the Whitepaper

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Highlights

Where are we on the Road to Recovery?

- LPL Financial Research is prepared to declare that the markets are currently transitioning from the defensive Stage 1 to the opportunistic Stage 2 of our 3-stage Road to Recovery.

What are the signs?

- The market looks for the economic growth "light" at the end of the recession "tunnel" to signal the turning point of an economy from one that is getting worse to one that is getting marginally better (or at least less worse).

What to do?

- After recommending a defensive posture since October 2008, LPL Financial Research now believes that neutral risk is the ideal target.
- For portfolios overweight stocks, we suggest watching portfolio levels and trimming any exposure to Developed International Equity and REITs.
- For portfolios significantly underweight stocks we would suggest dollar-cost averaging* in some risk to begin to position portfolios closer to neutral beta.

*Such a plan involves investment in securities regardless of fluctuation in price levels of such securities. An investor should consider their ability to continue purchasing through periods of low price levels. Such a plan does not assure a profit and does not protect against loss in declining markets.

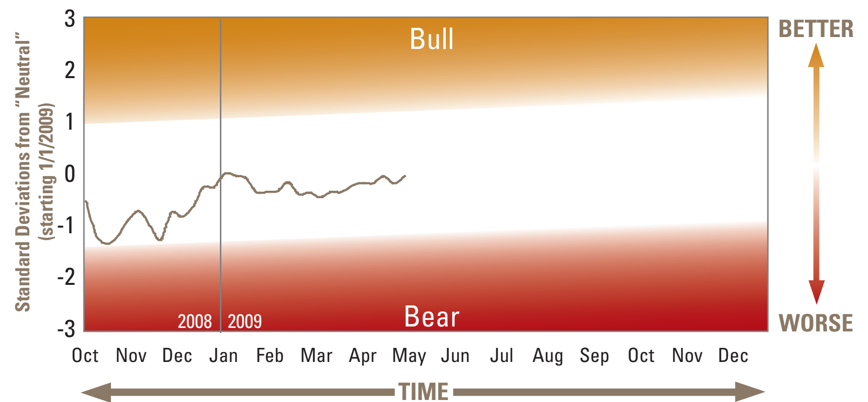
The Party is Close to Starting But Be Fashionably Late

One of the biggest social faux pas is to arrive too early to a party. Waiting around the punch bowl for other guests to arrive can seem like an eternity. Plus the party hosts are oftentimes still running around in preparation and you end up being drafted to help with final party tasks, like stocking the cooler or hanging decorations. It is often better to be fashionably late. But the trick is to peg exactly the right time. If you are too early, it can show you are overly anxious to join in the festivities but being too late means you miss much of the fun.

The same is true with investing. Following an extended bear market, which is kind of like a barren social agenda in the party metaphor, joining the market recovery "party" is often one for which investors either arrive too early or too late. The real key is to stay relatively defensive until it is the right time to re-engage the market "fashionably late" but with plenty of time to still get in on the recovery. Finding the most opportune time can be a tricky endeavor for investors, but by following a few "party" arrival techniques, investors can adopt strategies, instead of guesswork, to steer their portfolios to best take advantage of emerging opportunities presented by an improving market and a healing economy.

The good news is that the next market recovery "party" is likely coming soon. The economic backdrop has improved markedly over the last three months as consumer confidence has improved, retail sales have accelerated, and credit markets have become less frozen. While there are still tough roads to cross in this economic recovery, the backdrop has begun to show signs of improvement. LPL Financial Research's Current Conditions Index, a real time indicator of the acceleration or degradation of the economy, has shown steady improvement as of late and points solidly toward the economy validating our base case beliefs of an improving economic foundation and a return to economic growth by the end of 2009.

LPL Research Current Conditions Index



Source: LPL Financial

It is important to realize that the market recovery begins well before the end of the recession. The market is a forward looking machine that does not wait for the "all clear" signal to be sounded.

