The Financial Navigator – July Newsletter

In this issue of the Financial Navigator we provide some commentary on the just ended 2nd quarter and the recent market volatility. In addition, we review the latest performance results comparing active investment managers to their respective indexes. After seeing the results you may want to consider why you are paying that active mutual fund manager 6-10 times more than the respective index fund that routinely beats him or her. If you think the 0.25%-1% expense difference between the two types of funds isn't significant, then essentially you are saying \$50,000/\$100,000/\$200,000, or more, depending on the size of your current portfolio and savings rate, is irrelevant to your retirement. Might be something to keep in mind as you review your portfolio or meet with your broker who is pushing the latest hot investment manager, or '5 star fund'.

Please feel free to forward this newsletter to any individuals that you may think might be interested. Thanks and enjoy the remainder of the summer.

Sincerely,
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<u>2nd Quarter Commentary</u>

After 2008's sharp decline and last year's recovery in stock markets, many had hoped that 2010 would see a return to relative normalcy and stability. And certainly, the year started on a positive note, as stocks turned in one of the strongest first quarter increases on record. Then, in rapid succession came:

- The intensification of the budget crisis in Greece that arose in February, with the risk of contagion across Europe.
- Concerns that European budget cuts would slow down economies, with spillover effects globally; this is especially problematic in light of the need to compete with a devalued euro.
- Growing fears about a housing bubble in China.
- The April 22 sinking of a BP oil drilling rig in the Gulf of Mexico.
- The May 6 "flash crash" in which US markets plummeted in a matter of minutes without explanation.

Looking at these events, it's tempting to ask what the next catastrophe will be. In fact, based on these last six months, history may view this as "the calamitous decade," even though we're only 5% into it. In talking to our clients about how portfolios should be positioned in light of this, I point to some of the guiding principles from Benjamin Graham, considered the father of value investing. Starting in 1926, Graham taught at Columbia University and wrote on investments for thirty years, bringing a new level of rigor to security analysis. His views and approach shaped a generation of money managers, among them Warren Buffett, who enrolled at Columbia with the explicit goal of studying with Graham and who joined his firm after graduation. Recently, financial journalist Jason Zweig unearthed a 1963 speech by Graham that he posted on his website. Titled *Securities in an Insecure World*, Graham's talk reminds us of guiding principles that investors always need to bear in mind. I focus on a few of these principles in chaotic times like those of late.

Principle one: Invest in stocks and bonds only so far as you can live with

fluctuations in prices.

This principle is based on the idea that investors have to understand their own ability to live with volatility. Investors were reminded of this in 2008 – many investors discovered their true risk tolerance in that market.

In the concluding remarks to his 1963 talk, Graham mentioned an old Wall Street adage that whenever clients asked him to recommend stocks to buy, he'd answer by saying: "Do you want to eat well or sleep well? That will determine what I recommend." Graham went on to say that by following sound policies, almost any investor should be able to eat well without losing any sleep – even in the insecure world of 1963, shortly after the Cuban missile crisis. I share Benjamin Graham's view on the need to both eat well and sleep well – my goal with every client is to tailor a portfolio that achieves these dual and sometimes contradictory objectives. And to help retired clients maintain peace of mind during periods of volatility, I normally recommend that at least three years of cash needs (from savings) be kept in liquid, safe investments.

Principle two: The price you pay when you buy stocks is key.

There are many factors that determine how investments perform over time – but few are more important than paying a reasonable price when you buy. The difficulty is that there are many contradictory views on today's valuation levels; contradictory views on market valuations exist at all times which further complicates buying decisions. A strict adherence to a disciplined portfolio rebalancing process helps to cancel out the 'noise' or contradictory market valuation views, and drive 'buy low-sell high' behavior.

In his speech, Benjamin Graham outlined a methodology for valuing markets. Depending on your assumptions, it suggests that fair value for stocks today, given current low interest rates, could be as high as 23 times average earnings over the past ten years. By contrast, the most current data based on the last 10 years of earnings for US stocks, adjusted for inflation, from Yale economist Robert Shiller puts this multiple at 20 times. This would suggest that the market may be fairly valued – and if we see a continuation in profit increases as the economic recovery continues, today's prices may end up being viewed as quite inexpensive.

Principle three: Long-term goals demand long-term thinking.

Graham's student Warren Buffett has said that it only takes two things to make money – having a sound plan and sticking to it ... and that of those two, it's the sticking to it part that most investors struggle with. Markets like we've seen of late create understandable stress and can lead to short-term decisions. At the risk of repeating a timeworn cliché, our experience bears out the view espoused by Graham and Buffett that the only way to invest successfully over time is to maintain discipline and a long-term focus – to have the right plan and then to stick to it.

