalyptic article which characterized the entire 1982-2007 U.S. upswing as having been built entirely on a pyramid of confidence. It strikes us that this statement could well have characterized the economy of any nation at any time in history.

# Financial Crises And The U.S. Stock Market\*, 1830-Present



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\*S&P 500 Composite from 1928 to present; earlier numbers provided by Cowies Commission and Global Financial Data.

## A CHRONOLOGY OF PAST U.S. FINANCIAL CRISES

The significant market downturn experienced in recent weeks serves as a stark reminder of how a loss of confidence in the financial system can produce stock market declines that are both swift and dramatic. However, market history reminds us that previous financial crises—while frightening at the time—**have produced some excellent investment opportunities.**

The point of bringing up these past financial shocks is not to draw direct comparisons to the current events, because each crisis had characteristics that made them frighteningly unique to the market participants of the day. Rather, we emphasize that excess leverage, fear, uncertainty, and even the collapse of large institutions have existed within the U.S. financial system going back to the Panic of 1792. While the characteristics of each crisis are, in some respect, different from the others, one element stays the same: *They tend to produce exceptional buying opportunities.*

### **“History Does Not Repeat Itself Exactly—But Behavior Does”**

—Bob Farrell

## **Savings & Loan Crisis:** During the 1980s, S&Ls were deregulated and jumped into commercial real estate lending with both feet. Regulation that remained was lax and ineffective. Loans were large and stupid, far afield from home mortgages. As interest rates rose, the S&Ls found themselves paying more for deposits than they were earning on their real estate loans. About half the 3,234 S&Ls closed (1986-1995) sticking Federal Deposit Insurers with junk loans and a lot of lousy collateral. Congress created Resolution Trust to clean up the mess, which it eventually did, but it cost the taxpayers about \$160 billion dollars.

*.....Yet, during this ten-year period spanning the majority of the S&L Crisis (January 2, 1986—December 29, 1995), the DJIA gained 233% (an annual compound rate of 12.8%).*

## 1997-1998 produced a number of financial crises that culminated in the failure of Long Term Capital Management (a highly leveraged hedge fund run by former Salomon Brothers head bond trader John Meriwether, along with Nobel laureates Robert Merton and Myron Scholes). This failure resulted in a \$3.6 billion bailout orchestrated by the Federal Reserve Bank of New York in order to avoid a wider collapse in the financial markets. This period also saw the infamous Asian currency crisis, as well as the Russian government bond default.

*.....From the August 31st, 1998 stock market low, the DJIA went on to rally almost 44% one year later.*

## On Black Monday (October 19th, 1987), the U.S. stock market suffered its greatest one-day percentage decline, as the DJIA fell 22.6% for the day. The “crash” was global in nature, and was attributed to excessive use of Wall Street program trading, widespread use of portfolio insurance (an early ineffective risk reducing derivative), arbitrage, and market psychology with the complete absence of liquidity as the market crashed. Quickly the government, through the Fed, turned the monetary spigot wide open and cut rates.

*.....Just one year later, the market had rallied nearly 23% off the October 19th low. Two years later, the DJIA had gained more than 54% from its low.*

## **Great Depression Financial Crisis:** It all began with the stock market crash in 1929. By 1933 1,000 homeowners a day were losing their homes to the banks. 2500 banks failed in the 1930-1932 period. A new run on banks was accelerating in 1933. Recently elected President FDR declared a Bank Holiday on March 6th, 1933 and reopened them four days later after Congress (in one day) responded to the crisis by introducing and passing the Emergency Banking Act providing government funds to the banking system.

Shortly thereafter, Congress created the Homeowners Loan Corporation, a government agency to prevent foreclosures by buying defaulted home mortgages from the banks and refinancing them at lower rates with 15 year terms. Ultimately, the HLC issued mortgages to about 10% of the country's non-farm homeowners. The government agency closed the last of the loans out in 1951. Overall, 80% of the borrowers paid off on time or early. It is claimed this agency actually earned a small profit.

