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"The Killing Fields"

In 1984 acclaimed Hollywood director, Roland Joffé, released a brilliant and shocking movie entitled, "The Killing Fields".

"The Killing Fields" told the story of the living hell the Cambodian people endured under the reign of the tyrant, Pol Pot. Pol Pot, the leader of a communist revolutionary party named the Khmer Rouge, exercised authority over Cambodia from 1975-1979. During his murderous and barbaric regime, the Khmer Rouge killed an estimated one third of the population, essentially destroying a once proud nation.

"The Killing Fields" tells the story of Pol Pot and the Khmer Rouge through the eyes of a real-life New York Times journalist named Dith Pran. Dith Pran assisted famed Times correspondent, Sydney Schanberg, in covering Cambodia's collapse into total madness. Upon the fall of Cambodia in 1975, Dith Pran was sent to prison camp for four years, ultimately surviving and moving to New York where he was reunited with his former journalistic partner, Schanberg.

The movie's most gripping scenes focus on Pran's time in a Khmer Rouge prison. The Khmer Rouge imprisoned many of those they did not kill and the Khmer Rouge prisons were filled with brutality, torture and ultimately even more death. For the survivors it was arguable whether they benefitted by their survival as almost everyone they knew had been killed.

The motion picture was stunning and was nominated for seven Academy Awards. However, the only winner was Haing Ngor, a Cambodian refugee who portrayed Dith Pran in the movie. Ngor won the Oscar for best supporting actor. During the ceremony, the cameras kept focusing on Dith Pran, who was in the audience during Ngor's acceptance speech. Finally, the crowd spontaneously erupted into massive cheers for Pran – the cheers were the cheers for a survivor.

In 2008, investors faced their own version of "The Killing Fields," as virtually every global asset class tumbled 30%-70%, mostly during the three months of September – November. 2008 was unprecedented and virtually unimaginable. The volatility was extraordinary and the losses staggering. The wealth destruction and residual fallout will be felt for years and investor memories will forever be haunted.

2008 is quite simple to analyze: absolutely nothing worked in an investment portfolio and diversification appeared to become a hindrance.

In the table below you will find the stock market index returns for 2008:

S&P 500	-36.98%
NASDAQ	-39.98%
Russell 1000	-37.60%
Russell 1000 Growth	-38.43%
Russell 1000 Value	-36.85%
S&P MidCap 400	-36.24%
Russell 2000	-33.80%
Russell 2000 Growth	-38.53%
Russell 2000 Value	-28.93%
Russell MicroCap	-39.78%
MSCI EAFE	-43.06%
MSCI EAFE Growth	-42.46%
MSCI EAFE Value	-43.68%
MSCI EAFE Small Cap	-46.78%
MSCI Emerging Markets	-53.17%
CSFB High Yield	-26.17%

As you see the list is complete and covers virtually every global stock market index. A grisly list it is, the single best equity performer was the Russell 2000 Value at negative 28.9%, while the worst performer was the MSCI Emerging Market index which tumbled 53.1%. Astonishingly there was very little separation as almost all markets, regardless of market capitalization or continent, fell an average of roughly 40%.

Focusing on the U.S. for a moment, it is immediately apparent that diversification had no impact. Large cap stocks as represented by the S&P 500 were off 36.9%. Large value stocks (Russell 1000 Value) declined 36.8% while large company growth stocks (Russell 1000 Growth) fell 38.4%. Mid cap stocks (S&P MidCap 400) fell 36.2% while small cap stocks (Russell 2000) fell 33.8% and America's smallest companies (Russell MicroCap) fell 39.7%. Again, the theme is not just the **magnitude** of the decline but, more importantly, the **consistency** of the decline. Nothing saved U.S. equity investors in 2008 as virtually every single company, regardless of size or style, fell on average, 35%-40%.

However, this unpleasant phenomenon was a global problem and actually was a more pronounced issue around the world. One of 2008's savage truths is that no matter how intelligent or well-intentioned investment strategies were, they simply did not work. Moreover, many of what seemed to be "slam dunk winners" in 2007 were the biggest losers in 2008.

In 2007 and 2008 many investors became concerned about the potential for de-levering within the overall U.S. economy and financial system and emphatically felt moving money into commodities and emerging markets made the most sense. The sentiments were predicated upon the de-coupling of the four primary emerging markets (the so-called BRIC countries of Brazil, Russia, India and China) from the economies of Western Europe and the U.S. and their insatiable thirst for natural resources.