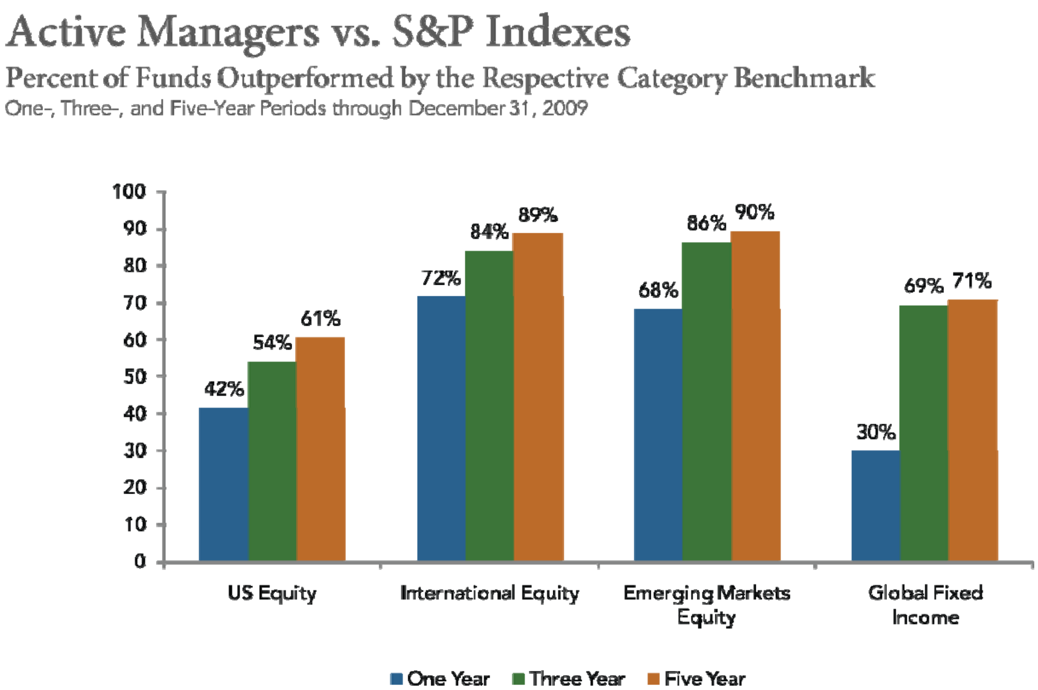
Hard as it can be at times – and at the occasional loss of a client who disagrees - I've found the only approach to investing that works over time is to keep that long-term view, modifying portfolios as circumstances warrant but never losing sight of the fact that long term goals demand long term thinking.

Managers vs. Markets

Proponents of active management believe that skilled managers can outperform the financial markets through security selection, market timing, and other efforts based on prediction. While the promise of above-market returns is alluring, investors must face the reality that as a group, US-based active managers do not consistently deliver on this promise, according to research provided by Standard & Poor's.

S&P Indices publishes a semi-annual scorecard that compares the performance of actively managed mutual funds to S&P benchmarks. Known as the SPIVA scorecard[1], the report analyzes the returns of US-based equity and fixed income managers investing in the US, international, and emerging markets. The managers' returns come from the CRSP Survivor-Bias-Free US Mutual Fund Database, and the managers are grouped according to their Lipper style categories.[2]

The graph below features fund categories from the most recent SPIVA scorecard—all US equity funds, international funds, emerging market funds, and global fixed income funds—and shows the percentage of active managers that were outperformed by the respective S&P Indices in one-, three-, and five-year periods. These are only four of thirty-five equity and fixed income fund categories. But a deeper analysis confirms that the active manager universe usually fails to beat the market benchmarks over longer time horizons. Underperformance of active strategies is particularly strong in the international and emerging markets, where trading costs and other market frictions tend to be higher.



Source: Standard & Poor's Indices versus Active Funds (SPIVA) Scorecard, March 30, 2010. Indexes used for comparison: US Equity Funds—S&P Composite 1500; International—S&P 700; Emerging Markets—S&P-IFCI Composite; Global Fixed Income—Barclays Global Aggregate. Data for the SPIVA study is from the CRSP Survivor-Bias-Free US Mutual Fund Database. Fund returns used are net of fees, excluding loads. Barclays Capital data provided by Barclays Bank PLC.

Over the last five years, about 60% of actively managed large cap US equity funds have failed to beat the S&P 500; 77% of mid cap funds have failed to beat the S&P 400; and two-thirds of the small cap manager universe have failed to outperform the S&P Small Cap 600 Index. Furthermore, across the thirteen fixed income fund categories, all but one experienced at least a 70% rate of underperformance over five years.

In 2009, active funds experienced more success over a one-year period, and proponents typically highlight those results in the SPIVA scorecard. However, one-year results are not consistently strong from year to year, and investors should not draw conclusions from short-term results. Over three- and five-year periods, most fund categories have not outperformed their respective benchmarks.

This poor track record appears in other research. A recent study compared the same actively managed funds in the CRSP database to the Russell benchmarks and showed similar results over the three- and five-year periods. Over the past five years, about 65% of all US equity managers failed to outperform their respective Russell Indexes, and 84% of fixed income managers failed to beat their respective Barclays Capital Indices.

Of course, the results of these studies will fluctuate over time, and a majority of funds in a given category might outperform over the short term. But the message is clear: As a group, actively managed funds often struggle to add value relative to an appropriate benchmark—and the longer the time horizon, the greater the challenge for active managers to maintain a winning track record.

1. SPIVA stands for Standard & Poor's Indices versus Active Funds. The report covers US equity, international equity, and fixed income categories. The actively managed funds are grouped according to Lipper style categories.

2. The Center for Research in Security Prices (CRSP), at the University of Chicago Booth School of Business (Chicago GSB), is a nonprofit center that also functions as a vendor of historical data. CRSP end-of-day historical data covers roughly 26,500 stocks listed on the NYSE, Amex, and NASDAQ exchanges. The Survivor-Bias-Free US Mutual Fund Database includes a history of each US mutual fund's name, investment style, fee structure, holdings, asset allocation, and monthly data, including total returns, total net assets, net asset values, and dividends. All data items are for publicly traded open-end mutual funds and begin at varying times between 1962 and 2008, depending on availability. The database is updated quarterly and distributed with a monthly lag.

If you have any questions on this topics, or need some help with other financial issues you are facing give me a call at (603) 373-8793.