- ## **Great Panic Of 1907:** A failed cornering of the market for United Copper triggered a run on banks that had financed the scheme. Knickerbocker Trust Company failed. The Treasury injected millions of dollars into the banking system, but it was not enough. J.P. Morgan stepped up and convinced others—including the Secretary of the Treasury and John D. Rockefeller and the sound banks—to form a joint pool and make large deposits in major New York City banks that were in trouble. Would Warren Buffet have the clout to do something like this today?
- ## **Mini-Panics Of 1884 & 1890:** Small-scale banking panics erupted in May 1884 (resulting in 42 bank failures) and November 1890 (18 failures).
- ## **Panic Of 1873:** Panic was triggered by the bankruptcy of the Northern Pacific Railroad and its major investor, Jay Cooke.
- ## **Panic Of 1857:** A recession had begun in 1856 after a long period of railroad expansion and land speculation. But the discovery of embezzlement at Ohio Life Insurance and Trust kicked off the panic. British investors pulled funds from U.S. banks. Land prices declined after the cancellation of new rail routes, and grain prices collapsed following the end of the Crimean War and Russia's re-entry into global markets. The major government response was a major reduction in tariffs.
- ## **Wildcat Bank Panic Of 1837:** The panic was set off by a decline in British direct investment following a period of heavy speculation in land and cotton. "Wildcat" banks that had financed speculation in Western lands began to fail. A six-year depression followed. President Andrew Jackson was philosophically opposed to intervening and was voted out of office in 1840. The Whig Party promoted active government programs to stimulate the economy including increased tariffs.
- ## **Panic of 1792:** This panic is not on the preceding long term chart because no valid stock market data is available as far back as 1792. But I found this period very interesting because **it was the first U.S. government bailout of the banking system**, taking place in George Washington's first term. The engineer was Treasury Secretary Alexander Hamilton.

It all started in 1791 when the federal government assumed the debt obligations that some states had incurred during the Revolutionary War, borrowing to do so. This debt bailout increased U.S. government domestic debt by 70%. To finance the bailout, the U.S. floated 6% bonds, popularly referred to as "The Sixes". The bonds proved to be very popular with speculators, including a syndicate that tried to corner the market. The price of the Sixes soared, but the bubble burst and the bonds fell a fast 25% over a two week period.

The government, per Hamilton's direction, intervened, borrowing from banks to buy Sixes and lift the price. He then insisted major U.S. banks accept these bonds as collateral and backed the bonds with a government guarantee. The financial system soon stabilized with not a single bank failure for the next 17 years. (Could it be that Paulson and Bernanke are learning from Alexander Hamilton?)

### **SUMMARY: A Government Bailout Of The Financial Establishment Is Nothing New**

As Alex J. Pollock of the American Enterprise Institute recently observed:

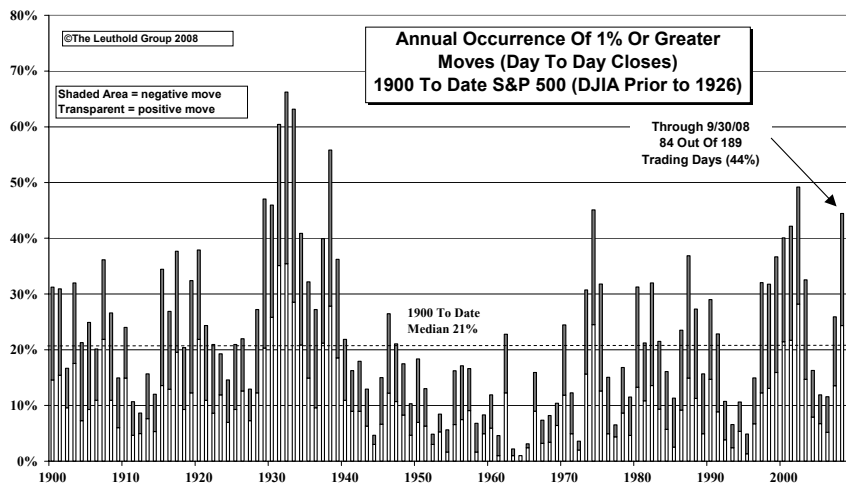
*"If you would like an empirical law of government behavior, it is in that a panic or threatened financial collapse, governments intervene—every government, every party, every country, every time."*

Contributors: Steve Leuthold, Doug Ramsey, Eric Bjorgen

## S&P 500... Approaching 2002 Volatility Levels, Which May Signal End Of Bear Market

# There were 14 High Volatility days (1% moves or greater) for the S&P 500 during September. There were also 10 Extreme Volatility days (2%+ moves) and 8 Ultra Volatility days (3%+ moves). The largest move in either direction was a decline of 8.79% on September 29. The YTD percentage of High Volatility days (44%) is just below the 2002 high of 49%.

