

# the Whitepaper

January 2009 | Vol. 3



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In this issue of *The White Paper*, LPL Financial Research revisits what we anticipated the markets would do and outline how well our plan has done in guiding us through the fog over the last three months. More importantly, we will discuss where we believe we are on the Road to Recovery and reiterate our plan to navigate what remains of this bad weather.

## Where are We on the Road to Recovery?

Investing can sometimes seem like walking along a shoreline path with heavy fog rolling in. The kind of dense fog used in all those scary movies. Visibility is low...the path is uncertain...what lurks around the corner?

As investors, fogginess is something we have to accept from time to time while we wait for clarity to eventually emerge in the markets. This does not mean that during uncertain times we have to walk aimlessly because thankfully there are tools that can help guide us. With forward visibility low, we use a map to show us the way. In December 2008 LPL Financial Research published our "investing map" — in which we outlined our view on the path the markets may take on their road to recovery.

This guide allows us to take small, well thought-out steps so we can navigate this tricky bout of bad weather. And, the good news is, in our opinion, the fog may be starting, ever so slowly, to lift.

### Current Environment

Our map outlined three distinct periods of "healing" that need to take place, with each offering distinct opportunities and challenges for investing. Currently, in our three phase process of market healing, we believe we are in the latter part of Stage 1, with a bumper sticker that reads, Liquidity Returns, A Bull Market for Volatility. In this first part of the market's healing, we anticipated that both volatility and illiquidity would remain elevated, but begin to improve, and there would be continued downward pressure on equity markets. As a result, we suggested portfolios slightly underweight stocks, transition to relatively more aggressive fixed income investments, and establish positions in alternative mutual fund strategies that help with heightened volatility, such as Covered Calls, Global Macro, and opportunistic Balanced funds.

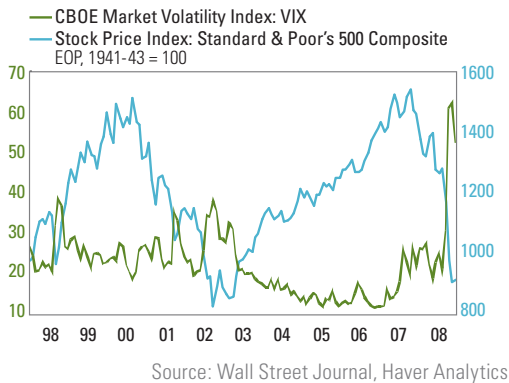
To date our "map" has been directionally correct and as a result, the investments we made in Stage 1 have worked well on a relative basis. Maybe more importantly, regarding the market's future recovery, we have seen material improvement in both volatility and illiquidity.

Equities Bias to Rally as VIX Levels and TED Spreads Decline



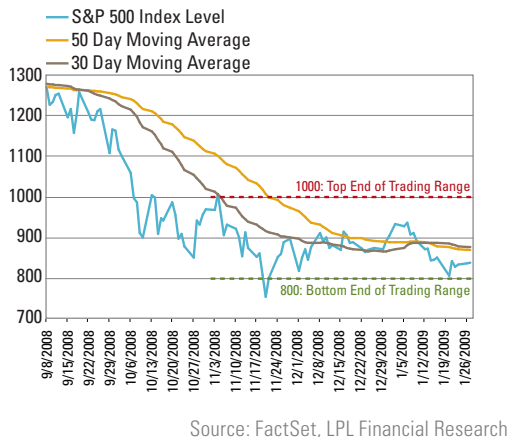
While still elevated, as shown in a nearby chart, the VIX, a measure of market volatility, and the TED Spread, a measure of illiquidity, have both declined appreciably. In the end, these are very positive indicators for the equity market's healing process. In particular, the VIX has historically displayed a strong inverse relationship to stock market returns, suggesting that as volatility continues to decline, equities have a bias to rally.

VIX Levels and S&P 500 Returns



As far as the equity markets go, LPL Financial Research outlined in a Road to Recovery in late 2008 that we anticipated the S&P 500, a broad market proxy for stocks, would remain volatile in a range bound between 800 and 1000. One of the questions that we receive a lot is, why do we feel the market's range is likely limited to a downside of approximately 800, especially given how much bad news abounds? While it is certainly possible the S&P 500 can drop to levels below 800, thus far, that is the level when buyers seem to outnumber sellers and technical levels have held. In fact, over the last 2,782 trading days (since 1996), the S&P 500 has maintained levels above 800 in all but 5 days and has rallied off of the 800 floor on several occasions. In addition, as shown in a nearby chart, 800 was the weekly low during the 2000-2002 recession and could signal the low end of the trading range in this current down market period as well.

