

By Jeffrey G. Johnson

Bear Market Takes Down Bear Stearns

Despite repeated efforts by the Federal Reserve to lower companies' and consumers' borrowing costs and jump-start lending activity, the financial markets struggled in the first quarter of 2008 in the face of a credit contraction, a slower economy, and declining corporate profits. The economic and financial woes have taken a toll, with the average U.S. diversified stock mutual fund finishing the quarter off 8.9%, one of the worst showings since the post-technology-bubble bear market. The widely watched Dow Jones Industrial Average declined 7.0% while the S&P 500 and tech laden NASDAQ slid 9.4% and 13.9%, respectively. After soaring for much of this decade, international stocks joined the losers' crowd, with most categories down 9% or more for the quarter.

The magnitude of the unprecedented steps the Federal Reserve and U.S. Treasury have had to take in an effort to bail out the U.S. financial system and save investment bank Bear Stearns from a potential collapse speaks to the depth of the problems we are facing. Besides encouraging the buyout of Bear Stearns, the Fed lowered the federal funds rate from 4.25% to 2.25%, dropped the discount rate (the rate at which a limited number of institutions can borrow directly from the Fed) from 4.75% to 2.5%, opened the discount window to investment banks, and reduced the capital holding requirements for Fannie Mae and Freddie Mac.

The Fed's rate cuts had a positive effect on bond prices (prices move inversely to yields) as the Lehman Brothers Aggregate Bond index produced a total return of 2.28% in the first quarter. By contrast, high-yield bonds declined 3.6% as investors sought the safety of lending to the feds. While government treasury fund returns ranged from 2% to 4%, the dual benefit of falling interest rates and a declining dollar boosted the international fixed income category to a 5.2% gain.

Just about any way you cut it, the U.S. markets' first quarter was ugly. It was hard to find a haven, as many equity categories fell sharply. The telecommunications and technology sectors were among the hardest hit, down 18.4% and 15.9%, respectively. Even healthcare focused investments, traditionally a defensive holding because health-care spending generally continues regardless of economic conditions, got hit as the average health-care fund was down 10.8%. Only the gold oriented precious metals sector was able to buck the negative trend, gaining 5.6%.

As expected, in a slower U.S. economy, bigger companies with global exposure fared better than small U.S. based companies, although both styles suffered. The average large cap growth gave back nearly 90% of its 13.4% 2007 gain, falling 11.7% in the first 90 days of '08. Small cap growth funds suffered even more shedding 14.4%, almost double their entire '07 return of 7.8%. Even value funds were hit by their traditionally heavy exposure to dividend-paying bank stocks as large and small cap value funds lost 9.4% and 6.9%, respectively.

