Miracle Mile ADVISORS

Providing Global Opportunities for the Risk-Aware Investor

What Does It Mean To Be Defensive?

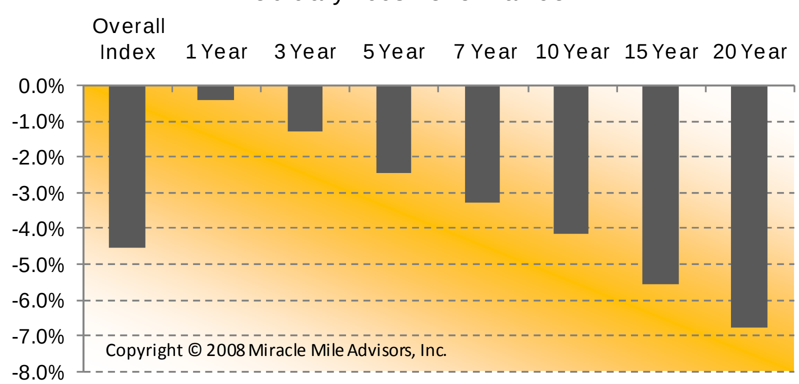
A common definition of the word *defensive* is, "performed so as to avoid risk or danger." We can relate to what this means when it comes to driving defensively, but what about when it pertains to investing? Is *avoiding* risk really our goal? For most investors, and certainly for Miracle Mile Advisors, the answer is No. We do not want to avoid risk – without taking on risk we would all be parked in cash, not even keeping up with inflation – but we do want to manage it efficiently and profitably, regardless of the market environment.

Investing Defensively, Circa 2008

Stocks and bonds historically have had an inverse relationship. As a result, a defensively-positioned portfolio traditionally meant weighting it heavily toward fixed income. While this relationship still largely holds, there are several reasons that this simple strategy is not sufficient in today's markets.

1. ***Not all areas of the fixed income market provide the same degree of safety.*** In February, Treasurys posted solid total returns, but the broad Lehman Municipal Bond Index fell nearly -5% as a record number of auctions in these securities failed. Some investors' capital has been locked into these supposedly-liquid securities due to a lack of interested buyers. With the S&P 500 Index also down -3.3%, many individual investors, who flock to Munis for their tax-efficiency and safety, took quite a hit in February.

Lehman Municipal Bond Index
February 2008 Performance



Source: Lehman Brothers

2. ***Treasury yields are already near historically low levels.***

10-Year Treasury Yield

Source: U.S. Treasury Department, Federal Reserve Bank

The U.S. market closed the day on March 14 with the 10-year Treasury yielding 3.44%. With current CPI inflation running at 4.3% year-on-year, and some concerns about accelerating inflation, yields have little room on the downside. In fact, with the 2-Year Treasury yield at 1.47%, we already have a negative real yield (real yield = nominal yield – inflation).

3. ***“Maintain diversification” should be investors’ mantra, not “let’s get defensive”.*** Regardless of the market environment, a prudent investor should always maintain some exposure to *non-correlated* asset classes like commodities and Treasury Inflation Protected Securities (TIPS). Instead of trying to market time moves between fixed income and equities, a consistently diversified portfolio will reduce volatility, decrease the chance of getting whipsawed by a market turn, and provide protection against inflation, currency deterioration and market downturns.

But Are Diversifying Assets Like Commodities Overheated Right Now?

The falling equity market has certainly put commodities into play as a pure investment tool. The proliferation of Exchange Traded Funds tracking these assets, particularly gold, has made investing in these somewhat obscure vehicles easier than ever. According to research from Macquarie Bank in London, investment in commodity index tracking funds has surged from $10Bn in 1998 to $142Bn in 2007, with another $30Bn flowing in during the first two months of this year. There is no question that the deluge of investors seeking return and safety has inflated the prices of some commodities, however many have strong fundamental backdrops supporting these higher prices.

The Supply/Demand Case

Commodity prices are determined by their supply-demand relationships, and almost across the board these relationships are tight. Power interruptions in metal-producing countries such as China and South Africa have impacted supplies of gold, copper, platinum and aluminum. Agricultural commodities are experiencing multi-decade lows in reserves due to extreme weather patterns in the U.S., China and Australia. OPEC decided to cut production of oil in both 2006 and 2007 constraining supplies. Meanwhile ongoing geopolitical tensions in the oil-producing areas of the Middle East and Latin America have also inflated prices with a higher risk premium.

On the demand side, world population growth all but assures continued pressure on agricultural commodity supplies. Corn and grain are tapped not only for direct food supply, but also are used as sources for alternative energy. China is second only to the U.S. in world corn production, yet its supplies are so stretched that it may need to begin importing corn from the U.S. this year to meet its food and fuel-grade ethanol production needs. If the Emerging Markets are indeed “decoupling” from developed countries, their continued growth should make even greater demands on world commodities supplies going forward.

Gold is one of the most hotly debated is-it-or-isn't-it-a-bubble? commodities, particularly as it tops $1000 per ounce for the first time. While a pull-back could slow down the acceleration in gold, we believe there are many pillars of support for continued strength:

- On an inflation-adjusted basis, gold is far from its historic high of $2,150, set in 1980 at a nominal price of $840.

- A free-falling U.S. dollar and aggressive interest rate cuts from the Federal Reserve have investors fleeing dollar-denominated assets in favor of the hard metal. We do not foresee either of these trends reversing in the near term.

- Demand for an inflation hedge grows as the prices of food and oil continue to skyrocket, and central banks remain more focused on stimulating economic growth than subduing inflation.

Diversified, Not Defensive

Although commodities currently may be attracting investors seeking quick returns, we believe that they should remain a defensive component in our clients' portfolios. As the fixed income municipal markets battle their issues, commodities and TIPs have provided a valuable hedge against inflation, a declining dollar, and equity market turmoil.

When credit spreads start to narrow (see our February research piece, *"Credit's Cheap, But It Ain't Easy"*), and investor confidence returns, equities could become a strong buy at these valuations. We are not at that point, yet. With uncertainty continuing to embroil the markets, we remain focused on strategically defending our clients' assets against further downturns. As the saying goes "a good defense is sometimes the best offense." We believe that *"a diversified portfolio is the best offense"* for our long-term investors.

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