Investing Insights

LPL FINANCIAL RESEARCH:

a road to recovery

The markets are currently experiencing extreme volatility, and asset prices have declined substantially. While current markets offer attractive buying opportunities for investors, we also see continued volatility for the foreseeable future. It is important to keep the lines of communication open in times like these. LPL Financial Research believes we will have a potential multi-stage market recovery spanning across the next few quarters and possibly years. Detailed below are what we believe those stages will be and our implementation plans.

1 Liquidity Returns, Bull Market for Volatility

We believe we are in the beginning of this stage, during which LPL Financial Research is using a two-pronged approach. On the equity side, we recommend mutual fund investment strategies that potentially benefit from volatility, such as Covered Calls, Global Macro, and Opportunistic Balanced strategies. Keep in mind such strategies are subject to increased risk due to the use of derivatives and futures, may not be suitable for all investors and should be considered as an investment for the risk capital portion of the portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses. As we've seen before, strong rallies are followed by down drafts that re-test and eventually help to shape the market's bottom.

On the fixed income side, unprecedented valuations and potential opportunities are present across the fixed income spectrum, as volatility has spiked among many bond asset classes. Consequently, we recommend allocating assets from relatively more aggressive to relatively less aggressive fixed income sectors, but remain positioned to benefit when liquidity returns. Attractive opportunities exist in Municipal Bonds, investment-grade Corporate Bonds, High Yield Bonds, Bank Loans, and Preferred Stocks.

2 Light at the End of the Tunnel

We anticipate Stage 2 will begin sometime in early-to mid-2009. LPL Financial Research intends to manage this second stage of the recovery with an increased allocation to relatively more aggressive equities, as the markets react to seeing the economic growth "light" at the end of the "recession" tunnel. In this stage, we want to be invested in equities that can help in strong up markets. We will allocate out of some of the volatility thriving, less aggressive equity strategies that benefited in Stage 1 but retain the relatively more aggressive fixed income exposure that will potentially continue to pay off in this stage.

Companies and sectors that can take advantage of such markets but do not depend on economic expansion to drive sales and earnings include "recession-proof" sectors such as Healthcare and Consumer Staples. They are sort of "motorboat" investments, as opposed to "sailboat" investments that depend on economic expansion to fill their sails.

The three stages:

Stage 1
Liquidity Returns; Bull Market for Volatility

Stage 2
Light at the End of the Tunnel

Stage 3
The Next Bull Market Begins

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3 The Next Bull Market Begins

This is 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, which we believe may begin in the second half of 2009. LPL Financial Research will use Stage 3 to shift our recommendations from the "motorboats" used in Stage 2 to "sailboats" in Stage 3. Investments that potentially benefit from an economic expansion that fills their sails include cyclical sectors like Energy and Industrials, as well as REITs, Commodities, and Emerging Markets. Using these sailboats during the economic expansion that accompanies the next bull market should pay off in this stage.

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what's the plan?

Any changes LPL Financial Research makes to our models are designed to help investors with the current market volatility, liquidity, and other conditions. These timely adjustments help investors stay on track to address their long-term investment goals. As the markets move through the three stages of recovery, LPL Financial Research will continue to look for ways to position portfolios appropriately for the given market conditions. 2008 has provided a challenging market for investment professionals and the clients we serve. LPL Financial Research remains dedicated to finding ways to help our advisors provide the best advice possible to you in this, as in any, market environment.

Covered Calls: These strategies typically hold a long portfolio of stocks and then sell covered calls. Some covered call strategies then buy puts to further protect against downside risk. The net result is a portfolio that is correlated to the broader markets, but with significantly less volatility.

Global Macro: These funds are similar to Managed Futures funds, but use fundamental inputs (focused on broad global economic themes) in their models as well as technical (or price related) inputs. Global Macro funds may also be less systematic than the typical Managed Futures fund. Historically, the benefit of Managed Futures and Global Macro has been solid long-term returns with very low correlation to equities and fixed income securities.

Opportunistic Balanced strategies: Balanced funds invest in stocks, fixed income securities, and sometimes, money markets. Traditional Balanced funds typically invest in some combination of "plain vanilla" securities: domestic and international stocks and fixed income investments—such as Treasury Bonds, Agency Bonds, Investment Grade Corporate Bonds, High-Yield Bonds, and Foreign Bonds. An Opportunistic Balanced fund will, in addition to the more traditional securities, use relatively more eclectic securities—Preferred Stocks, Convertibles, Synthetic Convertibles, Warrants, Futures, Options, Currencies, and others—with the goal of outperforming its benchmark.