Why This Isn’t 2008

Morningstar® Managed Portfolios℠ Commentary
For Financial Advisor and Current Client Use Only

Given recent market volatility, it’s understandable that some might draw parallels between the current selloff and the financial meltdown of 2008. Yet, we think there are important differences that are worth keeping in mind, especially before tinkering with an investment plan. In this commentary, we explore those differences and explain their significance.

Principles to Invest by

Before we turn to explaining how we think the current market pullback differs from the 2008 meltdown, we wanted to offer a few general thoughts about persevering through market adversity. We think a few principles are worth remembering:

- Manage what you can. This includes formulating a thoughtful investment plan, diversifying your assets to the greatest extent warranted, watching expenses, and rebalancing your portfolio on a regular basis but not over-trading.
- Try not to stress about what you can’t manage. This includes the market, especially when it’s gyrating wildly. It’s uncontrollable, especially over shorter periods of time. (Over longer periods, it’s governed by fundamentals, which we and our managers try to be mindful of when selecting investments.)
- Remember your time horizon. While times like these can make a particular target date seem all the more distant, we’ve found time and again that the most successful investors keep an unwavering focus on their long-term goals.
- Keep emotion out of it. Morningstar, Inc. research has found that investors mis-time their purchases and sales all-too-often. Why? Because they’re succumbing to emotions like greed and fear in buying near the top and selling near the bottom. This dents returns and keeps investors from reaping the benefits of a well-formulated plan.

In our experience, investors who heed these principles are far likelier to meet their goals, explaining why we try to observe them ourselves in the way we manage portfolios.

The Key Differences

What makes this downturn different from the 2008 financial crisis?

1. Markets are open and functioning
2. We have less debt
3. We have more cash
4. We’re less overextended
5. We’re reaping real, not illusory, profits
6. We’ve reined-in some of our excesses
7. We can invest in cheaper stocks
8. Diversification is working
1. **Markets are open and functioning**

While it’s true that European financial markets aren’t operating efficiently, we’ve seen no evidence those problems are spreading globally. For instance, banks are still lending to each other, as evidenced by the fact that the “Ted-spread”—a measure of confidence in the inter-bank lending market—has risen only modestly of late. True, corporate bond spreads have widened, but they’re a shadow of the panic levels they reached during the meltdown. Corporations continue to bring bond deals to market successfully, short-term financing markets are functioning more-or-less normally, and money-market funds have stemmed earlier asset outflows. This is a far cry from the financial crisis, when confidence evaporated, investors withdrew en masse from many markets, and liquidity dried up, making it all-but-impossible to transact.

2. **We have less debt**

Consumers, homeowners, and institutions of various kinds have wrung a meaningful amount of debt out of the financial system since 2008. While this process is still in its early-to-intermediate stages, the trend is unmistakable, especially amongst banks where leverage ratios have fallen dramatically. (Ironically, this deleverage wave is the chief reason that heavily-indebted economies have been unable to muster stronger gains during the recovery, as it’s somewhat throttled spending, reinvestment, and lending.) While it’s incorrect to say that this debt has disappeared (in fact, some of it has shifted to sovereign balance sheets) or that the risk of a debt-related event has fully passed (witness the sovereign debt crisis), we believe the private sector is likely to prove more resilient today than it did during the crisis.

3. **We have more cash**

Consumers and institutions are borrowing and spending less and saving more. This is most apparent among larger companies, which have used the recovery to pay-down debt, reduce reliance on short-term financing, and, in the absence of suitable reinvestment opportunities, amass large cash balances. Though they still have a very long way to go, consumers have been socking-away a greater share of their disposable income, explaining why the savings rate has risen in recent years. Consumer finances remain fragile, but many banks and commercial businesses should be able to better withstand the market upheaval this time around, which we believe will prevent more-lasting economic damage.

4. **We’re less overextended**

The economy entered 2007 and 2008 at or near full employment, when input markets were tight, and inventories were relatively full. When the crisis hit, financing dried-up, and demand fell off a cliff, companies that had overcommitted had to cut mercilessly to right-size their businesses. In addition, banks dramatically curtailed lending in order to boost reserves and avert insolvency. That’s a far cry from today, with unemployment high, wages flat, and inventories and capacity utilization fairly low. What’s more, while bank lending has risen somewhat, the spigot hasn’t fully reopened, meaning that the recovery has taken place largely without the benefit of plentiful capital. Put another way, the economy is already fairly lean and doesn’t need to break its reliance on borrowed money as it did “cold turkey” following the bursting of the housing bubble. This, we think, makes it less likely that the economic bloodletting of 2008 and 2009 will repeat itself.

5. **We’re reaping real, not illusory, profits**

Companies were handsomely profitable by many measures entering the 2008 swoon, just as they’re flush now. But there’s an important difference this time around: The financial sector, while important to the recovery, hasn’t led the way, nor has financial leverage been the catalyst for profit growth. Rather, companies have scaled their profitability the old-fashioned way—by growing revenue faster than expenses. The upshot? While leverage and ready means of refinancing were keys to the last recovery, they’re not the story this time around. Thus, if capital
becomes more scarce amid the market pullback, it’s much less likely to shred profitability and throw a wrench into the recovery.

