

Assessing Risk & Opportunity

Below we provide our opinion on what we perceive to be an upcoming period of potentially high equity risk. If our opinion is accurate, it could suggest that investors consider other opportunities that could help deal with increasing equity volatility, avoid potential capital loss while helping to provide income/return until stability returns.

The Basis of Our View

Most major equity markets are at three-year highs (some like the small cap Russell 2000 just reached new all-time highs in April) and earnings have been amazingly robust. For most of this tremendous run, most market pundits' forecasts were cautious. Now, many of these same pundits think new historic highs are in sight. So what merits this newfound belief? The answer is a combination of historical data suggesting equity markets rarely surge after such an extended price run up, combined with, a number of major uncertainties posing significant challenges to the health of the equity markets. Some obvious examples: the Middle East's instability threatens the long-term supply and hence price of oil; quantitative easing by central banks and government spending appear to be igniting the first signs of global inflation; stubbornly high unemployment continues to impede the domestic economic recovery; the European Debt Crisis is still simmering; emerging market countries have begun to significantly tighten monetary policy and now Japan, with its terrible earthquake and nuclear fuel situation, clouds the stability of the global economic supply chain.

What Could Investors Do?

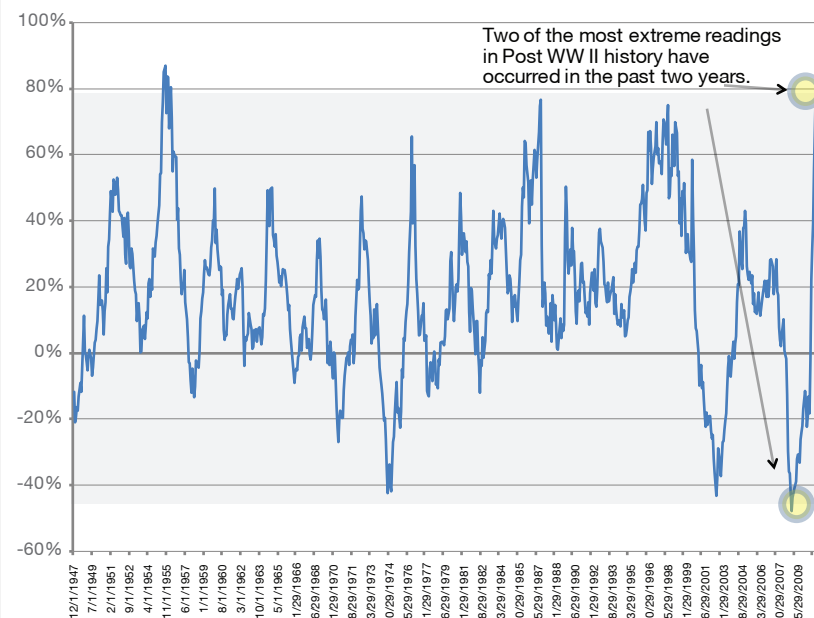
In our opinion, the answer to this question can be simple and complex. The simple answer is that in uncertain times, it is strategically correct to emphasize safer, short-term investments generating yield while providing flexibility to redistribute capital as things stabilize. The complex part comes about because there are very few investments currently fit this criterion. Today, most short-term investments offer liquidity and short-term safety but generate very little yield. As a result, there is a choice of either investments providing short-term safety and little return or more risky investments with potential yield encompassing the possibility of

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losing a great deal of their initial investment.

Not surprisingly, there is no perfect solution to this dilemma. We do think, though, there are factors investors should consider. To start, we believe the equity market is an excellent long-term barometer for measuring the economy's underlying strength. Historically, equities have alternated between decades of outsized returns with decades of sub-par returns. The past two decades are perfect examples. The 1990's were a strong period for the U.S. economy, during this decade the S&P 500 rose by 351%. In contrast, this last decade, noted for its slow growth, saw the S&P 500 decline by 24% (Sources: Bloomberg and S&P). Aside from the long-term correlation between equity returns and the economy, in the short-term, equity prices can (and do) become unpredictable like during the Tech Bubble (1999-2000) and the recent Financial Crisis (2008-2009). Because of the possibility of short-term equity performance that veers from long-term economic trends, it's important to recognize these periods as they represent opportunities to either increase risk (buy) or decrease risk (sell).