S&P 500 Volatility	Days Of High Moves Of 1% Or More *****	Extreme Moves Of 2% Or More *****	Ultra Moves Of 3% Or More *****
September	14 (67% of days)	10 (48%)	8 (38%)
YTD	84 (44%)	33 (18%)	13 (7%)
2007	65 (26%)	17 (7%)	1 (1%)
2006	29 (12%)	2 (1%)	0 (0%)
2005	30 (12%)	0 (0%)	0 (0%)
2004	41 (16%)	0 (0%)	0 (0%)
2003	82 (32%)	15 (6%)	4 (2%)
2002	124 (49%)	52 (21%)	17 (7%)
2001	105 (42%)	26 (10%)	8 (3%)
2000	101 (40%)	37 (15%)	11 (4%)
1948 To Date Median	16%	2%	0%
1948 To Date Average	19%	4%	1%



## ECONOMIC TIME CLOCK: Stock Market Bottom October/November 2008?

Since WWII, recessions have lasted 11 months on average, with the 1892 to date average recession lasting 15 months. **The roughly 12 month duration of the current recession can be considered to be at or approaching historical standards.** As in our long term stock market cycle studies, *there is no hard rule that the current recession must follow the course of statistical norms*, especially considering that the purging of excess leverage in our economy will have ramifications on household balance sheets and spending patterns. In the interest of “stress-testing” our economic assumptions, we could ask: What are the implications for equities if the current recession were to last yet another year? **This is no small assumption, since this would become tied with one other contraction as having been the second longest recession of the last 120 years.**

	Average Duration Of Recession (Months)	On Average Market Bottoms How Many Months Into Recession?	On Average Market Bottoms What Percent Of Months Into Recession?	Average S&P 500 Performance 12 Months Out From Market Trough During Recession
1892-1945 (14)	18	11	57.8%	+48.0%
Post WW2 (10)	11	6	55.3%	+37.0%
1892-Present (24)	15 Months	9 Months	56.8%	+43.7%

**Note:** The Stock Market did not register a bear market low during the entire duration of the 2001 recession.

→ **.....The table above indicates that the stock market typically bottoms just beyond the mid point of the economic contraction. Even assuming a two-year recession, a similar stock market bottoming time line would place the stock market bottom in October or November 2008.**

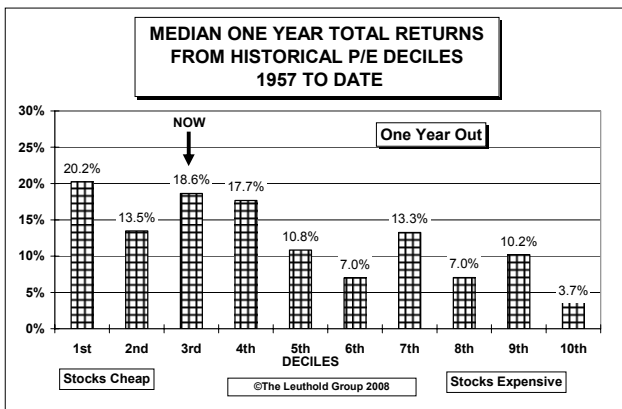
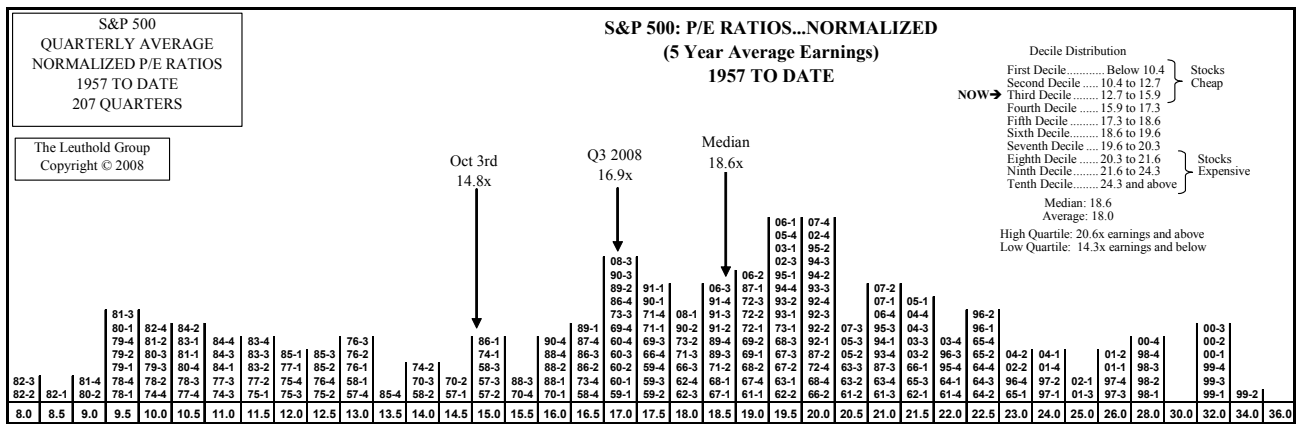
**.....Impressive 12-month returns averaging +40% follow these lows (column far right). You don't want to be out of the market when this happens.**

