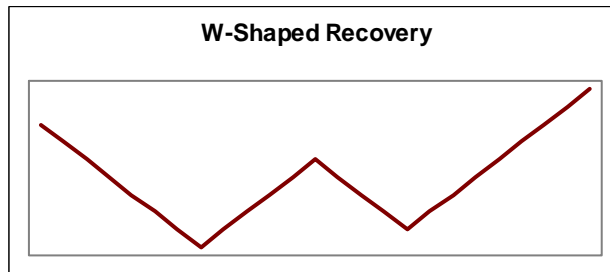
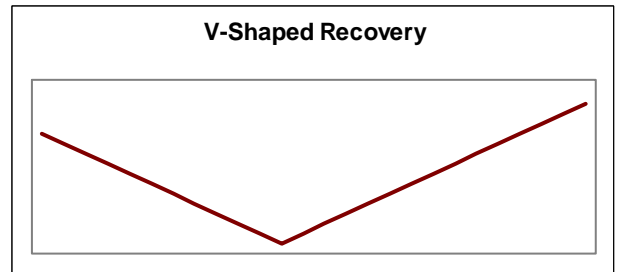


THE SHAPE OF THE RECOVERY (ALPHABET SOUP)

Peter Mallouk, J.D., MBA, CFP
Chief Investment Officer
www.thinkingbeyond.com

One can't watch or read any daily news without seeing a new perspective on the 'shape of the recovery', with economists, money managers and pundits strongly arguing their respective points. In this letter we will outline more popular theories.

A 'V Shaped Recovery' takes place when the economy rapidly contracts into recession, and is then followed by a sharp, strong recovery. A graph of an economic recovery in this fashion resembles the shape of a 'V'. Most economic recoveries resemble this shape, as historically, the harder the fall, the stronger and swifter the recovery. In V shaped camp you will find many of the world's top economists, including James Glassman of JP Morgan Chase, former Federal Reserve Governor Laurence Meyer, as well as top strategists at Merrill Lynch and UBS.



A 'W Shaped Recovery' takes place when the economy rapidly contracts, appears to sharply recover, only to collapse again before the real recovery. A graph of an economic recovery in this fashion resembles the shape of a 'W'. The early 1980's recession, one still fresh in the minds of many of our clients, is the most recent example of a W shaped recovery. In 1980, the economy fell into recession, only to quickly recover. The recovery took place so quickly that high inflation accompanied it. The Fed dramatically raised interest rates to slow inflation, only to drive the economy back into recession. The economy ultimately recovered in 1983, and continued a period of incredibly growth that went on for over 15 years. Many economists believe we are in the middle of a classic W shaped recession. They hold that the V shaped recovery we are currently experiencing is really the middle of a W shaped recovery, which means we are in for another massive move downwards before the real recovery begins. This group of prognosticators has been on the sideline with their investments, arguing that the recent 65% stock market run up is really a head fake. Famous

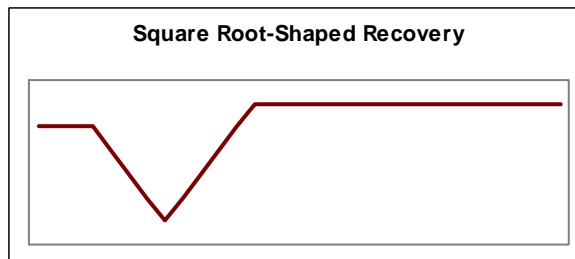
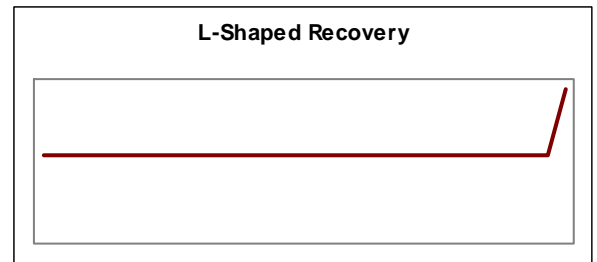
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'When the number of factors coming into play...is too large, scientific method in most cases fails. One need only think of the weather, in which case the prediction even for a few days ahead is impossible.'

