

## **End Game**

### ***Reflections on a Decade***

Investors and taxpayers will long remember—and carry the baggage of—the “boom and bust” decade. It began in the final stage of the technology “boom” and met a resounding “bust” commencing in calendar year 2000 that continued through 2002. A credit bubble followed shortly thereafter inflating financial asset values and real estate prices. And then again in 2008...Bust! Notwithstanding a roller coaster adventure of historic proportions, and giving effect to the recent “boom” in share prices, equity returns for the S&P 500 for the entire decade were negative.

The catalysts responsible for these extremes included excessive leverage, accounting gimmickry, improprieties and frauds, large-scale failures of corporate management, directors and other fiduciaries, the vast mispricing of risk and due-diligence failures by underwriters. In the wake of this latest crisis, the Treasury and the Federal Reserve Bank, in an effort to stabilize a deeply wounded banking system and economy, have rescued excessive risk takers and speculators without—in our opinion—exacting a sufficient price. Today, however, most economists and investors believe that we are no longer on the brink of systemic failure although serious economic, systemic, and regulatory challenges remain.

### ***2008 and 2009***

For calendar year 2009, the Dow Jones Industrial Average increased 22.68% and the S&P 500, Russell 1000, and Wilshire 5000 indices generated gains of 26.47%, 28.43%, and 28.56%, respectively. The Russell 2000 Small Cap Index and the S&P 400 Mid Cap Index increased 27.17% and 37.38%, respectively.

These gains were realized only after massive government intervention on an unprecedented scale in direct response to fears of systemic failure. As of March 9, 2009 the S&P 500 had lost (52.52%) of its value on December 31, 2007 (after dividends). By comparison, a portfolio invested 40% in the S&P 500 and 60% in short-term municipal bonds would have lost approximately (18.44%) of its December 31, 2007 value.

A portfolio that was allocated at the beginning of 2008 65% to equities and 35% to short-term municipal bonds would have lost approximately (23.00%) in 2008 and (10.10%) for the two years ended December 31, 2009, whereas an investor whose equity exposure was 50% would have lost approximately (17.00%) and (5.75%), respectively.

In other words, when viewing the period as a whole, the strategy of reducing allocation to risk-oriented assets as risk increased, proved advantageous, notwithstanding the 2009 run up in equity markets. As each KLS account is managed separately, please discuss your individual account performance with your KLS Managing Director.

### ***Looking Forward***

Today there is an improved outlook for corporate profits driven by cost-cutting, low interest rates, a weak (though recently firming) dollar, some uptick in foreign demand, and hopes for a resurgence of the domestic consumer. This, together with the Fed maintaining interest rates at unsustainably low levels, is driving investors to risk-oriented assets in hope of realizing a return greater than the *de minimis* returns available in short-term, fixed-income securities. As investors rushed to capture yield, bond prices rose, interest rates declined, and credit spreads collapsed in the corporate credit and high-yield markets. We question whether these investors appreciate the risks associated with their stretch for yield.

Although share prices have dramatically risen with increased earnings expectations and conviction on the part of some investors that government policies of fiscal stimulus, liquidity facilities and low interest rates will continue, we are not alone in questioning the Fed's "end game."

In our view, the Fed remains confronted and confounded by high unemployment, consumer balance sheets that are still over leveraged and credit restrictions likely tied to suspect, if not impaired, bank capital invested in illiquid assets, commercial loans, and real estate. The inability of the securitization market to meaningfully re-ignite has further constricted credit. While we recognize that macroeconomic domestic headwinds are not the only factors affecting growth in corporate profits, they continue to represent a substantial threat.

The combined forces of the Fed and the Treasury (see stimulus part II, III, IV, etc.) have the staying power to entice and drive investors into risk-oriented assets. Only the government knows when policy course headings will change. So it comes down to valuation and timing. Valuation obscured by the protective, enticing and illusive security blanket of government action and relaxed accounting rules, and timing obscured by presumably temporary suspension of the principles of a free-market action (with appropriate regulatory safeguards to address access to information and compensate for mismatching of sophistication levels). How and when the Fed and the Treasury will adjust their headings remains unclear.

### ***End Game***

While senior government officials contemplate their end game, we also reflect on the end game of each of our clients. Is a client's end game to preserve capital, to rapidly grow his portfolio, or to seek competitive market returns relative to the risks he is willing to accept? The end game for an individual investor should always be based in a risk/reward analysis taking into account both market conditions and valuations reflected in investment asset classes, and their own personal circumstances.