**S&P 500 NORMALIZED P/E.....A Buying Zone**

The following histogram presents the quarterly average normalized P/E ratios dating back to 1957. For the third quarter, the average normalized P/E ratio was 16.9x earnings, the lowest quarterly average since the fourth quarter of 1990, and the October 3<sup>rd</sup> P/E ratio of 14.8x ranks in the 26<sup>th</sup> percentile of this historical distribution. The “Decile Distribution” shown on the histogram places the current reading in the third cheapest decile.

⚡ *We have gone back and looked at what the subsequent returns have been for investors when buying stocks in the various deciles. Obviously, it makes sense to buy when P/E ratios are low (as they are today). The tables below the histogram present the One Year and Ten Year returns achieved at different P/E levels.*

*Note: Normalized earnings are a five year average of S&P 500 earnings, using the midpoint between operating and reported results. The earnings are normalized in order to smooth out the earnings stream over the course of the business cycle. We use 18 quarters of historical results combined with two quarters of estimates.*

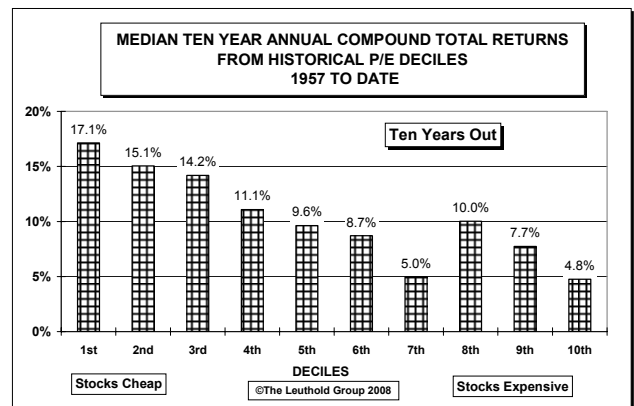


⚡ Since 1957, investors who have purchased the S&P 500 when the normalized P/E ratios were in the 12.7x to 15.9x range (the third decile), the **median one year total returns have been +18.6%**.

⚡ The stock market is again in this valuation zone, and we believe it offers an outstanding short term and long term opportunity to buy stocks.

⚡ Using history as a guide, investors buying at today’s P/E levels could expect to achieve an annual compound return of +14.2% over the next ten years.

⚡ Returns do get better when buying in the 1<sup>st</sup> and 2<sup>nd</sup> deciles, but there is no guarantee the market will fall to those lows. **Now is the time for long term investors to at least begin rebuilding equity exposure.**



## NOW IS NOT THE TIME FOR PANIC SELLING

The eighty year median and average bear market declines are now only about 200-600 basis points greater than the cumulative 30% decline in the latest bear market. **Historical standards suggest most, if not all, of the bear damage has already been done.** In the post-WWII era, two-thirds of the bear market cycles ended with declines that were equal to, or less than, the current 30% decline.

We recognize that individual bear markets are not bounded by statistical inference, nor historical scripts. But they do tell us what is normal or typical over the course of market history. Alone, these market history studies mean little unless there is other compelling evidence to suggest the potential for upside reward substantially outweighs downside risk.

