

MEMORANDUM

To: Wurts & Associates Clients
From: Eric Petroff, CFA, Director of Research
Date: December 15, 2008
Re: The Changing Landscape of Capital Markets

When it boils down to it, our clientele pay us for one thing, and one thing alone...to think. So with recent market behavior in mind, we believe our clientele would appreciate a brief summary of our thoughts regarding the continued evolution of capital markets and implications thereof.

As we have said in previous memos, investors continue to discount risky assets across the board. Given 10 year US Treasuries now yield less than 3% and the US dollar has rebounded almost 20% from its lows, a global flight to safety and aversion to risk is obvious. Presumably this is because there are too many near term unknowns in the world. Credit markets remain dysfunctional, jobs are being lost, a new US administration is taking office, the global economy is slowing, and all major central banks have posted negative real interest rates alongside trillions of stimulus with little to no benefit to date. Pessimism and uncertainty stubbornly permeate investors' perceptions.

We on the other hand see capital markets conditions for what they are - a fundamental change in the risk and return characteristics for every asset class in existence. Moreover, we see the implications for our clients' portfolios not only with respect to asset class opportunities, but in terms of overall portfolio structure. In our opinion, one paradigm is ended and another is about to begin.

Gone are the days when equities and fixed income were poised to provide mid single digit returns, and the only means to meet most return goals were through leverage and alternative investments. It should probably be some time before Committee members despair at not keeping pace with larger, leveraged institutions. Instead we expect hard lessons to be learned from taking poorly compensated risks such as those recently seen in credit markets, as well as a renewed focus on the merits of liquid, publicly traded investments. Beliefs that bigger firms, complicated strategies, preposterous fees, and Ivy League educations are correlated to success and stability will go the way of the dinosaur as well.

We foresee a more conservative and rational paradigm of investing that above all rests upon positioning portfolios in light of prevailing economic conditions and harnessing market forces to achieve return goals, as opposed to relying upon esoteric applications of human intellect. Investing need not be complicated. In fact, it probably shouldn't be.

To illustrate this change in paradigm, consider valuations for US equity and fixed income investments. The S&P 500's PE ratio relative to 10 year trailing real earnings has not been this low since the 1980's, and now stands around 14. Investment theory and empirical evidence tell us these valuations are indicative of 10% prospective returns over the next ten years, whereas a similar analysis would have indicated only a 6% return just a year ago; a 4% return back in 1999. Fixed income markets offer similarly compelling opportunities. Investment grade corporate and high yield debt are priced to provide 7% and 12% returns over ten years, respectively, and that even assumes 4 times the historic average (*Moody's since 1920*) default rate over the next decade. Government guaranteed mortgage debt via the Barclay's Agency index is yielding 5%, which is 3% over the Treasury index.

Given most institutions target high single digit return goals, the argument for leverage and alternatives should be reexamined in the current market environment. The fact of matter is 8% rates of return can reasonably be expected with modest amounts of risk in public market investments. Just consider the following example of a 50/50 portfolio based on the aforementioned expected rates of return.

	Expected 10 Year Return	Target Allocation
US Large Cap Equities	10%	50%
US Agency Mortgage Fixed	5%	25%
US Corporate Invest. Grade Fixed	7%	12.5%
US High Yield Fixed	12%	12.5%
Weighted Expected Return	8.6%	

The idea an 8% return goal can be met with a 50/50 portfolio represents a profound change in the landscape of capital markets. Return goals can be met for less risk, or the same amount of risk can produce a much higher return. On top of this, our research continues to uncover compelling opportunities over the next ten years based on macroeconomic implications of current events as well as valuation-based analysis of asset classes.

Most importantly though, recent events only serve to illustrate the crux of our role as consultant. We realize our responsibility is not to mindlessly report on past performance and defer responsibility to others for capitalizing on market conditions; i.e., money managers. But instead understand we are the sole advisor holistically viewing portfolio structure and the risk exposures that will drive returns over the next decade.

As such we are researching pertinent macroeconomic and capital markets data in order to best position our clients' portfolios in response to these historic events. Please join us in January for our next *Quarterly Research Conference Call* so we can share our thoughts and findings.