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THE TEMPO VANTAGE

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Diversification is not Dead

The markets are continuing the roller coaster ride that began last September. To put this statement in perspective, consider this sequence of returns for the Standard & Poors 500:

08/28/2008 to 11/20/2008 -42.1%
11/20/2008 to 01/06/2009 +24.2%
01/06/2009 to 03/05/2009 -27.9%
03/05/2009 to 04/09/2009 +25.5%

A bull market is defined as a 20% increase from a low. Conversely, a bear market is a 20% decrease from a high. Normally bull and bear markets take years to develop. We have now had four in less than seven months! To say that this is unusual would be an understatement.

Of course we all know the reasons for the volatility and declines – or at least we think we do. If I were to attempt to boil the reasons down to a single word it would be "leverage." Poorly qualified home owners, banks, investment banks / brokerages, insurance companies, and hedge funds were all over leveraged. Not one of these entities understood the true risk of what they owned. Extrapolating recent experience led to the erroneous conclusions that housing prices never fall, that there will always be a market for "ultra-safe" auction rate securities, and that counter-party risk for credit default swaps is irrelevant.

For the better part of this downturn the government has been trying to figure out what it can do to stem the tide. If they don't, the down trend will likely become a vicious cycle. Lower corporate profits lead to lay-offs. Lay-offs lead to less consumer spending. Less spending leads to lower corporate profits, and so on. Early efforts by both the Bush and Obama administrations (Troubled Asset Relief Program and American Recovery and Reinvestment Act of 2009, respectively) met little enthusiasm. More recent events, however, have given us reasons for hope.

In early March, JP Morgan Chase, Citigroup, and Bank of America announced that the first two months of 2009 were profitable. On March 18th the Fed announced that it will buy up to $750 billion of mortgage-backed securities (on top of the $500 billion already committed) and up to $300 billion in long term treasury bonds. Then on March 23rd the Treasury Department announced plans to form a series of public-private investments funds to buy $500 billion to $1 trillion in legacy loans and securities (toxic assets). It seems the market finally likes what it sees because each of these developments preceded significant upticks in the market. Or perhaps it is simply the cumulative effect of months of massive intervention. Either way, there seems to be significant sentiment that the rally that has been sparked is sustainable. What a welcome turn of events that would be!

Before we get too crazy with optimism, let's realize that we have further to go to recover the losses than a quick glance at the numbers above might suggest. Such are the mathematics of advances and declines. Consider this sequence: From 1/1/09 to 3/5/09 the S&P 500 was down 24.4%. Between 3/5/09 and the end of March the S&P 500 gained 16.8%. It would be wrong to then calculate a loss for the quarter of 7.6% (-24.4 + 16.9). If you lose 24.4% and then make 16.9% you are not down only 7.6%. Think of it this way: If you start with $100 and lose 24.4%, you lose $24.40 and have $75.60 remaining. Then if you make 16.8% on the remaining $75.60, you earn $12.70, bringing you back to $88.30, which is still down 11.7% from the start, which was the return for the S&P 500 in Q1 2009 (including dividends the S&P 500 was down -11.0%).

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In this environment, as with the better part of the past year, the extreme market conditions have taken down nearly every category of both stocks and bonds. The name of the game, therefore, continues to be: Lose less that the market. As you would expect from Tempo, our strategies have held up better than the overall market – how much naturally depends on the style(s) in which you are invested.

From a historical perspective we consider the **Dynamic Income Strategy** to be our most conservative strategy. This makes sense given that holdings generally consist of fixed income (bonds) and alternative funds, but not traditional equity. Unfortunately, though, even these more conservative categories continue to be negatively affected by the overall economic environment. The good news is that the first quarter loss of approximately 5% is less than half the loss of the overall market. The bad news is that we still lost money, which is never a welcome event.

In recent bond market action some of the more aggressive categories such as high yield bonds and convertible bonds have been holding up better than more conservative areas. As usual we are rebalancing accounts in the first few weeks of April. As of yet the strength in these markets has not been powerful enough and/or long enough in duration to "make the cut" in the rebalancing process, though I would not be surprised to see some of these categories filter into portfolios by mid-year.

The **Dynamic Growth Strategy** also had a loss in the first quarter of approximately 5%. Perspective is everything. Where we might be somewhat disappointed with that loss in the Dynamic Income Strategy, the 5% loss in the Dynamic Growth Strategy is entirely in line with expectations given the market's overall performance. Dynamic Growth continues to be extremely under-weight in equities, however, as mentioned above, with very few exceptions it almost didn't matter what you owned – it was likely down. Just because we are under-weight in equities does not mean there is no upside. In March Dynamic Growth accounts gained 4%.

Despite the uptick in March, the overall tenor for the first quarter as a whole was much the same as the previous few quarters. As such, the rebalance process will show relatively few changes to Dynamic Growth portfolios as we move to the second quarter.

I've read a lot recently about the failure of diversification over the past year. Let me just say that the rumors about diversification being dead have been greatly exaggerated. While it is true that correlations increase in times of great turmoil, and most investments lose value, what you own does make a big difference. As evidence we need look no further than the recent returns in **Tempo Lifestyle Portfolios.** While the broad market returned -11% for the quarter, Lifestyle accounts were generally down less (some much less) thanks to diversification and strategic positioning. More conservative accounts lost about 5% and more aggressive closer to 10%. On the equity side, our strategic over-weight positions in technology and healthcare helped portfolios as did avoidance of real estate and energy. On the fixed income side, positions in high yield bonds and inflation linked bonds were among the best performing categories. One recent strategic move you may have noticed is that we sold our long held over-weight position in healthcare. While this has served us well over the past few years, recent Obama administration proposals have negatively altered the attractiveness of this sector for the short to intermediate term.

Finally, a reminder to contact us if there has been a change in your financial circumstances that would warrant a fresh perspective on your portfolio.

Daniel J. Traub

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