

PRAETORIANSM GUARD



**CLIENT NEWSLETTER
JANUARY 2009**

2008 MARKET COMMENTARY:

We are confident you were as glad to see 2008 changeover to 2009 as we were at Praetorian Guard. In the immediate aftermath of one of the most challenging economic years in the last thirty, I will do my best to provide perspective and facts on the past year, place the United States' economic situation into historical context and help you understand how those affected our thinking for the future.

I want to begin by acknowledging the brutal reality for world equity markets in 2008.

Facts

- ◆ The Dow Jones Industrial Average *AND* the Standard & Poors 500 index suffered their third worst annual percentage decline in history, dropping 33.8% and 38.5% respectively in 2008.
- ◆ The NASDAQ declined 40.5%, which was a larger percentage drop than the tech bust of 2000.
- ◆ Of the 34 developed nation equity markets, 31 of them suffered worse declines (in dollar terms) than the United States.

source-Bloomberg

Perspective

- ◆ We will seldom, *if ever*, experience the average return in any given year. Vanguard recently completed a study finding that from 1926 to 2007, only **six years** (out of those 82) did the S&P 500's **actual returns** fall within plus or minus 2% of the long term average. The reality is that we **should expect** any individual year's returns to be better or worse than the long term average by a significant degree. source: The Vanguard Group
- ◆ In today's globalized economy, a recession will cause world equity markets' correlations will be higher than normal. The significance of this is that they will tend to react in a similar fashion to the same news and all decline.
- ◆ Market volatility and our own tendency to place greater importance on the most recent events and discount those in the more distant past (called recency bias which I discussed in the January 2008 newsletter) will cause all of us to question our long term strategies.

Impact on our thinking

- ◆ Markets are quantitative but people are human and a large part of Praetorian's responsibility is to *LISTEN*, inform and help to place the unending barrage of "instant analysis" of the *macroeconomy* into context of your family's *microeconomy*.
- ◆ Long term financial plans *require* adjustments and updates as external factors change. Modifications however must not be made based upon reaction to the moment but rather an understanding and assessment of your personal situation, goals and objectives.
- ◆ Daily (and more importantly *intra-day*) volatility during periods of market turmoil make market timing **appear** more attractive yet even more impossible to execute with any long term success. We remain committed to enduring principles of investing for your true investment horizon and broad diversification across sectors and asset classes.

PRESIDENT'S COMMENTARY



Dick Hewitt

My intent for this newsletter is two fold: To acknowledge that 2008 was a horrendous year but it is also one that is historically (and thankfully) infrequent. Returns worse than -30% have occurred seven times in the last 102 years and 2008 was the first time since 1937. The point is that they happen but only once in that period were they back to back (1930-1931).

Second, we can expect negative returns approximately one year in five and must recognize they are a normal part of the business cycle. This is not to minimize the decline in investment accounts, home values or other assets we experienced over the last 12-15 months. However, it is synonymous with the fact that we can *expect* four years of positive returns during the same generic five year time frame.

Many have asked when this will be “over.” No one knows for certain but it *will* end and the American economy will return to growth (second half of 2009, first half of 2010?).

WHY WE DON'T BELIEVE IT'S ALL DIFFERENT THIS TIME

The urge to force order and rationality on the year, and especially the period since September 19, 2008 when the Federal Government declined to bail out Lehman Brothers is over-whelming. The changes we have witnessed have occurred in a period of unprecedented media saturation, the longest election cycle any of us can remember (or want to forget) and government intervention in the economy. These are all parts of the one fundamental characteristic of a capitalist economy within a democratic society: *constant, brutal and effective creative destruction of the old way of doing things and the ushering in of a newer version of the same productive, efficient, wealth producing economic engine the world has marveled for the last 100 years.*

Recessions are a part of expansions. Unemployment rises but within the last 61 years we have seen it peak at 10.8% in 1982 with only four years in aggregate registering over 8%. We expect unemployment to peak in the third quarter of 2009 as it's a lagging indicator but do not expect to see a value of more than 8.8%

The turning point in the market will be well before the evidence is clearly identifiable in the economic data. I don't know when that will be but I do know that to capture it, we need to have equity exposure because a significant part of the recovery will occur while the analysts and commentators are trying to figure out if this is real or a false bounce. We'll only know it's real after the opportunity has passed us by.

WAS THERE ANY GOOD NEWS IN 2008?

Yes. The Federal Reserve clearly learned the key lesson of the Great Depression—sometimes the economy does need help and while they may not have designed the perfect solutions, they are acting early and additionally, are willing to alter course.

Additionally the oil bubble burst and we have experienced a large boost to consumer's spending power as the price of a barrel of crude fell \$111.58 from its high of \$146.93 on July 14th to a low of \$35.35 on December 24th (clearly Santa is flying a hybrid). This results is an approximate \$450-600 billion savings for US oil consumers. Also, this drop (and its associated decline in commodity prices) has allowed the Federal Reserve to cease worrying about inflation and cut interest rates to near 0%.



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TAX AND ESTATE PLANNING UPDATE

In the midst of it all, there are several changes that took place on January 1st. The estate tax exemption equivalent increased from \$2 million to \$3.5 million with the top rate remaining at 45%. The estate tax will cease to exist for 2010 only and we expect that the reversion to 2001 law (\$1 million exemption) will *NOT* occur.

The annual gift tax exclusion (the amount of money that can be given to anyone, for any purpose, without filing a gift tax return with the IRS) was increased from \$12,000 to \$13,000.

For people over age 70 1/2 who have been taking out minimum required distributions from their IRAs, that has been suspended *for 2009 only*, which will provide an opportunity to allow those accounts to grow without mandatory withdrawals until 2010.

We don't know all the details on the new administration's stimulus package but the fact that tax cuts are being added is a good sign. While the debate in Washington advances, we all want America to succeed, so we will closely follow the progress of this package and its implications for your family.

THREE DATA POINTS TO WATCH FOR THE FIRST HALF OF THE YEAR

We think the following are among the most indicative statistics to watch for the early quarters of 2009:

- a. **Existing Home Sales**. They have declined four of the last five years with 2008 showing an -8.7% year over year decline. An increasingly smaller decline over each of the next four quarters will indicate a firming of the housing market.
- b. **Weekly Hours Worked in the Private Sector**. A 10 year low of 33.5 hours/week was recorded 11/2008; an increase upwards to 33.7 or 33.8 hours/week will indicate that new job creation will likely follow within the next two quarters.
- c. **Business Inventory to Sales Ratio**. The 10 year average is 1.33 and we are currently at 1.34. A decline in the spring/summer will force businesses to begin to place new orders for the 2009 holiday shopping season and lead to inventory investment in the latter part of the year.

CLOSING THOUGHT

“The pessimist sees difficulty in every opportunity. The optimist sees the opportunity in every difficulty.” —Winston Churchill