As a result, LPL Financial Research is prepared to declare that the markets are currently transitioning from Stage 1 to Stage 2 of our 3-stage Road to Recovery. It is our opinion that the recent economic improvements and the subsequent positive market action signal the change in investment strategy from the defensive Stage 1 to the opportunistic Stage 2. Despite the favorable backdrop, however, we remain cautious about redeploying excessive risk into a market that has risen so far, so fast. We want to be deliberate in repositioning portfolios in the face of a potentially short-term overbought market. Nonetheless, the time is close to begin to add risk back into portfolios and reposition for a longer term market advance. In other words, the party has started; we just think investors should be cautious in their arrival and use patient portfolio management techniques in an attempt to re-engage the market recovery "party" fashionably late.

How Do You Know That the Party is About to Begin?

Well, you first have to wait for the invitation. With investing, this is often difficult as the market does not mail out invites to announce that the market bottom has been established and the time to buy has returned. Instead, the invitations are often hidden in fundamental and technical data that require deciphering.

On the fundamental side, it is important to realize that the market recovery begins well before the end of the recession. The market is a forward looking machine that does not wait for the "all clear" signal to be sounded. Rather, it looks for the economic growth "light" at the end of the recession "tunnel" to signal the turning point of an economy from one that is getting worse to one that is getting marginally better (or at least less worse). The mistake that many investors make is that they want to wait until the economy is entirely better before re-entering the market. While this sounds logical, one must always remember that the market and the economy are not the same thing. Markets can and usually do show improvement before the end of a recession, which rewards investors that are early, but not too early, to the "party".

When Recent Success Turns into Long-Term Success

From a technical or quantitative perspective, the objective is to uncover when short-term improvements turn into long-term success. When this occurs, it typically signals a successful backdrop for investing and risk taking. To determine when these favorable periods for investing begin, we need to watch for evidence that the market's shorter term performance is reverting back and crossing over it's longer term return pattern, which indicates a favorable backdrop for investment success.

The most common signal to watch for is the confirmed crossover of the 50- and 200-day moving averages (DMA). The calculation of both is quite simple. The 50-day moving average is the simple average of the last 50 days of an investment's price, while the 200-DMA is the simple average of the last 200 days. Obviously, when the market turns negative, the 50-DMA move lower at a faster rate than does the 200 DMA. The reverse is true on the way back up.

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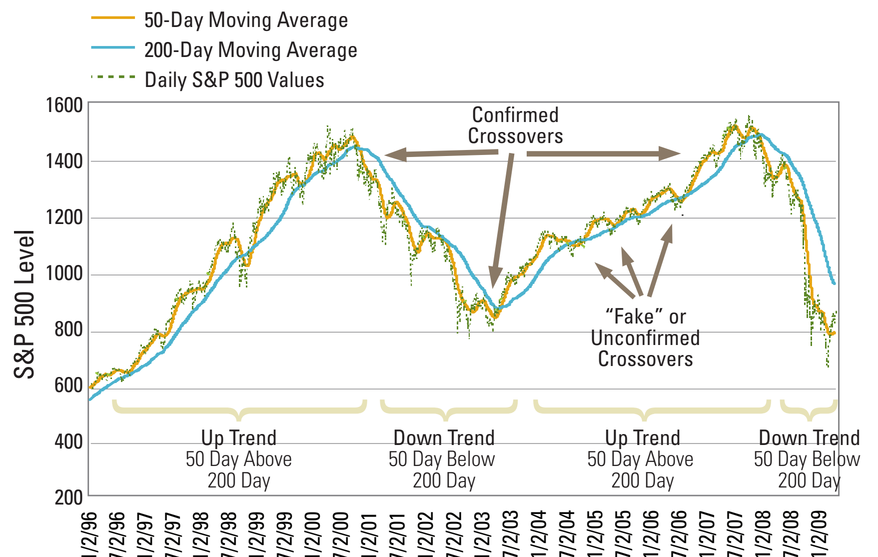
For a meaningful signal that the down trend cycle has come to an end, technical investors look for when the 50-DMA crosses back over the 200-DMA and stays above for a meaningful period, which we refer to as a "confirmed" crossover. This is usually the sign that the down trend has turned into an up trend and that the market has officially found its bottom. Notice in the chart below the three times when the 50- and the 200-day moving averages had a confirmed crossover and signaled a trend reversal. Currently, the 200-DMA is still somewhat above the 50-DMA, but the gap is closing fast as the 50-DMA has begun to swing higher given the recent market bounce but the 200-DMA continues it's descent.