This strategy worked throughout the end of 2007 and for part of 2008, and then completely came apart. The Dow Jones Commodity Index, which was up 27% the first six months of the year, fell 55% over the last six months of 2008. If you think back just one year, virtually every pundit was on the commodity bandwagon due to chronic long-term shortages and emerging market demand. The plunge in commodities was accented by the 77% fall in the price of oil.

As with commodities, many institutional investors dramatically over-weighted emerging market equities, keenly focusing on the strong probability of the de-coupling argument. Almost predictably this strategy unraveled quickly and emerging markets posted some of the largest losses of the year. The Russian stock market, after posting positive results through June, fell 78% in the last six months of the year. The Chinese stock market, the recent beneficiary of the world's fastest growing economy, dropped 68%. India was in trouble from the start of the year and fell 59%. Meanwhile, Brazil, which like Russia had benefitted from a robust natural resources component within its overall economy, declined 60%. In the end there wasn't a BRIC left in the wall.

In the past decade, many investors have embraced hedge funds as a diversifying element in their portfolios. In keeping with 2008's savage beating, hedge funds lost 18% on average and did not provide the bear market assistance that they did in 2000-2002. They did, however, lose considerably less money than equities or high yield bonds.

Finally, real estate has been placed in many portfolios as an insurance against inflation. Then the inflation story of the first six months of 2008 quickly became the depression/deflation story of the second six months. After holding its value through June, the Dow Jones REIT Index fell 63% in the three months between September and December.

Even money market funds were not spared the fun of 2008. On September 15 when Lehman Brothers declared bankruptcy, ultimately defaulting on its outstanding commercial paper, the short term credit markets completely froze, throwing the money market world upside down in a matter of hours. Bruce Bent, the founder of the money market industry and the force behind the well known money market fund, The Reserve Primary Fund, immediately froze his multi-billion dollar fund and was followed within the week by the Commonfund. By freezing their funds, these two organizations prohibited their investors from access to their most liquid and defensive asset at exactly the same time investors were clamoring most for their safe assets. Terror spread through the money market world and big name providers of cash funds such as Northern Trust and Bank of New York/Mellon had to pony up hundreds of millions of dollars to prevent their NAVs from dropping below the sacred $1.00 level. This amount of dislocation and dysfunction, in what is generally viewed as the safest segment of the investment world, was unprecedented and truly shows the massive amount of panic, disruption and volatility that existed throughout the second half of 2008.

I could go on and on. It's safe to say that there have been few, if any, of us living today who've suffered through such a tumultuous and stressful period for the global capital markets. The 1973-1974 and 2000-2002 bear markets were a morning pre-school session compared to 2008. In each of those bear markets, the worst performing periods for equities in the past fifty years prior to 2008, stock prices declined gradually over a several year period, allowing investors the critical breathing room to reduce risk along the way. Furthermore, other asset classes were positive performers, providing diversification benefits. For example, in the 2002 bear market, high yield bonds, small cap value stocks, mid cap stocks and real estate all made money in an environment where the S&P 500 plunged almost 50%. In comparison, 2008 was a cataclysm that left nothing standing in its way.

2008 is over and now we must begin to review what happened, how investors could have been better prepared and what we can do next time to minimize capital losses.

It should be noted, however, Monday morning quarterbacking in the investment industry does not take a back seat to dissecting your local NFL squad – if anything, the amount of critical thought and speech generated by the investment industry would leave any drive-time sports talk show host jealous with envy.

Moreover, in the next twelve months many theories will be created, spun and hatched and there will be more investors who saw this coming than voters who didn't vote for Nixon in 1972. Don't believe a word they say.

For starters, I've now seen a number of investors reach the possible conclusion that diversification didn't work and its role in a portfolio is up for debate. However, I believe the opposite is true and, importantly, the largest and most significant losers of 2008 were those who did not employ enough diversification.

Adolf Merckle, one of Germany's richest men, has taken his life as I am writing this. Merckle, a shy and frugal man, controlled a business empire that controlled 120 companies and employed over 100,000 people. Forbes has estimated his net worth at over $9 billion. However, Merckle committed suicide because he put himself into financial jeopardy by placing too much of his assets in one trade – the famed Volkswagen short of 2008. Merckle evidently felt that risking his vast global empire and entire family's net worth on a trade was a sensible idea.

Or consider the fortunes of Carl Shapiro. Shapiro is a 95 year old man who had the misfortune of becoming Bernie Madoff's best friend. Shapiro, who appeared to have lived an exemplary life as a shrewd businessman and noted philanthropist, had over 90% of his net worth with one manager (Madoff) and had also placed roughly one-half of the assets of his private foundation with Madoff. Shapiro evidently felt that having all of your assets in a single manager employing one strategy was an intelligent thing to do.

