International Equity

Overseas markets, particularly in Europe and the United Kingdom, shared the same financial woes as the U.S. As a result, international benchmarks retreated during the quarter. The MSCI EAFE index, which measures the performance of the major developed markets, plunged –20.5% over the past three months, its worst quarterly return since September 1990.

Part of the MSCI EAFE's decline is attributable to a 9.6% rise in the dollar versus other world currencies. An appreciating dollar hinders returns on international investments for U.S. investors. When measured in local currencies, the MSCI EAFE fell –12.9%.

The European Central Bank (ECB) has taken steps similar to those used by the Federal Reserve (Fed), injecting liquidity into the credit markets to ease the financial crisis. Although both the ECB and the Fed are central banks, multiple countries govern the ECB.

Germany is adamantly opposed to direct government intervention using taxpayer funds, whereas the French government proposed to purchase homes directly and make wider provisions for state-guaranteed mortgages. Meanwhile, Ireland offered billions in guarantees against bank deposits, a move criticized by the European Union.

The U.K. has considered a U.S.–style proposal to provide support to its banking system, as well as a plan to exchange troubled mortgage securities for government bonds.

Emerging markets plummeted –26.9% over the past three months, resulting in the largest quarterly decline on record for the MSCI Emerging Markets Index. Driven lower primarily by Latin America (-32.6%) and China (-25.2%), emerging markets were hit especially hard by global credit concerns.

Although there will be setbacks - emerging economies tend to be quite volatile - there is reason to expect growth in this market segment over the longer term. Emerging market populations will continue to strive for a better standard of living and, in the process, provide opportunities for continued growth.

REITs

Domestic REITs afforded some cover for investors as other asset classes struggled. For the period, the NAREIT Index advanced 4.5%, its best quarterly return since December 2006. By sector, apartment and self-storage REITs gained 13.1% and 19.3%, respectively.

In contrast, lodging and resort REITs have suffered amid the current economic slowdown as consumers curtailed their travel. Likewise, mortgage REITs, which don't own property directly but rather loans secured by real estate assets, posted declines for the quarter.

Overseas, REITs lost roughly –19.0% as countries coped with a real estate slump and weaker overall demand.

All performance information and figures provided by Bloomberg.

Kipp Brant Drummond & Associates Clients

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Market Commentary

Third Quarter 2008

"In a move that could help increase home ownership rates among minorities and low-income consumers, the Fannie Mae Corporation is easing the credit requirements on loans that it will purchase from banks and other lenders."

- Originally published in the New York Times, September 30, 1999, by Steven A. Holmes

Think back to the late 1990s. Companies were under pressure from shareholders to bolster profits (Fannie Mae and Freddie Mac were no exception), and politicians wanted home ownership for every American. But the stock market eventually returned to earth, and investors increasingly turned to what traditionally had been one of the surest assets of all: real estate.

Why real estate? Mortgages were suddenly cheap and lending standards less stringent (thanks in part to pressure from Washington). To satisfy increased demand for home loans, banks offered unconventional ways to finance, such as no money down and adjustable rate mortgages and deferred payment plans. At the end of the day, Fannie Mae and Freddie Mac were willing to back less-than-prime mortgages with the risk of default covered by insurance companies (remember AIG?).

Investment banks (like the now-defunct Lehman Brothers and Bear Stearns) also stepped in by purchasing collateralized mortgage obligations (CMOs). A CMO is backed by a pool of real estate assets like residential homes. Banks provide funding in exchange for the pool's mortgage payments, and the value of the CMO is directly related to the underlying property values and the ability of homeowners to pay their mortgages.

Investor appetite for CMOs was no surprise given their attractive returns. From 2004 through 2006, the yields on the riskiest CMOs averaged roughly 7% over the yield of comparable Treasury securities with relatively few defaults.

Low interest rates (i.e., cheap credit), rising property values and relaxed lending standards resulted in substantial profits for Wall Street firms. As long as home values kept rising, financial institutions (not just the local bank, but global investment firms and government agencies) were more than willing to lend.

But trouble was brewing: not everybody could afford the homes they were buying. As borrowing costs increased (interest rates climbed from 1% in mid-2004 to 5.25% in mid-2007), so did the rate of mortgage defaults. Homeowners stopped making payments, and demand for housing waned. As a result, banks were on the hook with delinquent loans and suspect mortgage investments.

Two primary factors helped contribute to the current panic: liquidity (or lack thereof) and leverage. CMOs are highly customized, private contracts that do not trade on a public exchange. With no buyers, financial firms had no way to value their mortgage investments at current prices (a rule required by an accounting standard called mark-to-market).

To make matters worse, investment firms borrowed money to purchase CMOs (i.e., they were leveraged). Because returns on mortgage assets exceeded borrowing costs for several years, investment firms magnified their profits. But as home values declined and market liquidity evaporated, CMO woes mounted quickly.

Investment firms could not repay the borrowed funds they used to buy CMOs and were forced to write down asset values. Meanwhile, lenders required additional collateral at higher interest rates, and credit rating agencies were forced to downgrade.

This double whammy - a lack of liquidity and excessive leverage - is what brought down Lehman Brothers and Bear Stearns, among others. If only someone would step in and buy the troubled assets, investment firms and banks could wipe the slate clean and restore investor confidence.

