Marathon
Investment
Management

My Neighbor Cashed Out…..Why Didn't I?

As difficult as 2008 is to digest and deal with, in order to maximize investment opportunities, it is one of Marathon's responsibilities to appropriately align your portfolios with your investment time horizon. Accordingly, most of our clients' goals include a period greater than one or two years. As such, Marathon continues to recommend positioning only short-term needs into cash equivalents. Therefore, it is critical to **<u>notify us if you have any cash needs from your portfolios in the next 12 to 24 months as adjustments to your investments are strongly recommended</u>.**

Every year has winners and losers. It is very unusual to have cash/treasuries as a winner for any given year; but in hindsight, cash/treasuries was the place to be in 2008. Just like any hot stock, news travels and money continues to pour in at record levels due to the irresistible past returns, or in this case a guarantee. According to Bloomberg News and Leuthold Group by the end of the year $8.85 trillion was piled in cash, bank deposits and money market funds.

In order to make a cash position work on a long-term basis, you must accomplish two difficult tasks: First, when to cash out, and second, when to get back in.

It is clear that investors have 'cashed out.' Moving forward, the question your neighbor will need to answer is when to invest? Consider the following historical events noted by Bloomberg:

- Cash holdings peaked one month before equities began to recover during the two longest recessions since World War II – in 1982 and 1974.

- In July 1982, money of zero maturity as a percentage of the U.S. stock market's value rose to 95% before a 20-month bear market ended and the S&P 500 began a six-month, 36% advance.

- Cash on hand reached $604.5 billion in September 1974, representing a record 1.21 times U.S. stock capitalization. That preceded a 31% gain in equities between October 1974 and March 1975.

- Cash totals at the end of 2008 represent 74% of the entire market value of U.S. companies, the highest ratio <u>since 1990</u>.

One might benefit to recall what happened <u>post-1990</u> – the biggest bull market in history where the S&P 500 returned 324% during the decade. Investors gradually moved from record level cash positions and bombarded the open market with equity investments. Investors parked in cash will not be satisfied with dismal interest returns for long. Cash is a short-term asset for a reason; at some point additional risk will be worth the reward…and history shows there will be a *great* reward.

Are Treasuries King?

Last year even bonds, the asset used to stabilize a portfolio during market falls, got hit due to the credit freeze and decreasing credit ratings. The ONLY sector of the market that was positive in 2008 Treasury obligations. As the year continued to deteriorate, a mass exodus occurred from assets assuming any kind of risk to the risk-free asset: government guaranteed assets, treasuries. In a one-month period ending October 9th individual investors purchased $484.5 billion of Treasuries. Currently investors are being *enticed* with yields of a 30-year T-bond at 2.82%, 10-year notes at just 2.40%, and Treasury bills squeezing 0.05% at the beginning of this year – which is virtually nothing.

With the trillions of dollars that moved into treasuries last year, the biggest threat that investors should be concerned with is price and interest rate risk. These investments are amazingly overvalued due to extreme demand which has also pushed down the yield. Once the market starts to recover, investors will gradually feel safer about risk and require a higher rate of return and the minimal treasury yields will not satisfy their appetite. Rather than waiting until these bonds mature, a flood of treasuries will be up for sell on the open market to the highest bidder but investors will not be willing to pay much for something that has virtually no return!

For example, Jim paid $100,000 for a 30-year bond that pays 2.82% per year. Several months following the purchase, the market begins to recover and as such Jim now wants to reinvest in equities but needs to free up money to do so. However while trying to sell his bond he encounters the following issues. First his bond will be one of 500 billion other treasury bonds trying to be liquidated with a slim amount of buyers in the market and a measly yield of 2.82%. Second, an investor would not pay as much for Jim's bond as they would the new issue yielding 4.35% (where it was on Nov. 13th 2008). The price of the original bond would be discounted by about 25% and Jim would receive only approximately $75,000 instead of waiting until maturity to receive the original $100,000 investment in return.