Finally, for sheer scale there is the story of famed Las Vegas gambling tycoon, Sheldon Adelson. Adelson founded and controls the publicly traded company, Las Vegas Sands Corp. Adelson has spent his lifetime in the gaming industry building his company. Consequently, he had the vast majority of his net worth in his own company. Adelson, one of America's wealthiest men, saw his net worth decline from over $27 billion to just over $1 billion, and is left grappling with his numerous creditors on the future of his company. Adelson also clearly felt that having almost all of your money in one company was a prudent thing to do.

The single company wealth destruction of 2008 is another terrifying element of 2008's total story. Employees who had worked their entire careers at Bear Stearns, Lehman Brothers, AIG, Washington Mutual and Wachovia lost almost all of their net worth, as those stocks plunged to one or two dollars per share or, in the case of Lehman, zero. The Wachovia story is particularly sad because over the past two decades, Wachovia had purchased dozens of small town banks in the south. Many of these institutions were broadly owned by their local citizens who would then swap their local bank's stock for that of Wachovia's. When Wachovia became virtually worthless, it had a particularly devastating effect on a number of small towns in the South. I have read numerous stories about investors who had almost all of their assets in Wachovia stock and were wiped out as Wachovia declined from over $40 to less than a dollar during 2008.

The surprising truth is diversification did work – it just didn't work as well as normal. Based on the statistics I've seen thus far, the average institutional portfolio lost between 20% and 30% for 2008. While it is factual that 2008 provided the worst returns for portfolios since 1974, what it did not do is completely bury diversified portfolios and leave them with no hope for recovery.

For example, if an investor lost 25% in 2008, due to the complexity of negative compounding, that portfolio would need to generate a return of 33% to get back to even ground. Comparatively, a portfolio that lost 50% needs to return **100%** to return to the starting line!

History suggests that when we recover from this severe recession and bear market the return for the S&P 500 in the first twelve months will be strong. In the post-World War II era, equity investors have recovered over 30% of their losses in just the first forty days of a new bull market.

Importantly, while 2008 hurt diversified portfolios, it did not kill them. A diversified portfolio helped to contain overall losses and most performed much stronger than the 40% decline in the equity markets.

Returning to "The Killing Fields", once the Khmer Rouge controlled Cambodia, they began to "re-educate" the Cambodian citizens through a massive indoctrination program. Khmer Rouge officials stridently marched through the numerous prison camps they'd established throughout the country, yelling "Today this is Year Zero – Everything you know and everything you have learned no longer exists." Investors should be confident that most of what they've learned in the past **is** still valid. After all, if you are frustrated with diversification, then the obvious solution is to eschew diversification and concentrate your assets. If 2008 has taught us anything, it is that concentration renders investors more vulnerable in most cases and generally produces much larger losses.

Finally, 2008 was a thrashing, gyrating force that crushed everything in its path. The cataclysm unleashed record volatility that produced wave upon wave of forced selling due to margin calls, redemptions and general de-levering. Given that the forces at work were so monumental, I would caution investors from immediately jumping to conclusions based upon 2008's price action. While I am certain there will be lessons to learn, I am also certain that immediate conclusions have an abnormally high probability of being wrong – I believe a little distance will provide us with a stronger education and a better understanding. As one of my favorite curmudgeons H. L. Mencken was fond of saying, *"There is always a well-known solution to every problem—neat, plausible, and wrong."*

2009 and Beyond…

As many clients of Monticello Associates know, we are believers in the ruthless statistical term known as regression to the mean. Regression to the mean is roughly defined as the following: "Once a long-term pattern of investment results has been established, then the future returns will be driven by the return pattern regressing up or back to the long-term mean." For example, if the long-term average of an investment return stream is 5% and the returns over the past 5 years have been 0%, then the strongest probability is that future returns will be higher than the long-term average of 5%.

Practically speaking, regression to the mean is a ruthless factor at play in the investment markets and while it doesn't work all the time, it works in fact most of the time. For instance, if you employed an investment manager who had doubled or tripled the returns of their relative index over the previous five years, regression to the mean would dictate that the manager has an abnormally high probability of dramatically underperforming its index in the future.

Consequently, while silver linings are admittedly hard to find these days, U.S. equity investors should take great comfort in regression to the mean and that the next decade may bring an era of very strong returns.

