The more things change, the more they stay the same

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This year, and particularly the past few weeks, has seen some of the most dramatic and historical change that the U.S. financial system has ever witnessed. While change is a constant, at times like these it can be unsettling to say the least.

In just the past month, the U.S. Treasury pledged up to $200 billion and essentially "took over" Fannie Mae and Freddie Mac, the previously public Government-Sponsored-Entities (GSEs) that were the bedrock of our country's home financing system. Then Lehman became the largest bankruptcy in U.S. history. On top of that, Merrill Lynch agreed to merge with Bank of America, presumably to avoid a similar fate. And just so we all were reminded that the pain isn't limited to investment banks, the Federal Reserve was forced to save American International Group (AIG). And then the government proposed its bailout, which was just passed by the Senate and the House.

A discussion of how this happened could span several textbooks. In a nutshell, it's the result of the crashing of our previously inflated housing bubble, the widespread abuse of leverage and ignorance of risk, and the subsequent consequences that have led to both crippling losses at some institutions and the systemic tightening of credit and capital flow.

Since the start of the credit crisis in mid-2007, an important behind-the-scenes market force has been widespread "deleveraging". Individuals and institutions, increasingly unable to obtain financing, are being forced to reduce their leverage by selling assets, even attractive ones. In the stock and bond markets, this is affecting the prices of even high quality stocks and bonds that are dropping in price not because of poor business results (aka – fundamentals), but simply because too many of their stock and bond holders have had to liquidate assets.

The capital markets have reacted to these developments with roller-coaster-like volatility. We think the most important takeaways of the current situation are as follows:

- There is no ignoring or arguing with the fact that the current crisis is big, and unlikely to be resolved in the short-term. Worldwide deleveraging will take time. The magnitude of change will be huge. However, the change does not need to be complete before the markets return to some form of normalcy and there will be no "green light" when that time comes.
- Unfortunately, diversification has not really worked as the only asset or strategy that has held up over the past few months is U.S. Treasuries. This will not last forever.
- Throughout history, short-run asset prices can be driven by a wide variety of factors that are often not apparent or rational, and which are often temporary. That is occurring today. The fundamentals will come back into play when this panic is over. That's not to say that we think the future of the economy is necessarily bright, but market volatility of the past ten weeks, and especially the past ten days, is not being driven by fundamental factors such as sales, earnings, and economic growth as much as it's being driven by financial dislocations.

- Those who are forced to sell due to deleveraging or who get too scared to hang on are going to be the big losers; and there will be many. Those with the capital and the courage to invest in this market will likely find themselves very handsomely rewarded five years from now.
- The Government's creative and unprecedented actions are constructive. As a result of their bailout, mortgage rates are falling, which should boost our economy.
- Sharply declining commodity prices should be a big relief to the U.S. and global economies.

At times of stress, it's important to maintain a consistent portfolio management process:

- Investor's long-term "target" portfolio mix should be a function of their investment objectives, risk tolerance and time horizon.
- Our recommended portfolios are very well diversified across asset classes, styles and money managers. For some time now, we have advocated the use of Alternative Strategies to help mitigate risk and we currently recommend an overweight to these strategies. Until recently, these have often provided very useful diversification to traditional assets. But in the financial deleveraging environment of the past couple of months they have not provided the benefits that we've come to expect. We're confident that over any reasonable time frame, that they will return to providing important diversification benefits.

Additionally, we understand that investing is not just about portfolio design and economic analysis. Nowadays many Americans may be second guessing themselves, their advisors, and their entire financial plans. At times like these, perspective, not panic, is critical. The worst time to make investment decisions is during a big move up or down. Emotional, fear- or greed-based decision making can easily wreck your long-term financial plan. Those who remain calm and make rational decisions with an eye on the long term are those who will most likely capitalize on the current uncertainty.

- Market rebounds from corrections can be significant and happen without notice. Investors who are considering moving to a more conservative portfolio profile should ask themselves when they think they will get back in.
- Selling doesn't recoup one's losses. It just realizes them.
- Investors must differentiate between temporary declines in portfolio value, and the loss of capital. Short-term volatility and temporary declines in value are the necessary "cost" to earn inflation-beating returns over the long run.
- There is an inverse relationship between the typical investor's ability to stick to a long-term plan and the frequency with which he or she monitors their portfolio and listens to market commentary. If you watch CNBC or Bloomberg every day, or check your portfolio value more than four times a year, you will certainly increase your stress level during periods of market declines and raise your chances of making a poor investment decision.
- Much of one's perspective on these events may be dictated by where one sits. If you work in New York City, have friends who worked at Lehman or Bear Stearns, then you likely feel like the world is coming to an end. But Americans working at Google or Apple, or at one of the many U.S. companies with booming exports, likely watch the headlines with less anxiety.
- It is critical that investors remind themselves of their time horizon when making portfolio decisions. If one is willing to look out three to five years, then one may be more comfortable with a current portfolio, maybe even optimistic about the prospect for a return to a more stable financial system and attractive long-term returns that outpace inflation.