Yanni Partners
A Division of GBS Investment Consulting, LLC

MEASURING UP

DELIVERING THE PROMISE

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IN THIS ISSUE

A continuing discussion of the current financial landscape.

Capital Market Prospects — Promise or Peril?

Our previous *Measuring Up*, "Looking Beyond the Turmoil," discussed the severe credit and equity market losses that culminated in September 2008. "Looking Beyond the Turmoil" explained the links between the economy and the capital markets. In the article, we expressed our expectations that the markets will ultimately recover. Since then, jarring volatility has continued to roil the markets. Prices for low-risk assets (U.S. Treasury instruments) have soared, while prices of "risk" assets (corporate bonds, real estate and global equities) have continued to plummet. This edition of *Measuring Up* extends our discussion from the previous edition. We elaborate on the key drivers of long-term performance of the capital markets. We reiterate our belief that the credit, equity and real estate markets will ultimately deliver meaningful long-term returns.

Recent Market Performance

Since September 2008, relatively risky assets have continued to fall, whereas high-quality investments have risen. *Figure One* shows the markets' returns as of November 2008 since October 2007 and since September 2008.

Since September 2008, global equity losses have surpassed 20%, whereas real estate security prices have nearly halved. The Baa credit sector has declined by more than 8%. In contrast, U.S. Treasuries have gained nearly 9%.

The following sections discuss the equity, real estate and credit markets. Each section assesses the market's performance prospects based on an historical context and structural characteristics.

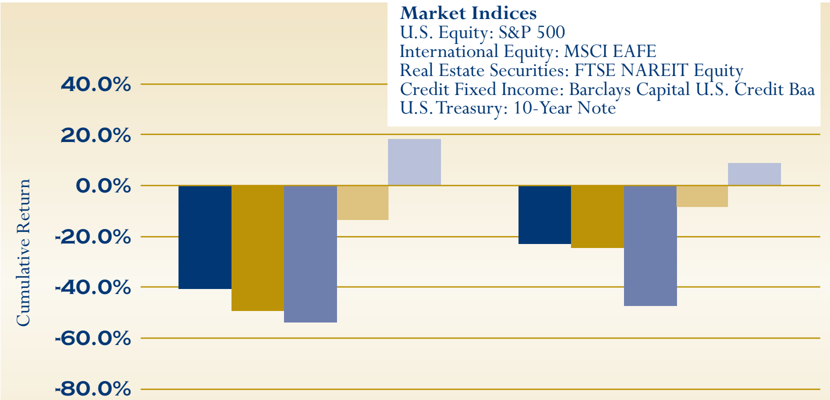
Equity Markets

The post-September 2008 equity market losses have tested investors' patience. Some investors have questioned whether the market will recover in their lifetimes. One must acknowledge that a stock market can collapse. In the past, certain markets outside the United States have sustained massive, and in some cases, complete losses following wars and political upheavals.[1] Germany and Japan provide examples. An investor can never dismiss the risk of a national market's demise due to political and social turmoil. Broad diversification among markets abroad mitigates single-nation risk. Given the economic and military strength of the United States, however, we discount the risk of a total market collapse here. We believe that the U.S. equity market will ultimately recover, and it offers the potential for a long-term performance premium over investment-grade fixed income. Our current capital market assumptions project long-term returns of 8.5% for U.S. equities, 10.5% for international equities and 5.2% for core fixed income.

[1] Philippe Jorion and William N. Goetzmann, "Global Stock Markets in the Twentieth Century, "The Journal of Finance, Volume 54, Issue 3, 1999.

FIGURE ONE

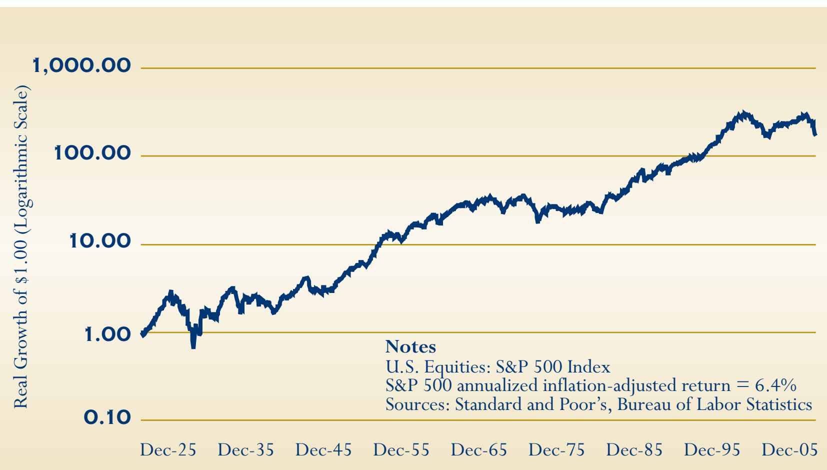
Capital Market Returns as of November 2008