Inflation risk also posses a major threat to Treasuries. If $3.50 can no longer buy a gallon of milk and you have to pay $4.50, the small amount of interest that you are receiving on your treasury will not be worth as much. With trillions of dollars being thrown into the economy to keep it afloat, many analysts agree there will be an inflation problem in the future.

Evaluating Junk, a Diamond in the Rough?

On the opposite side of this flight to guarantee is the corporate bond arena. Just as high demand in treasuries has pushed yields down, extremely low demand of corporate bonds has pushed yields up – considerably. Because of this along with the credit freeze, businesses are being forced to raise capital by issuing bonds, which has increased the availability of new issue bonds.

The yield spread of 20.25% on December 16 is a record according to John Lonski, chief economist at Moody's Investor Services. That means on that date you could have bought non-investment grade corporate bonds yielding 20.25% more than Treasury notes. To put that into perspective, the previous record was set in October 2002 at 11.5% - which was interestingly the same month as the bottom of stocks for the respective bear cycle (Donald Luskin of SmartMoney.com, "It's Time to Add Some Junk to the Trunk").

This 20% premium is available to investors who are willing to forgo a guarantee and take on some degree of risk; a 10-year term bond with a 22% plus annual return. Lonski says the default rate for these bonds over the last year has been about 3.5%, well below the historical average, however his expectation is for this rate to increase to 11% by the end of 2009. Considering the default rate during the Great Depression was 15%, an 11% expectation is closer to a worst case scenario. Reasonably, even if 50% of junk bonds in a mutual fund defaulted, an investor could still receive half of the return which would be about 11%.

Bearing in mind the S&P 500 has posted a negative average annual return for the past 10 calendar years, junk bonds could add a spark to a portfolio. We believe this sector has great potential in a well diversified account.

Another Dead Decade?

Although many investors shunned investing in the 70's due to its 'Dead Decade' reputation, not investing at all during the period would have cut an investor's earnings based on cumulative contributions by more than 50% over 38 years! The 1970's was an expensive decade to miss out on. Today, the media commonly refers to the 2000's as another 'Lost Decade'…**makes me wonder what is around the corner?** *See charts on the following page.*

Which Decade Did Investing Make a Difference?

Based on $100 per month contributions

Investing 1970-2008				
	Cumulative Contributions	Value at Period End	Cumulative $ Earnings	Cumulative % Earnings
1970	$ 12,000	$ 13,598	$ 1,598	13%
1980	$ 24,000	$ 68,156	$ 44,156	184%
1990	$ 36,000	$ 318,308	$ 282,308	784%
2000	$ 46,800	$ 203,935	$ 157,135	336%

Investing 1990-2008				
	Cumulative Contributions	Value at Period End	Cumulative $ Earnings	Cumulative % Earnings
1970	No Contributions			0%
1980	No Contributions			0%
1990	$ 12,000	$ 32,744	$ 20,744	173%
2000	$ 22,800	$ 28,379	$ 5,579	24%

Investing 1980-2008				
	Cumulative Contributions	Value at Period End	Cumulative $ Earnings	Cumulative % Earnings
1970	No Contributions			0%
1980	$ 12,000	$ 23,978	$ 11,978	100%
1990	$ 24,000	$ 133,210	$ 109,210	455%
2000	$ 34,800	$ 90,142	$ 55,342	159%

Investing 2000-2008				
	Cumulative Contributions	Value at Period End	Cumulative $ Earnings	Cumulative % Earnings
1970	No Contributions			0%
1980	No Contributions			0%
1990	No Contributions			0%
2000	$ 10,800	$ 8,249	$ (2,551)	-24%

All returns based on historical S&P500 monthly returns

Period Returns:	
1970's	34%
1980's	188%
1990's	324%
2000's*	-33%

*through 2008

Please give us a call if you would like to review your portfolio(s) or if you have any questions. We look forward to serving your investment and financial planning needs in 2009!

Sincerely,

Amy Mahlen, CFP®
Certified Financial Planner™