Miracle Mile ADVISORS

Providing Global Opportunities for the Risk-Aware Investor

The Case for Scenario Analysis

Financial pundits are full of doom and gloom these days, making bold statements that current economic conditions are some of the worst in their lifetimes. Since one of the cornerstones of Miracle Mile Advisors' investment process is our downside risk analysis, we wanted to see if in fact this downturn is one of the worst in history, or if our scenario analysis has proved an accurate guide.

In the chart below, we compare the current market environment, which we call the "Housing & Credit Collapse" with the most recent bear-market scenario, the "Post-Tech Bubble + September 11" time frame. We find that while the specific underlying macro conditions are somewhat different, the performances of the MMA Model Portfolios are very much in line with expectations based on the post-Tech bubble period.

The Backdrop

From the mid-1990s through early 2000 equity markets were soaring, led by the Information Technology sector. Easy credit, leverage, and speculative investors led to an explosion of dot.com start ups and 22 year old entrepreneurs. Some analysts were calling it a new paradigm, where growth was unstoppable despite the fact that many burgeoning tech companies had no earnings to report for the foreseeable future. On the other side of the coin, some were calling for a dramatic pop of the Tech balloon; there were no fundamental underpinnings for what was happening in the markets and a correction was inevitable. Finally, things started to unravel. Start-ups ran out of capital, accounting scandals dominated the headlines, Wall Street analysts were fired for misleading investors, and many people lost much of their investment capital as companies went bankrupt. On the back of this market scenario, the September 11th attacks occurred virtually paralyzing the U.S. economy. A recession ensued and the equity markets fell for the next three years.

	Full History	Post-Tech Bubble + September 11	Housing & Credit Collapse
Beginning Month	Jan-88	Apr-00	Oct-07
Ending Month	Jun-08	Feb-03	Jun-08
Number of Months	258	35	9
Asset Class Annualized % Return During Period			
US Equity	10.8%	-16.8%	-19.3%
International Equity	6.7%	-19.5%	-16.3%
Fixed Income	7.4%	10.1%	5.6%
NASDAQ Composite	9.4%	-34.4%	-19.6%
REIT Index	11.8%	13.3%	-20.5%
Real Assets	7.6%	11.5%	46.6%
Correlation of US Equity & Fix. Inc.	0.17	-0.41	-0.40
Economic Data During Period			
CPI Inflation (Annualized Avg.)	3.1%	2.5%	4.8%
GDP Growth (Annualized Avg.)	2.9%	1.5%	1.0%
Fed Funds Target Rate			
Beginning of Period	6.75%	6.00%	4.50%
End of Period	2.00%	1.25%	2.00%
Change	*-4.75%*	*-4.75%*	*-2.50%*
Unemployment Rate			
Beginning of Period	4.60%	3.80%	4.80%
End of Period	5.50%	5.90%	5.50%
Change	*0.90%*	*2.10%*	*0.70%*
Conservative Investor Portfolio			
Annualized Return	9.56%	-0.96%	-0.11%
St. Deviation	6.61%	7.28%	7.23%
Moderate Investor Portfolio			
Annualized Return	10.28%	-6.23%	-5.05%
St. Deviation	8.95%	10.72%	10.64%
Aggressive Investor Portfolio			
Annualized Return	10.96%	-9.70%	-7.80%
St. Deviation	10.89%	13.30%	13.49%

Source: Federal Reserve, Bureau of Economic Analysis, Bureau of Labor Statistics, U. S. Dept. of the Treasury, Yahoo! Finance, REIT.com, S&P, Russell, MSCI, Lehman Bros.

From the early-2000s through mid 2007, equity markets were climbing along with a red-hot real estate market. Interest rates were at historical lows as officials eased the federal funds rate down to 1% in order to lift the U.S. out of the 2001 recession. Average Americans were using this easy credit to leverage their spending habits with home equity credit lines and mortgage refinancing. People who could never before afford to own a home were buying with no money down, adjustable-rate mortgages, and interest-only payments. Speculation ran rampant as people bought multiple houses to "flip" and turn a quick profit. Housing prices were rising at break-neck paces, with the hottest markets like Southern California, Miami and Las Vegas rising 20%+ per year. People thought it was impossible for their real estate investments to lose money and bought homes well above what they could afford. Analysts predicted that the frenzy had to end, and the only question was whether it would be a "rust or bust" finale. As interest rates started to rise, a soft landing turned into a "bust" by mid-2007 as mortgage lenders were hit with huge losses from the sub-prime mortgages they extended to below-credit worthy borrowers. These problems soon spread throughout the financial sector when mainstream investors found themselves holding bundles of these sub-prime loans, repackaged as investment-grade debt. Access to credit began drying up, major banks recognized hundreds of millions of dollars of losses, and Bear Stearns nearly failed only to be rescued by a government-orchestrated takeover. Currently, record high oil and food prices, a weak dollar and negative real interest rates are fueling inflation fears in the midst of slowing growth.

It's (Not) Different This Time

Looking at the two economic scenarios side by side highlights the similarities. Easy money spurs growth in a particular sector or asset class, people pile in looking for a quick buck, a speculative run-up ensues followed by the inevitable pop. Despite calls that this is the worst crisis since the Great Depression, it really is not that different this time. In fact, history tends to repeat itself, which is why we believe strongly in historical scenario testing to gauge the sensitivity of our portfolios to various conditions.