Turning Points for the S&P 500 Index Occur at Crossover Points



Source: LPL Financial

So, When is the Right Time to Hit the "Party"?

LPL Financial Research thinks that the time is close, but not yet. While much improvement has been made on the economic front, we still have obstacles to overcome before the "all clear" siren blares. However, the fundamental backdrop has improved and we are close to having a confirmed crossover of the 50- and 200-day moving averages.

In fact, if the market stays unchanged, the crossover of the 50- and 200-DMAs will occur around the middle of June at around 900 on the S&P 500 Index. If we assume the market advances another 8% over the next month, which happens to be the performance for the trailing 4-week period through May 6, 2009, then the crossover will be even sooner—about a few weeks away in early June at just above 900. Given that the market as of this article's publication date is trading around 920, LPL Financial Research believes that further upside is probable given we are trading near the expected "break-even" crossover level. This means that the market recovery "party" is likely right upon us and investors have to begin to get ready to reposition their portfolios to take advantage.

What Is the Dress Code for the Party?

Even if investors arrive at the right time for the party, making sure you have the correct dress code is essential. It is quite embarrassing to show up for a formal event dressed as your favorite Harry Potter character thinking it was a costume party. For investing, establishing the right "dress code" is simply making sure your portfolio emphasis is on the most optimal investments to help take advantage of the market's recovery.

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For portfolios that are neutral beta, indicating benchmark like risk, we would suggest staying put. After recommending a defensive posture since October 2008, LPL Financial Research now believes that neutral risk is the ideal target. Given that the risk/reward relationship for the market is balanced between further gains or a smallish retest, we believe maintaining benchmark-like risk is the most optimal strategy. However, we would use this opportunity to refocus stock exposure to more cyclical areas of the market to prepare for the soon to be arriving market recovery "party". We suggest reallocating less attractive opportunities in Large Cap, Developed International (Large Foreign), and REITs in favor of the economically sensitive areas of Emerging Markets, Commodities, Small Caps, and Mid Caps.

For portfolios overweight stocks, you have arrived a tad early to the party. While we would not suggest leaving, watching portfolio risk levels will be important. If beta is well above the benchmark, we suggest trimming any exposure to Developed International Equity and REITs. We would use this time to establish larger exposures in Emerging Markets, Commodities, Small Caps, and Mid Caps.

For portfolios significantly underweight stocks, you are taking a bit long to get ready for this party and run the risk of being too late. We would suggest dollar-cost averaging in some risk to begin to position the portfolio closer to neutral beta. We would start on the fixed income side by overweighting High Yield, Investment-Grade Credit, and Bank Loans. On the stock side,

look to establish positions in Emerging Markets and Commodities, while adding exposure to Small and Mid Cap equity. While a small retest of the market, if it occurs, will test your resolve, adding risk in the 900 range on the S&P 500 is likely an attractive entry point for portfolios that have been defensive through this market's sell off.

Conclusion

Everybody loves a party. The market appears poised to prolong its advances as the economic backdrop continues to show signs of improvement. With Stage 2 of the Road to Recovery right around the corner, now is the time to begin preparing for the transition from a defensive to a neutral position to an eventual opportunistic portfolio posture. Make no doubt about it, this is the social event of the year, so be sure to arrive fashionably late and be sure your portfolios have the right dress code.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

High yield/junk bonds are not investment grade securities, involve substantial risks and generally should be part of the diversified portfolio of sophisticated investors.

The market value of corporate bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield.

Beta measures a portfolio's volatility relative to its benchmark. A Beta greater than 1 suggests the portfolio has historically been more volatile that its benchmark. A Beta less than 1 suggests the portfolio has historically been less volatile than its benchmark.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price.

Stock investing involves risk including loss of principal.

International and emerging markets investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

The fast price swings in commodities will result in significant volatility in an investor's holdings.

Mid capitalization companies are subject to higher volatility than those of larger capitalized companies.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

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