The following chart outlines two time periods. The first displays the ten years ending 1999 and the second shows the recently ended time period.

S&P 500 Compound Annual Returns through 1999

1 Year	3 Year	5 Year	7 Year	10 Year
21.03%	27.56%	28.56%	21.53%	18.22%

Given that the long-term average annual return for stocks is approximately 10.0% and the returns for the decade of the 1990's were substantially above average, then the regression to the mean strongly suggested in 2000 that returns in the future should be much lower. Let's look:

S&P 500 Compound Annual Returns through 2008

1 Year	3 Year	5 Year	7 Year	10 Year
-36.98%	-8.34%	-2.18%	-1.53%	-1.37%

As you can see that was indeed the case. In fact, U.S. equity investors have not made money in stocks for the past decade. **Within this statement is the silver lining – as a result of disappointing returns for all of the past decade, investors have a very strong probability of enjoying comparatively positive returns for the next 5-10 years. Moreover, stock market history suggests that in the 5-10 years after posting a negative ten year return, not once has the market failed to be positive for the next decade. As far as silver linings go, I believe this is a pretty strong one for investors to have on their side.**

Much work has been performed regarding regression to the mean, but without question the firm who has had the most success in this area is the excellent Boston-based investment management firm, GMO. GMO has spent thousands of hours creating an excellent statistical advantage with which to measure future asset class returns based upon regression to the mean principles and current valuation levels. In a conversation with one of the firm's principals in December, he mentioned the following: "I'm surprised to tell you this, but for the first time in my sixteen years at the firm we've become positive on equities!"

GMO's recent opinion on this matter was based upon today's starting point and the firm has just published a brilliant paper on this subject. Not surprisingly their conclusion is that today is the best time in years to own risk assets and they expect equity returns to be in line with historical results over the next seven years. It should be noted that their long-term forecasts have a stunning degree of accuracy and in our opinion offer the closest thing to a Holy Grail in the investment industry.

Finally, for the first time in my career there is too much cash on the sideline relative to stock market capitalization. Statistics indicate that at this point in time, the total amount of money in cash ($8.5 trillion) almost exceeds the total U.S. Stock Market Capitalization. This development is strong medicine for future stock appreciation as money market investors will inevitably become weary of earning less than one percent on their money.

The key question today is getting from here to there and that is what investors need to now focus on. More than likely 2009 will continue to provide increased volatility, frustration and the potential for negative returns. Consequently, if investors are going to capture the upside over the next five-to-ten years, then they are going to have to steel their nerves and hold fast for the foreseeable future. For many this will prove easier said than done as emotion will undoubtedly enter the equation.

While it is quite probable that the current environment will deteriorate further, it should also be mentioned that in the lengthy history of the United States a recovery has never failed to happen. Not once. In conclusion, I will leave you with one of my favorite stock market quotes that has never been more applicable, "The purpose of bear markets is to separate the pretend owners of capital from the rightful, long term owners of capital."

B. Grady

Investment management is a 100% personnel driven business and it is critical for elite firms to continue to invest in their personnel. At roughly forty professionals, our company has recently added a number of terrific people.

Erin Bawa moved to Denver and joined us from Investure in Charlottesville, Virginia. Erin earned a BS degree from Wake Forest University in Math and a BA in Physics. (She grew up near the Wake campus in Winston Salem as her father was a Professor). After leaving Wake Forest she entered the graduate program in Mathematics at the University of Virginia, earning both her Master's Degree and, finally, a PhD. Upon earning her PhD she joined our friends at Investure where she focused, not surprisingly, on quantitative strategies. Erin is a member of the Research Department and focuses on Absolute Return strategies and Fixed Income. She will earn her CFA this year.

Brian Harrigan joined us in our Cleveland office and is an associate in consulting and research. Brian, an Ohio native, moved to Cleveland from Chicago upon accepting a role with the firm. Brian received degrees from Miami University in Finance and Accounting and holds an MBA from the University of Chicago. Additionally, he is a CPA and a CFA. Prior to joining Monticello, Brian was with Harris Bank.

Duncan Burn joined the firm in late 2007. Duncan grew up in Greenwich, CT (his father, Harry, is a prominent investment manager) and attended Trinity College. While at Trinity, Duncan was a member of the school's undefeated squash team and he participated in two NCAA Championships, ultimately being elected captain his senior year. Once he graduated from college he moved to Richmond, Virginia and worked at Davenport & Company where he engaged in investment management research. Duncan ultimately received a MBA from the University of Virginia and moved to Denver with his wife, Cameron.

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