-Albert Einstein

economist Nouriel Roubini (famous, that is, as far as economists go) has been a recent convert to this theory. Initially, he advocated a 'U' shaped recovery, but since that scenario is no longer possible, he has become a convert to the next most pessimistic outcome, the 'W'. With a U shaped recovery, the economy goes down sharply, stays down for a period of years, and then recovers. We have clearly had a move up, so while many scenarios are still possible, the 'U' isn't one of them. In August 2009, Paul Krugman, Nobel Prize winner, and one of the nation's most influential economists, when asked the shape of the recovery, predicted "It certainly is not going to be V shaped. I guess there might be a W but you won't be able to see it." (whatever that means).

With an 'L Shaped Recovery', the economy stays weak for many years until it finally recovers. In April 2009, Paul Krugman also predicted an L shaped recovery (yes, the same Krugman that predicted the W is also predicting the L—of course, it's not possible for both to happen). In an interview with the *Economic Times* he said "I'm in the camp that really worries about the L-shaped recession. We level off but we don't get the recovery. We hope it isn't, but it has all the markings of it. This looks like the kind of slump that has all the markings of where normal recovery forces are very, very weak." Prior to its collapse, which it was unable to predict, Lehman Brothers also predicted an L shaped recovery. An L shaped recovery has never happened in the United States. For a recent example we need to look to Japan, which plummeted into a severe recession in the late 1980s, taking nearly 20 years to recover, and never again reaching its rapid growth rates.



Quickly running out of letters, we turn to a mathematical symbol, the square root. With a 'Square Root Recovery', the economy plummets, quickly recovers, then stays flat for a period of years. George Soros, considered one of the greatest investors ever, predicts we are in

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the middle of this recovery, having plummeted and quickly recovered, only to flatline from here. Liz Ann Sonders of Charles Schwab joins Soros and many other analysts in predicting this recovery pattern. The idea of a ‘square root’ recovery is new, and there are no modern historical examples of it, but, hey, there’s a first for everything.

An investor who believes in a V shaped recovery would likely do best entirely invested in stocks, as a recovery can only happen if companies profits increase, thus driving up stock prices. An investor believing in a very sharp V shaped recovery would likely invest in real estate and commodities, knowing a strong recovery can’t happen without higher real estate prices and energy fueling the new expansion. An investor believing in a W shaped recovery would rotate from bonds to stocks, then back to bonds and once again to stocks during each step of the recovery (good luck with that). An investor believing we are in the midst of an L shaped or square root recovery would be best served in bonds, as the yield received would be one of the best investments available in an economy weak enough that companies aren’t profitable, and real estate and commodity prices stay low due to lack of demand.

‘A wise investor is focused on designing and implementing a portfolio that has the highest probability of meeting their short and long term needs, regardless of how the economy twists and turns in the short run.’

So what are all these predictions essentially worth? Absolutely nothing. The greatest minds in economics and finance can’t reach any sort of agreement, and the reason for that is that no one really knows what the recovery will look like. Two of the greatest living economists and the two probably most cited through this crisis, Nouribi and Krugman, can’t even agree with their own thoughts, changing their strongly articulated positions within months of their previous positions. Also, there have been 30 recessions in the United States. This is hardly a sample to base anything on. Our physician clients would never take seriously a study based on 30 patients. Likewise, we find it hard to take seriously that a ‘shape’ can be predicted at all. There are simply too many variables in play, and they have never interrelated in the current fashion before. Albert Einstein said, “When the number of factors coming into play...is too large, scientific method in most cases fails. One need only think of the weather, in which case the prediction even for a few days ahead is impossible.” The same can be said for the economy.

The bottom line is that investing based on guesses as to how the economy will move has a word to describe it: speculation. That’s because moving your investments around based on the unknown is a guessing game, and in the world of investing, that tends to end badly. *A wise investor is focused on designing and implementing a portfolio that has the highest probability of meeting their short and long term needs, regardless of how the economy twists and turns in the short run.* The

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majority of Americans lost a tremendous amount of money, money they will never recover, moving to cash as the market plummeted, and getting back in far too late if they got back in at all. Such are the harsh realities of investing based on the day to day notions of prognosticators.

Our position remains the same as it was before the crisis: every client is advised to hold enough high quality bonds to provide for income needs for the short run (and by short run, we mean years, not months), and enough in stocks to meet long term needs. We also recommend holding enough in real estate and commodities to reduce volatility and counter any damage the bond portion of the portfolio may encounter due to high inflation.

One other note: all major economists have their various predictions, but all of them have the word 'recovery' in it. That is a change from a year ago, when many were seriously contemplating the demise of the United States as we know it.

We remain confident that the recovery, whatever shape it takes, is inevitable. And in the end, for properly positioned investors, that's all that matters.

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