	Oct. 2007 - Nov. 2008	Sept. 2008 - Nov. 2008
U.S. Equity	-40.7%	-22.8%
International Equity	-49.5%	-24.5%
Real Estate Securities	-53.8%	-47.4%
Credit Fixed Income	-13.3%	-8.4%
U.S. Treasury Fixed Income	18.3%	8.6%

FIGURE TWO

Inflation-Adjusted Growth of U.S. Equities December 1925 - November 2008



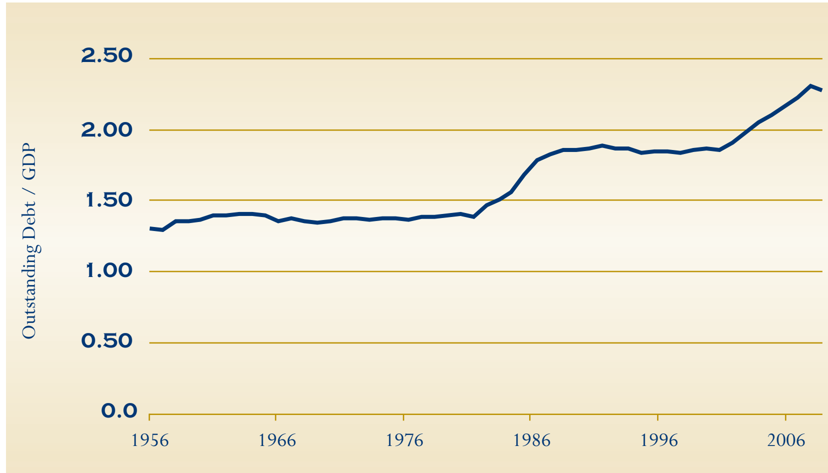
We base our confidence in the market's prospects to the close link between the economy and corporate profits. In our September 2008 *Measuring Up,* we documented the historical correlation between growth in the economy and corporate profits. Equities entitle investors to a share of corporate profits. Economic growth will likely fuel profit growth, spurring the long-term performance of equities. We express confidence in the economy's capacity to grow. The economy provides vital services to consumers, businesses, governments, schools and hospitals. Key industries include pharmaceuticals, personal care products, food processing, software, media, forest products and capital goods. Individuals and organizations depend on these basic goods and services to function and survive—and which can continue to sustain demand for them. Such demands have the potential to propel the economy's secular growth. The economy will likely experience periodic slowdowns, such as the current recession. Recessions serve as a therapeutic function, correcting imbalances that develop during expansions.

An evaluation of the U.S. equity market's long-term record offers some insight into its volatility patterns and its potential to recover. *Figure Two* plots the inflation-adjusted growth of the domestic market, as measured by the S&P 500 Index from December 1925 through November 2008. Over this long period, the market has generated substantial wealth. After inflation, $1.00 invested in December 1925 grew to $172.10 as of November 2008. The market produced an annualized total return, after inflation, of 6.4% over this period. This 6.4% return surpasses the economy's long-term, inflation-adjusted growth rate of approximately 3%. The market's significant generation of wealth has withstood shocks to the nation's economic, political and social structures. Since 1925, the United States has encountered a depression, recessions, wars, terrorism and political strife. Investors have paid a price for the long-term productivity of equity capital. The market has periodically inflicted large losses on investors. Investors have endured long periods when their equity holdings have been "under water." From December 1972 to September 1974, the market fell 52%. It did not recover from this loss until December 1984, twelve years from its peak. The market reached its recent peak in August 2000. More than eight years later, as of November 2008, the market stands 45% below the August 2000 peak.

We offer a word of caution: The markets' steep losses since October 2007 have occurred during an environment of "deleveraging." Leverage generally heightens an investor's risks because the assets purchased with borrowed funds might fall below the debt. Many investors have recently sold equity and credit investments in an effort to reduce their borrowings to control risks. This deleveraging has placed downward pressure on the prices of equities and credit instruments. The recent deleveraging has begun to reverse a long-term trend. *Figure Three* plots the history of leverage in the U.S. economy since 1956. *Figure Three* employs a common measure of leverage in the economy: the ratio of nonfinancial debt to GDP. Nonfinancial debt encompasses Government, household and business debt. In 1981, leverage began to increase. The pace of leverage accelerated in 2000 and peaked in 2007. Several economists project a continued decline in the economy's leverage as investors endeavor to curtail risks.

FIGURE THREE

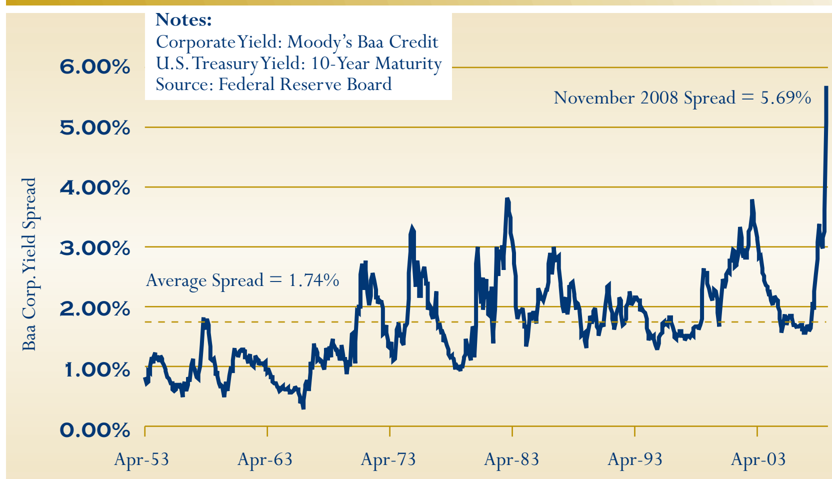
Degree of Leverage in U.S. Economy: 1956 - 2008



