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THE TEMPO VANTAGE

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Europe is the Key

The 2008 mortgage-credit crisis in the United States can fairly be blamed for throwing the world into recession. And while things were certainly touch and go for a while, at least our administrators (The Fed and Treasury Departments) and legislators had the ability and the will to take extreme measures to restore stability to our economy.

Today the reverse contagion is occurring with the sovereign debt and bank liquidity crises in Europe now threatening to throw the world economy back into recession. Many, including me, had surmised that the Europeans would take a cue from the U.S. experience of a few years ago and take the necessary steps to stem the tide. So far that has not happened.

I believe the Europeans genuinely want to take the action necessary. The structure of the EU and the lack of central authority, however, make it even more difficult to get things done there than to get Republicans and Democrats to agree here – and that is saying something.

Back in the U.S. the Fed continues to do whatever it can to keep us afloat.

The most recent action, Operation Twist, is a plan to sell short term government t-bills and buy long term t-bonds in an attempt to lower long term rates. The theory is that if long bond rates are lower, investors will be forced to take more risk to generate needed yield. And this will start a chain reaction to still riskier assets. The first logical step would be into high quality corporate bonds. Then, as corporate bonds prices rise (rates fall), investors would continue their search for return to areas such as high yield bonds and eventually to other financial markets including stocks.

I am in the camp of those who believe that stocks in the U.S. are attractively priced, that Operation Twist has a reasonable chance of succeeding, and that the market is poised for an upturn. But I also believe that this rosy scenario will occur only if Europe is able to regain stability. Until then investors will prefer the safety of treasuries, no matter the yield, and no matter how attractive valuations are.

The stock market, and indeed most markets, has not reacted well these past few months as governments around the world have struggled to right their economies. For starters, volatility has returned in a big way. Daily moves in excess of 2% have become fairly common.

More startling has been the relatively swift and deep declines in nearly all asset classes. In the 3rd quarter the S&P 500 was down -14% - and that was one of the better asset classes! The Russell 2000 (small cap stocks) was down -22% and the EAFE (international stocks) was down -20%. Reminiscent of the bear market in 2008, almost no asset class was spared from the decline, with many bond categories also falling between -5% and -15%.

Tempo Financial Advisors' 3rd Quarter Investment Performance

As you would expect in such a negative environment, **Tempo Lifestyle Program** client portfolios suffered in the 3rd quarter. What made this past quarter different from declines we've experienced over the past few years is that diversification was not only not helpful, but it was a hindrance. In past declines we were able to outperform relevant benchmarks by 2% to 4% thanks in part to diversification. This quarter, however, cornerstone diversifiers such as mid cap U.S. equities, small cap U.S. equities, and international equities all performed significantly worse than the overall market (see above). Conservative Lifestyle clients lost between -10% and -12%, moderate clients lost about -14% (in line with the S&P 500), and aggressive clients, who by nature have higher allocations to equities, lost between -15% and -17%.

Please don't read the above as an indicator that diversification is dead. Far from it.

The whole idea behind diversification is that each asset will have its turn to outperform. Since the S&P 500 is so broadly used as a benchmark, when it outperforms it tends to make everything else look bad. It is tough to beat the S&P 500 when the S&P 500 is the best asset class! Over the past 30 years, though, between large cap stocks, mid cap stocks, small cap stocks and international stocks, large cap stocks have been the best performer only five times, or 16% of the time. I'll stick with diversification!

Although **Tempo Dynamic Income Program** clients also experienced losses in the third quarter, the loss was relatively modest compared to some of the extreme losses in other areas. On the one hand our loss of -5% was only about 1/3 the drop of the S&P 500 and 1/4 that of other benchmarks. On the other hand this loss ranks among the worst in Dynamic Income history. Do we see the glass as half full or half empty? The other times losses of this magnitude occurred was when the overall market performed particularly poorly, such as this past quarter. From this perspective, then, performance is within past precedent. Still I hate losing any money, as I know you do.

The **Tempo Dynamic Growth Program** was the clear outlier in terms of performing below expectations. In past quarters when the S&P 500 fell more than 10% we were able to contain our loss to less than half the decline. This quarter, however, our decline of -11.5% experienced the brunt of the decline. The only other time that happened was in the 3rd quarter or 2008. That happens to have been another time when nearly every asset class fell at the same time and diversification didn't much matter. As so it was this past quarter.

As I write this newsletter we are still a few days away from the 4th quarter rebalance for both Dynamic Programs. Thus it is a bit too early to determine for sure how portfolios will evolve. I think it is fair to project that both strategies become somewhat more conservative, which should afford us greater protection if the markets continue down this volatile and negative path.

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