In an economic and capital markets environment where there exists some probability of high-impact risks, the prudent investor must act to mitigate the possibility of personal wealth destruction even though the probability of such a high-impact event occurring may be low. Failure to appreciate this has, in the past, given rise to rampant mispricing of risk and destruction of wealth. The probability and consequence of a high-impact event is further magnified by excessive leverage throughout the capital markets including derivative securities as well as conventional borrowings to carry investments, and the interconnectivity of investment assets and asset classes within the capital markets (for example, counterparty risks in derivative securities and liquidity squeezes causing selling pressure in unrelated asset classes).

For most individual investors, until further clarity as to regulatory and economic matters exists, a reduced allocation to risk-oriented assets is appropriate. However, as the risks recede or are better priced into asset valuation, modest increase in exposure to risk-oriented assets is appropriate, notwithstanding that risks remain elevated from baseline or neutral levels.

### ***Alternative Investments***

From time to time clients inquire as to investing in private equity funds and/or hedge funds. With regard to private equity, we have advised that where companies are purchased at the appropriate price and with the appropriate capital structure in place, fundamentally sound growth-oriented businesses can prosper and provide attractive equity returns. We have also advised that such investments are in many respects highly correlated to the public equity capital market and that illiquidity in these investments has its own risks. Recently, we have seen that many private equity transactions were greatly burdened by initially high purchase prices funded with leverage that proved to be excessive in an economic downturn.

As for those clients who have inquired about hedge funds, we have cautioned that there are many different types of hedge funds. Some have a longer-term investment orientation while others employ short-term leveraged trading strategies. Many hedge funds also use various shorting techniques or derivative trading strategies in an attempt to capture movement in related securities or markets. In each case, we have cautioned that these investments are not immune to the correlation of risk and reward. Where there is an opportunity for outsized gains, there is also the opportunity for outsized losses.

### ***Other Matters***

Beginning in 2010, high-income individuals may convert traditional (previously deductible and non-deductible) IRA accounts to Roth IRAs. The consequence of this will be to trigger income tax upon conversion but allow for all future gains that accrue in the converted accounts to be free of tax even when withdrawn from the Roth IRA. While a case-by-case analysis is required for each individual circumstance, we believe (assuming no adverse changes in future tax laws) that the conversion of a traditional IRA to a Roth IRA is advantageous for (1) an individual who has substantial liquid assets independent of IRA accounts and can fund the conversion tax liability from those other assets, (2) an individual who has a substantial estate that will not require invasion of the Roth IRA to pay estate taxes, and (3) an individual whose children will not likely

need to access the Roth IRA funds inherited by them for a substantial period of time. In this case, the compounding of tax-free returns over long periods produces a net benefit. We caution, however, that should tax laws change, for example, by encouraging IRA withdrawals by lowering income tax rates on such withdrawals, the Roth conversion could prove to be disadvantageous.

We also note that as of this writing, there is no Federal estate tax in effect for those individuals dying in 2010 and that the estate tax rates and exemptions are scheduled to revert back to the prior estate tax law (in effect before the Bush tax cuts) at the close of calendar year 2010. We will continue to monitor these developments and advise as to the necessity of amending estate documents.

### ***Developments at KLS***

Finally, as we look forward to a new year, we are delighted to announce the following promotions:

Maritza Chow Young has been promoted to Associate Director. Previously Maritza had been Manager of Client Services. In this capacity she has led our Account Analyst, Portfolio Accounting and Account Administration groups and has had significant responsibility for many client relationships. Maritza will continue to work with clients and will assume further responsibilities in managing client relationships in her new capacity.

Joseph Callaway and Patrick Wren have been promoted to Account Manager. Previously as Senior Account Analysts they have worked with many clients under the direct supervision of Managing Directors and will continue in this capacity while assuming additional responsibilities for certain client relationships. Patrick and Joe have done an exemplary job of managing their client relationships and have mentored many junior professionals in our firm.

Tara Sheehy has been promoted to Manager of Client Services. In her new capacity she will assume responsibility for the Account Analyst, Portfolio Accounting and Account Administration groups. Tara has been a Senior Analyst with substantial client responsibilities. She also has mentored many professionals in our firm and continues her role in these capacities while adding her new responsibilities.

Many of our professionals at KLS have been with our firm for many years. We are delighted to offer continued growth and opportunities for those being recognized today with promotions. Continuity in client relationships is important as we continue in our culture of excellence in technical matters and client service.

All of us at KLS greatly appreciate the confidence and trust that our clients have in our firm. We are mindful that we must earn this each and every day.

All of us at KLS wish you and your families a Happy, Healthy, and Prosperous 2010.

January 4, 2010