

August 10, 2011

## Our Thoughts on the S&P Downgrade and the Recent Equity Market Turmoil

### Dear Clients and Friends:

The downturn in the financial markets over the last couple of weeks has been both swift and stressful. We understand that sharp market declines can be worrisome; therefore, we wanted to share our perspective about what's been going on and how it impacts our investment view. Getting our comments out in a timely manner to all of our clients prevents us from addressing the specifics of each client's portfolio, ***so we encourage you to call us if you would like to discuss how these changes might apply to your own portfolio.***

***The short answer is that recent events, troublesome as they may be, are consistent with the broad view we have held for some time, and our portfolios are already allocated conservatively based on this view.*** In fact, as a result of the stock market decline, we will be adding back a small portion (5%) of our equity weighting to many of our portfolios. We were underweighted to equities in most of our balanced strategies by 10%–15% and we felt the market decline was sufficient enough to begin reestablishing a portion of our equity allocations. We will not make this move in our most conservative portfolios because clients in these portfolios are the most risk-averse. However, if the market continues to decline, we may add to our equity positions across all models. Keep in mind that as equities decline in value, all things being equal, future expected returns increase.

On Monday the market reacted to the Standard & Poor's rating agency downgrade of U.S. sovereign debt from AAA to AA+. The reasons listed for the downgrade are not a surprise to us, as we have been writing about these and related risks for several years. Conversely, we have been surprised that stocks continued to climb over the last few quarters despite all of the macro level risks, as these risks were precisely why we have been scaling back our equity risk in our balanced accounts as markets climbed.

The latest headlines: The S&P downgrade, "worse-than-expected" U.S. GDP growth, the increased risk of a double-dip recession, and worsening European sovereign debt concerns (including now Italy and Spain) are consistent with our big-picture outlook regarding the risks facing the U.S. and global economy in the aftermath of the financial crisis, and the negative impact these conditions would ultimately have on corporate earnings and the stock market. So with the same investment framework in place, as the stock market moves lower, equities become relatively more attractive to us compared to bonds and we will be adding additional money back to equities (though we still remain underweighted).

### Key details behind our recent addition to equities in some of our balanced portfolios:

- Recent events are consistent with the macro view we have held for some time: Excessive debt (at the household and government level) and resulting efforts to deleverage, likely make it harder for the economy to grow at a normal pace in the years ahead and create a complex environment with a variety of uncertainties and risks that may result in periods of market volatility.
- Our portfolios are positioned consistent with our scenario analysis and our outlook for asset class return potential. In most scenarios, we find risk assets (equities) fairly unattractive—although now improving in terms of both absolute returns and returns relative to other asset classes. As a result, we have been and remain underweighted to equities. It is also the case that the recent decline has helped marginally improve return

potential for equities such that we are slightly increasing our equity exposure in some of our balanced portfolios. Should we see additional significant declines, we may reach the point at which we would further add to equities. (Just to reiterate, all things being equal, a lower entry point improves future return potential.) We are not adding equity exposure to our most conservative portfolios at this stage, but may do so in the future if stock-market values continue to decline.

- Investment-grade bonds, typically where we would turn when risk assets are relatively unattractive, are also unattractive due to low potential returns as well as their vulnerability to rising interest rates or other potential outcomes of excessive government debt, such as inflation and a declining currency. Therefore, we own a number of fixed-income strategies that seek a low risk of loss and that work to achieve positive returns regardless of the market environment. These funds have wide latitude to pursue their absolute-return orientation. At the same time, we are cognizant of the important role core investment-grade bonds can play in a recessionary or deflationary environment or in a flight-to-quality environment so we have also retained a sizeable allocation to core investment-grade bonds.
- We continue to view emerging markets as a relative bright spot in the global economy over the long term and own an emerging-markets local-currency bond fund as a tactical allocation. (This position also provides diversification relative to the U.S. dollar.) That said, we are aware of risks here too, including the fact that short-term valuation metrics suggest quite a few emerging-market currencies are fairly valued to over-valued. Also, there is a risk of a hard landing for China, which would be a negative for emerging-markets local-currency bonds, at least over the short term.
- Finally, we hold an allocation to alternative strategies, which we believe offer relatively attractive return potential and that we would expect to have relatively low correlation to traditional asset classes as well as lower downside relative to stocks in most environments.

***We understand that watching a market decline sharply over a short period of time can be unsettling and stressful. It is important during times like this to remain objective and follow a disciplined investment process. We will continue to evaluate the markets and their underlying drivers with an eye towards minimizing risk and maximizing long-term returns in all of the strategies we manage. We have been underweighted to equities over the past few years due to the risks associated with the market. Now that the market is starting to price in some of these risks, we will be using this opportunity to increase our weightings to equities so that they are closer to our benchmark weightings. As always, our moves will be measured and based on our careful analysis, rather than emotion.***

***If you have any questions about our investment outlook or recent portfolio moves, please don't hesitate to contact me at (716) 580-3906 or email at [glk@waterfordadv.com](mailto:glk@waterfordadv.com). As always, thank you for your continued confidence and trust.***

Best regards,

*Gregory L. Kozerski*

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