Sources: Federal Reserve Board, Bureau of Economic Analysis

FIGURE FOUR

Baa Corporate Yield Spread: April 1953 - November 2008



Economist Henry Kaufman states: *"The rapid growth of nonfinancial debt has been a key driver of U.S. economic growth in recent decades…Already we are seeing a dramatic slowdown in the rate of growth of household and business debt, a trend that will continue for some time."*[2] A continued reduction in leverage might dampen the near-term prospects for the economy and equity market. Longer term, lower leverage will likely prove healthy. We reiterate our confidence in the market's ability to generate long-term returns.

Real Estate Securities

The market for Real Estate Investment Trusts (REITs) enables investors to participate in high-quality real estate with diversification and liquidity. REITs generally hold commercial properties in the office, retail and industrial sectors. Real estate has produced historical returns on par with the broad equity market, but with more inflation protection. The REIT market has fallen 61% in inflation-adjusted terms, as of November 2008, since January 2007. Despite this recent loss, the market has achieved an inflation-adjusted annualized growth rate of 6.0% from December 1971 to November 2008. REIT investors receive a significant portion of their returns from dividends. The REIT market offered a dividend yield of 9.4% as of November 2008. The recent increase in the dividend yield provides a cushion against potential dividend cuts.

Credit Fixed Income

The credit market's recent losses reflect the widening of credit spreads. The credit spread measures the difference between the yield of a bond that is subject to credit risk (potential for a default) relative to the yield of the highest quality

[2] Henry Kaufman, "How the Credit Crisis Will Change the Way America Does Business," Wall Street Journal, 6 December 2008.

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A Division of GBS Investment Consulting, LLC

310 Grant Street, Suite 3000
Pittsburgh, PA 15219-2302

bond (U.S. Treasury). This yield spread reflects investors' required compensation for bearing credit risk. The credit spread has typically widened during an economic downturn and narrowed during economic expansions. During recessions, investors have perceived an increase in the risk of corporate defaults, thereby demanding requisite compensation. During expansions, investors' fears of credit defaults have waned, and spreads have contracted.

Figure Four displays a history of corporate credit spreads from April 1953 to November 2008. The spread has generally exhibited a "mean-reverting" tendency, hovering around its average level of 1.74%, until recently. Since January 2007, the credit spread has exploded from close to its average level of 1.58% to its November 2008 level of 5.69%. The November 2008 spread far exceeded the previous peak of 3.79% in October 2002. Since January 2007, the 10-Year U.S. Treasury yield has eased, reflecting investors' "flight to quality." During this period, the Baa Corporate Yield has surged, reflecting the recent freezing of the credit markets. Investors have expressed an extreme aversion to credit risks.

The pronounced tendency of credit spreads to revert to their historical levels over the long-term provides a basis for expecting a reduction in current credit spreads. Whenever the markets offer very high expected rewards for bearing risk, investors begin to assume such risks. If investors increase their appetite for credit risk, spreads are likely to narrow. The current high credit spreads provide the potential for favorable returns from credit instruments (relative to U.S. Treasury instruments) unless losses from defaults far outpace historical experience in the future. Borrowers such as corporations, local governments and hospitals depend on functioning credit markets. A moderation in credit spreads will help such borrowers secure financing. Yanni Partners, a Division of GBS Investment Consulting, LLC, believes that investors will begin to gain confidence in the credit markets once they stabilize and the economy begins to recover. The persistent repetition of the historical credit cycle bolsters the expectation for a reduction in credit spreads.

Conclusion

We encourage investors to look forward. Falling prices often present buying opportunities. We believe that equities provide investors the potential to generate substantial long-term growth in capital and income (from dividends). REITs and credit fixed income also appear attractive relative to historical data. An investor can develop a plan to benefit from these opportunities following a rigorous assessment of the investor's liquidity and operating needs.

Mark Your Calendars

Plan to Attend the 2009 Client Education Symposium

April 2, 2009

Hyatt Regency Hotel
Pittsburgh Airport

Attendance by invitation only

Yanni Partners provides a full range of consulting services vital to the management of various portfolios. Our ultimate goal is to offer a basis for improved investment monitoring and performance.

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If you have any questions or comments concerning *Measuring Up*, please contact: Rosemarie A. Martin
Coordinator of Administration. **Phone:** 412.232.1000 **Email:** martin@yannipartners.com **Web:** www.yannipartners.com