Fig. 1 - S&P 500 Two Year Rolling Return



Of course, there is no crystal ball to assess this condition. Instead, investors must look at clues that suggest its presence, such as the pace of past performance of the equity markets, which we believe provides a gauge of expectations. Consider the chart (Fig. 1) which shows the two year rolling price return of the S&P 500 since 1945. Note from 1947 through 2007 the S&P's 24-month price return stayed within a clearly definable bandwidth. In fact, the only times it exceeded this range were in 1955 and in the past two years (when both the bottom and top of the range were exceeded). In other words, these extremes have only happened three times in the past 65 years and two of them were very recent.

Two Conclusions

We believe there are two main conclusions to take from this data. The first is when the S&P 500 has such a powerful advance, it rarely sustains it over the short term. To illustrate this, if you look at the periods of price gain readings above 70% over a rolling 24-month period from January 1947 through April 2011, which has occurred 14 times, the subsequent 12 month return was 1.3%. Only the 1998 readings went on to generate strong 12-month returns (16.8% and 18.6%) and removing these 1998 readings results in a negative -1.7% return for the remaining 12 observations.

Interestingly, the data for the 24-month average return is slightly higher at 2.6% but that is also only because of the two readings from 1998 that can be attributed to the power of the Tech Bubble in 1999 and early 2000. Removing those two readings results in an average of -2.7% for the 24-month returns **with over 63% of the 24-month readings being negative.**

Fig. 2 - Subsequent S&P 500 12 & 24 Month Performance

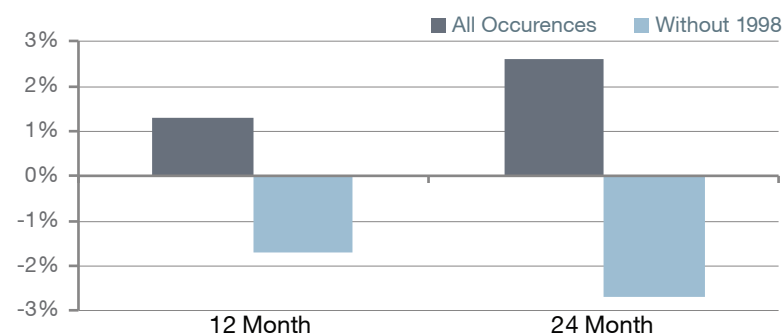
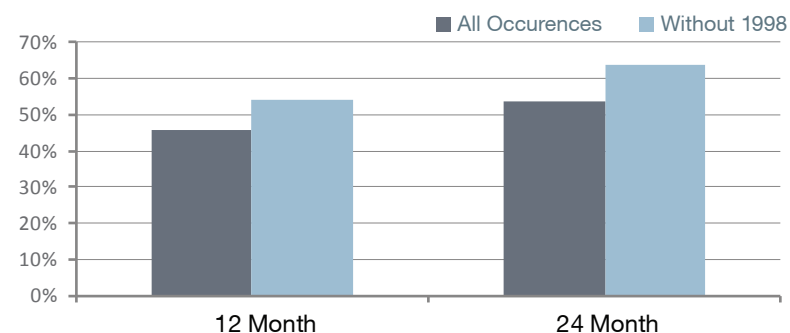


Fig. 3 - Percent Subsequent S&P 500 12 & 24 Month Returns are Negative



The second conclusion we draw is the economic circumstances surrounding 1998 were very different than those of today. We feel this suggests future equity gains will probably remain muted, consistent with the historical record. Without getting into great detail, in 1998 the U.S. economy was five years into an incredibly powerful expansion that was amplified by the Federal Reserve's rate cuts in response to the Asian Crisis. Obviously a different set of circumstances are now in place.

If history is any indication, we believe this evidence suggests that for current equity investments, caution should prevail. It is likely equity prices will meander, or even decline, for another year or two before we see any meaningful resumption upwards. ■

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