



HILL INVESTMENT GROUP

Take the long view

Special Market Commentary – February 2009

Only a few clients have asked about our views on the market and whether they should take some action. While we are proud that many of you have remained cool during this difficult period, we want to take this opportunity to provide our perspective on the markets and actions, if any, that should be taken.

What is happening?

Every financial crisis has different causes, but the commonalities are booms in asset values and increases in leverage before a crisis, followed by sudden drops in asset values and problems in financial institutions that had provided the large amount of credit, or leverage, from the start. This global market decline is more widespread than most, and when it will end is still to be determined.

Has anything changed? No, these market difficulties confirm the passive investment strategy is the best approach.

- Broad equity diversification provides the best protection against volatility and uncertainty. Our clients hold approx. 10,000-12,000 stocks in their equity allocation. In this current decline, every asset class and all foreign market are affected. However, we have avoided being concentrated in a limited number of stocks (i.e. Lehman, GM, etc.) or one segment of the market (i.e. financials).
- Fixed income invested in high quality securities, as we recommend, is the best way to mitigate risk. Other investors, who stretch to get the highest yield securities, have been hurt with stocks *and* with bonds. The low credit quality bonds have had substantial declines. Examples in 2008: Vanguard High Yield Corporate: -21.3%, Vanguard Intermediate Term Investment Grade: -7.9%
- Simplicity and transparency are more important than ever. Having an understanding of what you own is key to avoiding situations like Madoff, Stanford, etc. Our clients have a separate 3rd party custodian with strong financials and audited results that provide another layer and additional strength to the relationship.

Did the best active managers see it coming?

Looking back to December of 2007, it is difficult to find a fund manager or economic expert who predicted every major asset class being down more than 30% in 2008. Even the best of the bunch, famed managers Warren Buffet and Bill Miller (from Legg Mason), are down more than 50% in their flagship funds. While we know that most active

managers fall below their benchmarks over time, even those renowned for their investment prowess offer no assurance of superior performance in a difficult market.

What can we learn from past financial turmoil?

- The expected returns from investing in risky assets should be higher during a downturn than around a peak. One would not invest in today's market unless they expected higher returns in the future. According to Ned Davis Research, when the unemployment rate is higher than 6% (currently it is 7.6%), the S&P 500 has risen 15% per year on average, which is 50% higher than the average gain of 10%.
- Nobody can predict when the market will start to recover, but this is the risk we must bear when we decide to maintain our equity positions. Switching some of one's equity allocation to fixed income may allow one to sleep better at night in the short-run, but how will they know when to return to the equity market?

What should we do now?

- Ignore the market noise. This is hard to do because of the constant communication about the state of the economy and stock markets. We don't pretend to know what will happen next. But we do understand the sources of long-term returns and what has happened in other financial crises. The markets will recover and the short term returns from market troughs have historically been very high and unexpected. The markets will start to go higher before the economic news turns positive. One achieves the higher expected returns from equity because they are willing to hold their positions during these difficult down periods.
- Focus on things you can control, like your asset allocation, savings, spending, etc. This down market may cause one to delay their retirement date or modify their spending plans.
 - *We are also focusing on things that we can control - Harvesting tax losses and Rebalancing portfolios.
- Have sufficient fixed income to provide cash needs for the next 3-5 years. This is always a good plan because historically about every five years, the markets decline on average about 25%. As long as one anticipates periodic equity declines, one can live through them with less anxiety and discomfort. The current decline provides a good test to see if your equity/fixed income asset allocation is suitable for your family.

As always, we welcome your feedback and are always available to answer any of your questions.