Weekly Returns of Range Bound S&P 500 Including Moving Averages

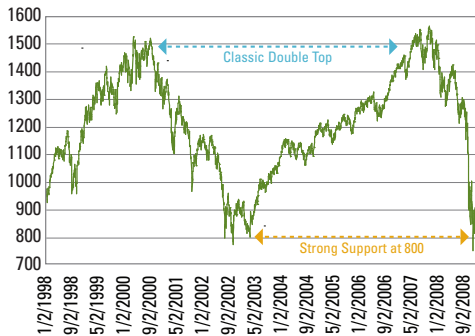


NUMBER OF DAYS AT VARIOUS S&P 500 INDEX LEVELS SINCE 1996

S&P 500 Levels 1996-2008	Days	The Five Days the S&P Dropped Below 800	
1600+	0	07/23/2002	797.70
1500 - 1599	115	10/07/2002	785.28
1400 - 1499	380	10/08/2002	798.55
1300 - 1399	440	10/09/2002	776.76
1200 - 1299	533	11/20/2008	752.44
1100 - 1199	595		
1000 - 1099	320		
900 - 999	221		
800 - 899	173		
700 - 799	5		
600 - 699	0		

Source: FactSet, LPL Financial Research

## Long Term Levels of the S&amp;P 500 Index



Source: FactSet, LPL Financial Research

## Our Recommendation

We continue to be cautiously optimistic. We believe the proper positioning is to maintain a slightly lower equity risk profile but allocate relatively more aggressively within fixed income opportunities. We continue to like investment grade Corporate Bonds, Bank Loans, Preferred Stocks, and to a lesser degree High-Yield Bonds. The equity markets will continue to not be directional in nature (up OR down) but rather saw-tooth (up AND down). For portfolios that are overweight equities, we suggest having a plan to move to a slightly lower equity beta than the benchmark. Since it appears that the S&P 500 is in a trading range of 800 to 1000, maintain patience, and look to re-position the portfolio above 900. For portfolios that are underweight equities, do the opposite: look to add equities opportunistically at the low end of the range (800 to 840) to be only slightly underweight.

## What's Next?

So, why does LPL Financial Research feel that we are coming to the close of Stage 1? In our forecast, the end of Stage 1 would come when volatility moved lower, liquidity improved, the stock market held the low end of our predicted range of 800 to 1000 and we traded above the 30- and 50-day moving averages on a sustained basis. These healing events have begun, and frankly, they have occurred far faster than we imagined.

It is important to note that we never outlined that the shift from Stage 1 to Stage 2 would coincide with when the “fog lifted” and it’s hasn’t yet as current headlines seem as uncertain as ever. It is the improvements in the foundation of the economy and the markets that spark the transition to Stage 2, so this is not the complete “all clear” signal.

At this point we have found some confirmation that volatility is moderating and liquidity is improving signaling the start of Stage 2 and therefore we plan to begin moving to a relatively more aggressive stance, relatively being the key word. This move will be a nervous one for many, as it is human nature to not want to change a strategy that has been working so successfully. Indeed, our decision to reduce beta has worked, but that is the past. As investors, we have to move forward and we know that historically markets rally long before the economy pulls out of a recession and, more importantly, before the end of the bad news. We are, in a sense, looking for the first glimpse of the economic growth “light” at the end of the recession “tunnel”.

Timing is important. Of equal importance is finding an attractive entry point. To increase aggressiveness, we will look for an attractive entry point at the extreme low end of our 800 to 1000 trading range to begin to shift portfolios to an increased risk posture in Stage 2. It is important to note that the shift in portfolio construction and strategy between Stage 1 and Stage 2 will be done in a deliberate manner, and likely encompass several steps. The market does not just shift its focus overnight or in a straight line, and neither should we. Thus the prudent strategy is to step into Stage 2, not leap.

## Conclusion

Not all maps are good ones. But so far, the market’s Road to Recovery that LPL Financial Research mapped out has guided us well. While we remain humble to the market’s ability to alter the landscape of investing quickly and render even the best map useless, we remain convinced, and so far validated, that our current plan is helping us confidently navigate this foggy, shore-lined path.

## Road to Recovery Stage Summary

### Recovery Stage 1

- Bumper Sticker: Liquidity Returns, Bull Market for Volatility
- Scenario: The first stage in the recovery is the return of liquidity but the continued presence of high levels of volatility.
- Strategy: Maintain beta slightly lower than the benchmark and utilize investment strategies that help with volatility, and on the fixed income side, position the models with significantly higher beta with allocations to those asset classes that will benefit most from an increase in liquidity.

### Recovery Stage 2

- Bumper Sticker: Light at the End of the Tunnel
- Scenario: Examining every recession and bear market since WWII reveals that stocks have always bottomed before the recession was over and delivered on average powerful 25% gains as measured by the S&P 500 Index, recouping nearly all losses by the end of the recession.
- Strategy: Increase in equity beta as the market begins to anticipate the end of the recession.

### Recovery Stage 3

- Bumper Sticker: The Next Bull Market
- Scenario: The last and final stage of the recovery. Stage 1 saw liquidity improve and stage 2 saw the stock market improve. Stage 3 will be marked by the economy improving.
- Strategy: The market is still likely to maintain an upwards slope and with the improvement of economic conditions, economically sensitive investments such as Real Estate, commodities, emerging markets and managed futures should be market leaders.

### IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

High yield/junk bonds are not investment grade securities, involve substantial risks and generally should be part of the diversified portfolio of sophisticated investors.

Investing in Mutual Funds involve risk, including possible loss of principal. Investments in specialized industry sectors have additional risks, which are outlined in the prospectus.

The market value of corporate bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield.

Beta measures a portfolio's volatility relative to its benchmark. A Beta greater than 1 suggests the portfolio has historically been more volatile than its benchmark. A Beta less than 1 suggests the portfolio has historically been less volatile than its benchmark.

Alternative investments may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

Alternative investments mutual fund strategies are subject to increased risks due to the use of derivatives and/or futures.

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