6. **We’ve reined-in some of our excesses**

There’s no question the economy is still struggling to absorb the excess housing inventory and construction labor-force that swelled amid the real-estate boom. But we’ve seen meaningful progress in reducing real-estate supply, as household formations have outpaced growth of housing stock. There’s also far less borrowed capital swishing around in the system, which represented its own form of oversupply amid the housing and financial mania last decade. The implication is that, while the problems of a real-estate retrenchment and high joblessness have hardly been put to bed, a downturn is less likely to crack-the-whip on the economy the way it did during the financial crisis when lenders yanked financing from borrowers who’d bet their life on it.

7. **We can invest in cheaper stocks**

At its peak in April 2007, the S&P 500 Index was trading for around twenty-seven times cyclically-adjusted (i.e., average) long-term earnings, which well exceeded the historical norm. By the spring of 2008, the S&P had fallen about 18% from its April 2007 peak, which is more or less equivalent to its decline from the recent April 2011 high. How do valuations today compare to where they stood in the spring of 2008? Back then, the S&P was still trading for twenty-one times average long-term earnings. Today, the S&P is trading at a less lofty nineteen-times earnings. By other measures, the S&P looks downright inexpensive. For instance, Morningstar, Inc.’s analysts estimate that the S&P’s holdings are now about 25% undervalued, in aggregate and the index is trading for 14.5 times trailing twelve-month earnings, twelve times forward earnings, and sports a 2.15% dividend yield.

8. **Diversification is working**

Trust is the asset class that rules them all; when it recedes, as happened during the financial crisis, then the returns of even seemingly disparate assets can converge, increasing correlations and greatly eroding the benefits of diversification. That largely explains the “whitewash” quality of the financial crisis, which spared very few asset classes. But that’s not been the story of this pullback. In fact, there have been stark differences between asset classes, with bonds holding up far better than equities and large-company stocks trumpping small-caps, as illustrated in the chart above at right. This has benefited investors who have diversified their portfolios, as shown in the chart below at right, where we show the hypothetical year-to-date returns of various asset mixes.

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**Returns of Selected Asset Classes**

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>YTD (through 8/10/11)</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Small-Cap Stocks</td>
<td>-25.00</td>
</tr>
<tr>
<td>Developing Mkt. Stocks</td>
<td>-20.00</td>
</tr>
<tr>
<td>Foreign Developed Mkt. Stocks</td>
<td>-15.00</td>
</tr>
<tr>
<td>US Large-Cap Stocks</td>
<td>-10.00</td>
</tr>
<tr>
<td>Commodities</td>
<td>-5.00</td>
</tr>
<tr>
<td>Global REITs</td>
<td>0.00</td>
</tr>
<tr>
<td>US Inv-Grade Bonds</td>
<td>5.00</td>
</tr>
<tr>
<td>US Government Bonds</td>
<td>10.00</td>
</tr>
</tbody>
</table>

**Hypothetical Portfolios: YTD Returns**

<table>
<thead>
<tr>
<th>Portfolio</th>
<th>YTD Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>100% Stocks</td>
<td>-12.0%</td>
</tr>
<tr>
<td>80/20</td>
<td>-10.0%</td>
</tr>
<tr>
<td>60/40</td>
<td>-8.0%</td>
</tr>
<tr>
<td>40/60</td>
<td>-6.0%</td>
</tr>
<tr>
<td>20/80</td>
<td>-4.0%</td>
</tr>
<tr>
<td>0/100</td>
<td>-2.0%</td>
</tr>
</tbody>
</table>

Asset classes shown are unmanaged and not available for direct investment.
Conclusion

Despite these differences, there are still risks. The economy has a smaller margin for error given persistently high joblessness, a fragile housing market, and the improbability of further massive stimulus or monetary accommodation. The European debt crisis could hobble growth in the eurozone, chilling global demand and throwing us into recession.

That said, the market has already experienced a significant pullback, as investors appear to be discounting a much higher probability of a global recession than they were a few months ago. Investors also seem to be increasingly factoring-in the possibility of a 2008-style meltdown, with all of the attendant volatility.

While those possibilities shouldn’t be taken lightly, we believe that the economy can sustain its recovery, though we expect it to remain relatively shallow and uneven. The dollar is weak, which should goose exports. The jobs market continues to improve, if tentatively, while housing is showing some signs of stabilizing. Corporate profit growth has remained strong and companies are flush, giving them the flexibility and wherewithal to reinvest in ways that stimulate additional growth. Put another way, we see more positives than the market seems to be willing to acknowledge.

With respect to a crisis, we’ve enumerated the various differences that we believe separate the recent pullback from the 2008 meltdown. The European debt crisis is no doubt serious and its resolution uncertain. But markets continue to function normally, companies are able to raise capital and finance their daily operations, debt levels and excess supply are being right-sized, and operating profit-growth is strong.

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