Scenario Testing

When we sit down with a client to build their strategic allocations, one of the most important discussion points is the concept of downside risk. Our goal is to build a core, diversified portfolio that can weather market turmoil as well as reap the rewards of a bull market, and we want our clients to understand how that is accomplished.

	Full History	Post-Tech Bubble + September 11	Housing & Credit Collapse
Beginning Month	Jan-88	Apr-00	Oct-07
Ending Month	Jun-08	Feb-03	Jun-08
Number of Months	258	35	9
Conservative Investor Portfolio			
Annualized* Return	9.56%	-0.96%	-0.11%
St. Deviation	6.61%	7.28%	7.23%
Moderate Investor Portfolio			
Annualized* Return	10.28%	-6.23%	-5.05%
St. Deviation	8.95%	10.72%	10.64%
Aggressive Investor Portfolio			
Annualized* Return	10.96%	-9.70%	-7.80%
St. Deviation	10.89%	13.30%	13.49%
S&P 500			
Annualized* Return	10.82%	-16.79%	-19.28%
St. Deviation	13.66%	17.80%	14.39%

This table highlights our MMA Conservative, Moderate and Aggressive portfolio returns during the scenarios we have described. Our current allocations would have produced annualized* (one-year) returns of -0.96%, -6.23% and -9.70%, respectively, for our models during the 35-month market peak to trough. During this same period, the S&P 500 fell -16.8%.

So how does this compare with what has happened during the current decline, measured since the market peak in October 2007? It compares very well, meaning that the "Post-Tech Bubble + September 11" scenario served as an excellent gauge for the current downturn. On an annualized* basis, our model portfolios have returned -0.11%, -5.05% and -7.80%, which is slightly better than what the Post-Tech scenario would have predicted. During this period, the S&P 500 has declined at an annualized* rate of -19.3%.

This example highlights how our scenario-based analysis can help us build the most appropriate allocation for our clients' risk tolerance. We believe that using real historical scenarios helps clients relate their current investments to their experiences in past markets. Of course our allocations may change as market conditions produce new opportunities, but our goal of providing active indexing outperformance never waivers.

* Annualized return means equivalent to a 12-month return. Since the current decline has been only 9 months, we extrapolate the rate of return as if it continued for another 3 months. On the other hand, the Post-Tech decline lasted 35 months; therefore, we represent that return as the average 12-month return.

Disclosures

The views of Miracle Mile Advisors, Inc. ("MMA") may change depending on market conditions, the assets presented to us, and your objectives. This research is based on market conditions as of the printing date. The materials contained above are solely informational, based upon publicly available information believed to be reliable, and may change without notice. MMA makes every effort to use reliable, comprehensive information, but we make no representation that it is accurate or complete. We have no obligation to tell you when opinions or information in this report change.

MMA shall not in any way be liable for claims relating to these materials, and makes no express or implied representations or warranties as to their accuracy or completeness or for statements or errors contained in, or omissions from, them.

This report does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The securities discussed in this report may not be suitable for all investors. MMA recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a financial adviser. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives.

This report is not an offer to buy or sell any security or to participate in any trading strategy. In addition to any holdings that may be disclosed above, owners of MMA may have investments in securities or derivatives of securities mentioned in this report, and may trade them in ways different from those discussed in this report.

The value of and income from your investments may vary because of changes in interest rates or foreign exchange rates, securities prices or market indexes, operational or financial conditions of companies or other factors. There may be time limitations on the exercise of options or other rights in your securities transactions. Third-party data providers make no warranties or representations of any kind relating to the accuracy, completeness, or timeliness of the data they provide and shall not have liability for any damages of any kind relating to such data.

The information and analyses contained herein are not intended as tax, legal or investment advice and may not be suitable for your specific circumstances; accordingly, you should consult your own tax, legal, investment or other advisors, at both the outset of any transaction and on an ongoing basis, to determine such suitability. Legal, accounting and tax restrictions, transaction costs and changes to any assumptions may significantly affect the economics of any transaction. MMA does not render advice on tax and tax accounting matters to clients. This material was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. federal tax laws.

The projections or other information shown in the report regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results.

Other Important Disclosures

Physical precious metals are non-regulated products. Precious metals are speculative investments and, as such, their value can be subject to declining market conditions.

Real estate investments are subject to special risks, including interest rate and property value fluctuations as well as risks related to general and local economic conditions.

Foreign/Emerging Markets: Foreign investing involves certain risks, such as currency fluctuations and controls, restrictions on foreign investments, less governmental supervision and regulation, and the potential for political instability. In addition, the securities markets of many of the emerging markets are substantially smaller, less developed, less liquid and more volatile than the securities of the U.S. and other more developed countries.

This report or any portion hereof may not be reprinted, sold or redistributed without the written consent of MMA.

Additional information on recommended securities is available on request.

Miracle Mile Advisors, Inc. | 499 North Cañon Drive, Suite 301, Beverly Hills, CA 90210 | tel 310.887.7075
www.MiracleMileAdvisors.com | info@MiracleMileAdvisors.com