Enter the U.S. Treasury Department and Treasury Secretary Hank Paulson with a proposal for Congress. Under the Treasury plan, U.S. taxpayers would provide funds to purchase distressed assets, particularly mortgage-related securities, and stabilize the financial markets. The proposal was viewed as a bailout by some, an investment by others.

According to Paulson, given enough time to appropriately value the assets, the Treasury eventually could sell the securities at a profit for taxpayers (hence, the plan is an investment with upside opportunity). But Paulson's view wasn't shared by the residents of Main Street, who instead considered the proposal a bailout for irresponsible Wall Street behavior.

After much debate, the House of Representatives initially voted against the proposal. The bill was returned to the Senate with revisions, including an increase on deposit insurance limits and tax cuts for businesses. The revised bill was eventually passed on October 3rd.

The ultimate benefit of the stabilization package remains unclear (the congressional vote was sharply divided). But the injection of liquidity could provide a near-term stimulus for the credit markets and, to some extent, restore investor confidence. Many view the package as a step in the right direction, but by no means the solution.

From Times of Panic, Opportunity Is Born

When markets are gripped by uncertainty and panic, the credit market dries up. Banks are not willing to lend for fear of loss. When businesses can't access credit, they can't expand operations, let alone their workforce. Venture capitalists and private equity firms have difficulty funding new enterprises. Consumers can't get affordable loans.

But the uncertainty doesn't last forever. To be sure, the coming months are likely to be volatile, and equities could see further declines. However, as confidence is restored (which is highly dependent on Congress and the Treasury agreeing on a meaningful infusion of liquidity), the billions of dollars that have poured into gold and Treasury securities will slowly move back into the market.

Business cycles are nothing new, and the current cycle certainly won't be the last. Once credit starts flowing again, business conditions should improve, and shareholder wealth gradually will be created. The question now is twofold: Is the economy at or near the bottom of the current cycle and how long will a recovery take?

Market Recap

Domestic Equities

The Standard and Poor's 500 Index (S&P 500) experienced a quarterly drop of –8.4% and is down –19.3% year-to-date. The broader-based Russell 3 000 index fell –8.7% over the past three months and is lower by –18.8% for the year.

Performance deteriorated as market capitalization increased (i.e., mid- and large-cap stocks bore the brunt of the quarterly declines). Small-cap stocks, which typically don't access the credit markets to the same extent as their larger-cap counterparts, held up reasonably well on a relative basis, losing –1.1% for the quarter. Mid-cap stocks gave back –12.9% for the same period. Meanwhile, large-cap stocks suffered a –9.4% setback.

By investment style, value trumped growth –5.3% to –11.93%, respectively, over the past three months. The primary reason for value's outperformance was a larger allocation to the financial and healthcare sectors, which edged up roughly 0.9% and 0.5%, respectively, during the period. Furthermore, growth stocks were more heavily weighted to the basic material and energy sectors, which tumbled –22.5% and –24.6% for the quarter, respectively, against a backdrop of falling commodity prices.

Utility stocks also suffered over the past three months. Traditionally considered one of the safer sectors, utilities rely heavily on borrowed funds to finance new projects. But given the tighter credit markets, the sector slid –18.0% during the quarter.

Historically, one sector that tends to hold its own in an economic downturn is consumer staples. Concentrated primarily in companies that provide household goods, beverages and food, the sector usually lends some relative stability in an otherwise unstable market. True to form, consumer staples gained 4.8% for the quarter.

What's Ahead?

The future for stocks is cloudy at best, and much hinges on the Treasury's stabilization plan and its ultimate impact on the credit markets. What history has shown is that after stocks drop to extreme levels, the subsequent rebound typically is substantial.

Since 1950 the economy has experienced nine complete business cycles according to the National Bureau of Economic Research. During every cycle, the S&P 500 plunged to an extreme, or bottom, only to experience a significant recovery as the cycle progressed. Through all the market volatility, the S&P 500 has averaged an annual return of roughly 12%.

If history is a guide, there's potential for improved equity returns as the economy works through the current cycle.

Fixed Income

When investors shifted from equities amid the market turmoil, they turned in part to the fixed-income market, particularly U.S. Treasuries. While the Lehman Brothers Aggregate Bond Index declined modestly by –0.6% for the quarter, the Treasury sector advanced 2.3% for the same period.

With investment banks and government agencies losing ground, investors sought a short-term safety net in Treasury bills (T-bills). The yield on T-bills fell dramatically in the latter part of the quarter as demand soared. At the beginning of September, the 3-month T-bill yield was 1.7%. As the quarter came to a close, that yield had sunk to 0.9% (when demand for T-bills goes up, the yield goes down).

Despite the gains in the Treasury sector, the broader fixed-income market was weighed down by corporate bonds, which dropped –7.8%. Unlike Treasury securities, corporate bonds carry credit risk, or the uncertainty of repayment.

In particular, longer-term investment-grade corporate bonds experienced meaningful declines of roughly –10.0% for the quarter. The prospect of tighter credit conditions and the inability of companies to raise capital in the near term led many investors to sell riskier corporate debt in favor of Treasury securities.

High-yield corporate bonds also registered losses for the past three months, falling roughly –8.7%. Longer-dated bonds were lower by –10.4% for the same period.