TEMPO
Financial Advisors, LLC

One Apple Hill Drive, Suite 316 ▪ Natick, MA 01760
Tel 508.655.7827 ▪ Fax 508.655.7829
www.TempoAdvisors.com

THE TEMPO VANTAGE

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Market Will Turn Before Economy

In the third quarter Vantage (October 2008), I indicated that there were reasons for optimism. At that time the market was down 25% in just the first few weeks of October. Initially my sentiment could not have appeared further from reality as the market continued down another 11% and there was (and still is) wide spread pessimism regarding prospects for future gains. Eventually, though, the market did reach at least an intermediate term bottom (on November 20) and subsequently gained more than 20% to a level above where it was in late October. Still, few will be rejoicing quite yet. After all this 20% increase merely brought the market to down 22% for the quarter, 37% for the year, and 42% from the peak of October 2007. In the end 2008 was the second worst calendar year for stocks since 1926 (1931 was the worst).

Perhaps the most common fear I hear these days is that this economy will result in a second Great Depression. I do not think that will happen. In the 1930s it took the government a long time to institute any policy that would have a positive impact on the economy. In fact, crazy as it may sound, one of the early government responses was to raise tariffs, which exacerbated the problem. This time around the government has been quite proactive and is doing everything it can to pump liquidity into the system. Even more action is expected as Obama is set to take office. We may argue over the details, but there is little doubt that eventually this money will work its way through the system.

What does seem quite clear is that this recession will be one of the deepest in decades, though no one knows for sure exactly how long it will last. More optimistic economists figure it will end mid 2009, while others expect it won't be over until 2010. Either way, do not confuse economic performance with stock market performance. You must realize that the stock market is a forward looking vehicle. In theory the current outlook is already priced into the market.

Take the 1930s for example. The Great Depression is widely considered to have started in October 1929 and ended in 1941 (at the start of World War II). But the stock market was not simply in a downward spiral the entire time. The bottom in the stock market occurred in mid 1932, nine years before economic activity returned to pre-1929 levels. In the ensuing 5 years (July 1932 to June 1937) stocks returned an average of 34% per year. In fact, two out of the three best calendar years for the stock market occurred during this period (+53.9% in 1933 and +47.7% in 1935). The problem is that few investors enjoyed those gains as many had been scared away from ever investing in stocks again.

I don't know if the stock market has hit its final bottom or not, I only know that I want to be invested when it does.

For years we have been hearing what astute investors the large college endowments such as Harvard and Yale are. Due to their infinite time horizon and massive size they can invest in illiquid asset classes and gain access to the best alternative investments. Their returns were always better than everyone else and seemed impervious to the cycles of the stock market that affect the rest of us. Not so this time around. Recently Yale and Harvard announced that from July through mid-December their endowments were off by 25% and 30%, respectively. This is not to imply that the folks at Harvard and Yale are any less intelligent today than they were a few months ago. It merely highlights

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the fact that no investment has been immune to the breadth and depth of the declines that have occurred in virtually every asset class in the second half of 2008.

Tempo had varying degrees of success in the fourth quarter. Our investment strategies had a range of returns from down 2% to down 20%. Normally I consider any loss in our Dynamic Investment strategies as a failure, though these are not normal times. In the back drop of an overall market that lost over 22% I am quite pleased with these results.

The **Tempo Multi Asset Dynamic Income Strategy** certainly had a bumpier ride than usual in the fourth quarter. While we kept cash positions far above normal levels, we also held positions in intermediate term bonds, global bonds, and a few alternative funds. In the end I am happy to report that our loss was contained to -2% for the quarter. Not what we expect from our most conservative strategy, but certainly acceptable in light of overall market performance. We will be rebalancing accounts in the first few weeks of January and, although it is too early to say exactly what those positions will be, I expect portfolios to remain quite defensive.

The **Tempo Multi Asset Dynamic Growth Strategy** was conservatively positioned in the fourth quarter, holding 40% of the portfolio in bonds of varying types (inflation linked, intermediate term, global bonds, and cash), 30% in conservative alternative funds, and 30% in equity funds. That only helped so much, though. At the low point (November 20), when the stock market was down over 35%, Dynamic Growth was down in the high teens. But we hung in there and in the end were able to cut losses in half to approximately -9.8% for the quarter. The first quarter 2009 has picked up right where it left off in 2008 – volatile. So far net movement has been sideways and portfolios are stable.

As you would expect, **Tempo Lifestyle Portfolio** accounts were the most exposed to the extreme negative markets. The good news is that all portfolios held up better than the overall equity market. The bad news is that the result was still a loss between 15% and 22% depending on how conservative or aggressive you may be. Diversification still helps, but only so much in times like these. One of the dirty little secrets of the investing world is that correlations increase in times of major turmoil. What does that mean? In basic terms we invest in a variety of asset classes because they tend to zig and zag at different times, making our portfolios as a whole more stable. In extreme times, however, they tend to zig and zag more in sync with each other.

At Tempo we also try and make a difference by over and under weighting segments of the market we believe we will be relatively strong/weak compared to the overall market. In the second half of 2008 that lead us to overweight healthcare and underweight segments such as real estate and commodities. This is an ongoing process, and while we do not make major shifts ever week or even every month, we do want to be on the right side of long term trends in relative strength.

As you know we utilize the services of select investment advisors to outsource management of portions of our clients' portfolios where deemed appropriate. We do this to increase diversification, reduce risk, and in some cases increase risk. We make this decision on a case by case basis, depending on each client's needs. We are happy to report that these sub-advisory relationships are working quite well, behaving much like Tempo's own Dynamic Investment strategies in the sense that they have held up much better than the overall market. In fact, the most conservative of these strategies was just about break even in the fourth quarter. In case there is any doubt, I want to assure you that these sub-advised relationships bear no resemblance to the secretive hedge fund world where fraud can easily happen (look no further than the Madoff situation). These accounts are held in custody and reported by an independent third party (Fidelity) and we (both you and Tempo) have complete transparency as to how accounts are invested every day.

Daniel J. Traub

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