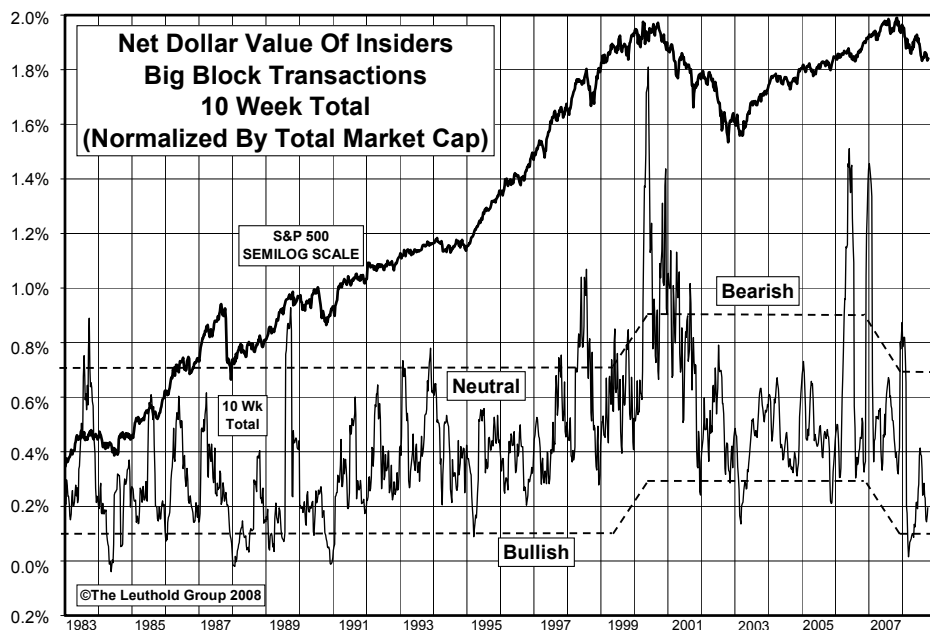
## S&P 500 Bear Markets

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(1926 to Present)

Stock Market Peaks & Troughs			Bear Market Statistics			
Date Of Market Peak *****	Market Peak Level *****	Market Trough Level *****	Date Of Market Trough *****	Peak To Trough Performance *****	Duration Of Bear Market *****	
Sep-7-1929	31.92	4.41	1	Jul-8-1932	-86%	34 Months
Jul-18-1933	12.20	8.06	2	Mar-14-1935	-34%	20 Months
Mar-10-1937	18.68	8.50	3	Mar-31-1938	-54%	12.5 Months
Nov-9-1938	13.79	7.47	4	Apr-28-1942	-46%	41.5 Months
May-29-1946	19.25	13.55	5	Jun-13-1949	-30%	36.5 Months
Aug-2-1956	49.75	38.98	6	Oct-22-1957	-22%	14.5 Months
Dec-12-1961	72.64	52.32	7	Jun-26-1962	-28%	6.5 Months
Feb-9-1966	94.06	73.20	8	Oct-7-1966	-22%	8 Months
Nov-29-1968	108.37	69.29	9	May-26-1970	-36%	18 Months
Jan-11-1973	120.24	62.28	10	Oct-3-1974	-48%	20.5 Months
Sep-21-1976	107.83	86.90	11	Mar-6-1978	-19%	17.5 Months
Nov-28-1980	140.52	102.42	12	Aug-12-1982	-27%	20.5 Months
Aug-25-1987	336.77	223.92	13	Dec-4-1987	-34%	3.5 Months
Jul-16-1990	368.95	295.46	14	Oct-11-1990	-20%	3 Months
Jul-17-1998	1186.75	957.28	15	Aug-31-1998	-19%	1.5 Months
Mar-24-2000	1527.46	776.76	16	Oct-9-2002	-49%	30.5 Months
			<b>Average</b> <b>-36%</b> <b>18 Months</b> <b>Median</b> <b>-32%</b> <b>18 Months</b>			

## BIG BLOCK INSIDER TRANSACTIONS (\$1 Million+)



≠ This indicator tracks large block transactions of corporate insiders on a market-wide basis. The readings are normalized as a percentage of total market capitalization. The buy/sell bands were raised during the 1999-2006 period to reflect the widespread use of options as a form of executive compensation. They have since been lowered.

≠ The bullish readings on the lower band have been remarkably opportune times to become bullish. Note prior "buy signals" in 1984, early 1988, 1995 and early-2003. A recent signal in 2008 suggests the biggest insiders view their companies as bargains.