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THE TEMPO VANTAGE

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Room for Optimism Amid the Gloom

While there have certainly been credit crunches in the past, it is now clear that this one is broader and deeper than any in at least the last 75 years. Large financial companies and government sponsored enterprises have failed or required assistance, which was almost unfathomable just a short time ago. What brought us to this point will be debated for years. Legislation will surely be introduced in an attempt to avoid a similar situation in the future.

As is often the case when it comes to the government, we must unfortunately choose between the lesser of two evils. If the government did nothing the crisis would surely deepen (even more) and we would all be worse off. By intervening, those that stand to gain the most are the same companies/people that caused the situation in the first place, not to mention that the extreme nature of the intervention smacks of socialism. For better or worse there was no real choice: the government had to step in. More recently, governments around the globe have been coordinating efforts to stem the tide. How much these efforts will help is yet to be determined, though I am optimistic.

Ultimately the way out of any credit crunch is to restore confidence. Banks will remain solvent as long as depositors don't pull their money and banks are willing to lend (to businesses, consumers, and each other). In a very real way "we have nothing to fear but fear, itself." FDR's words still ring true, perhaps more now than ever. Will government action be the catalyst in turning the tide of confidence or will it be something else? I do think government action will go a long way toward this goal, though it is too early to say.

From an investment perspective this has been a frustrating time, and not just because the stock market is down. We have had bear markets before and we will have them in the future. The challenging part is that most often when stocks decline to the extent they have we can count on other non-correlating assets such as bonds, commodities, or real estate to provide at least some lift to our portfolios. This year, however, everything is down. This includes stocks, commodities, gold, real estate, and bonds (even short term bonds). Amazingly, even some money markets were vulnerable, with a few "breaking the buck" (having a net asset value, or price, less than $1.00 per share). With literally every segment down the market may now be signaling that it is worried about deflation.

From time to time I like to return to some tried and true measures of stock valuation to get a handle on where we are. Let's look at the price/earnings ratio (P/E). The long term average of the P/E ratio is about 16. Historically, when the P/E gets above 20 the market is over-valued. Conversely, prices are considered under-valued when the P/E gets to 9. Going back nearly 100 years, buying when the P/E dipped below 9 was a very reliable entry point. Recent market declines have brought the current P/E ratio to about 11. Not quite slam dunk bargain territory, but close. Certainly this provides reason to at least be cautiously optimistic. By the way, in order to get to a P/E of 9 we would have to fall another 15% – and that assumes that earnings will remain constant, which seems unlikely as more and more businesses struggle. (There has not been such a buying opportunity since the early 1980s.)

There are other reasons for optimism as well. Investor sentiment (the percent of investors that purport to being bullish compared to those that are bearish) is a contrary indicator. Simply put, the higher the percent of bulls versus bears, the worse the prospect for stocks, and vice versa. Most of the time this metric bounces around the middle range and is of little value. At the extremes, however, it is a fairly good predictor. As you can imagine there are not too many optimists out there today and the sentiment index is showing extreme pessimism, which bodes well for stocks. But I'm not the only optimist out there. Two legendary investors, Ken Heebner (CGM Focus) and Marty Whitman (Third Avenue Value) have gone on record recently about how cheap they think stocks are right now. In fact, Mr. Whitman went so far as to say "this is the opportunity of a lifetime."[1.] I am certainly not suggesting that you go out and leverage your investments, but this is not the time to abandon the ship either.

As you know, I do not invest with my personal sentiment, no matter how bullish or bearish I may feel. I rely on solid professional money management principles, hard work, and quantitative strategies. In both theory and based on historical precedent, the Tempo Dynamic Income and Tempo Dynamic Growth strategies should have been well positioned over these past few months. While it is true that both have contained the losses somewhat, the losses were more than we would have expected, even in tough time like these.

The **Tempo Dynamic Income** strategy had no exposure to equities in the third quarter, but was spread among various types of bonds such as inflation linked bonds, floating rate bonds, and global bonds. Very often in turbulent times there is a flight to quality. A flight to quality is when investors flee risky investments, such as stocks, in favor or investments that are perceived as more secure, such as bonds. That has not happened and bond prices of all types have fallen. As a result the bond portfolio held in the Dynamic Income strategy fell about 5%. Of course your specific outcome will vary based on when your account was opened. In the midst of rebalancing portfolios I have raised a significant amount of cash (80%) and will be very cautious in putting it back to work.

Many equity benchmarks fell between 10% and 20% in the third quarter. Despite having very little exposure to equities, with such broad declines **Tempo's Dynamic Growth** Strategy fell approximately 10%. Certainly not what we would expect, even in difficult times.

Thus far October has been nothing short of a disaster for both stocks and bonds. As I write this letter stocks are down by more than 25% in just the first few weeks. By comparison Tempo's Dynamic Income and Dynamic Growth Strategies are down by 3.5% and 7.5%, respectively. Certainly not great news, though we are holding up relatively well considering these extreme conditions.

Times are toughest, of course, for those with a **Tempo Lifestyle Portfolio**, since these accounts are always invested, typically with a healthy dose of equities. I wish I had some magic words to sooth you. Perhaps the best thing we can do is to remember the long term perspective, because that is what we need to be invested in a long term strategy. A long term perspective means that you can think of this investment in terms of a decade or more. There has never been a 10 year period in US history in which stocks haven't at least broken even. Even over the last 10 years, which includes not only the current bear market, but a severe bear market from 2000 to 2002, stocks were up. If this statistic is to hold moving forward as well then it stands to reason that over the next nine years the market will have to return to the peak level a year ago. I know it seems outlandish at this stage (it always does at the bottom), but this means the market will rise a minimum of 75% in the next nine years.

Daniel J. Traub

1. New York Times, Sunday October 12, 2008