The Financial Navigator – May Newsletter

In this issue of the Financial Navigator we focus on a two topics that have been in the news a lot lately, market volatility and how to manage inflation risk. Please feel free to forward this newsletter to any individuals that you may think might be interested. If you don't want to receive future editions, please follow the link at the end of this email to safely unsubscribe, or email us at the above email address. Thank you for taking the time to view this email.

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Putting Market Volatility In Perspective

The US stock market has taken investors on a bumpy ride in recent years. This volatility has tested investor discipline and prompted some people to question their commitment to equities. While no one knows the future, looking at the past may help you gain a better view of long-term market performance and put the recent market volatility in perspective.

The chart below shows the historical distribution of US market returns since 1926. The performance years are stacked in ascending order by return range. This chart illustrates a few key points:

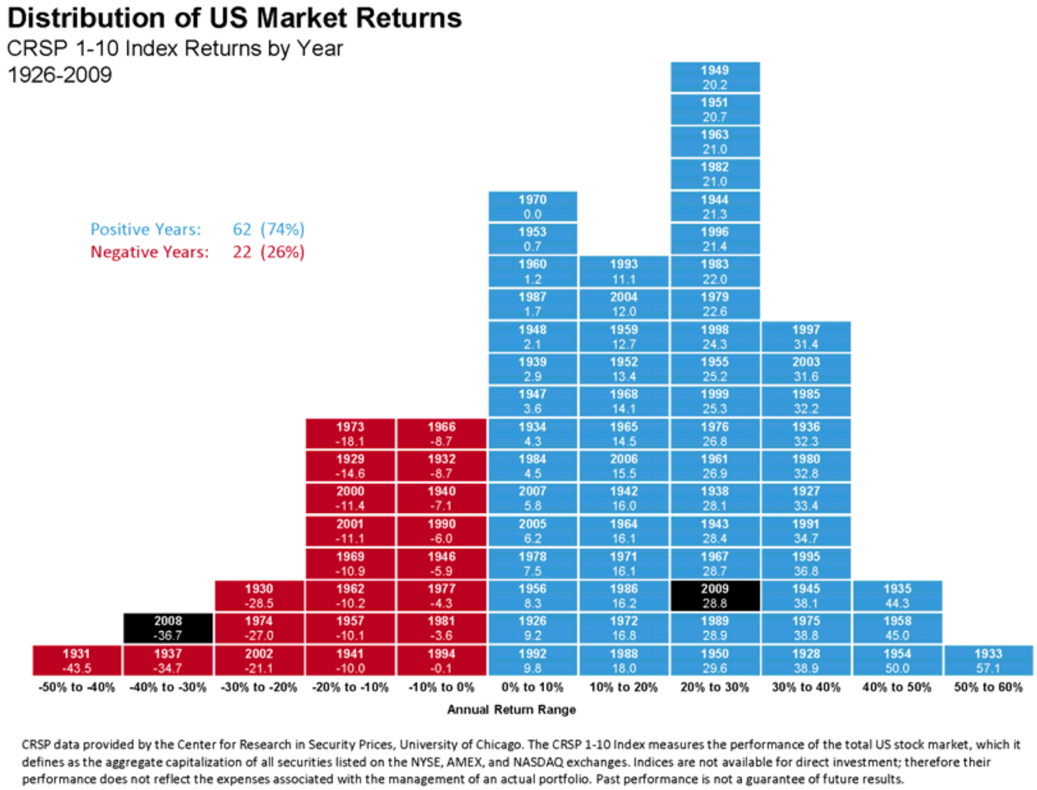
- Market performance over the past two years has been extreme by historical standards. In 2008, US stocks experienced their second-worst calendar return in eighty-four years. Then, in 2009, stocks rebounded strongly to deliver a return in the top quartile of the historical distribution.

- Over the long term, the market's positive return years have outnumbered the negative return years. Since 1926, the market has experienced a positive return in almost three-quarters of the calendar years.

- Not only are the positive years more numerous, the chart shows a larger concentration of performance in the higher ranges of returns.

- The sequence of calendar returns appears random; years where drastic declines took place are followed by years of strong returns (see 2008-2009 and 1937-1938). This suggests that accurately predicting future performance is a difficult task for any investor or professional manager.

Over time, the market has rewarded investors who can bear the risk of stocks and stay committed through various periods of performance. However, if the extreme volatility cannot be tolerated, consider tempering it through diversification into other asset classes, especially fixed income; because as exhibited in the chart, volatility has always been with us and will be in the future.



Managing Inflation Risk

As the capital markets have improved, more investors have shifted their concern from weathering the financial crisis to anticipating the inflationary effects of rising federal spending and debt. Many people are asking how they can prepare for potentially higher inflation. This article explores two basic ways to address inflation uncertainty and highlights asset groups that may prove useful.

Hedging vs. Total Return Strategies

Investors can prepare for unexpected inflation by following one of two basic strategies—hedging the immediate effects of inflation or earning a total return that outpaces inflation over time.

Hedging involves choosing assets whose value tends to rise with inflation. Although holding these assets may reduce the total return of a portfolio, the positive correlation with inflation can help an investor keep up with rising consumer prices, at least over the short term. (Correlation refers to the co-movement of asset returns. When two assets are positively correlated, their returns tend to move together; when negatively correlated, their returns are dissimilar.)

Candidates for hedging include retirees, fixed income investors, and others who would experience a diminished living standard during an inflationary period. These investors are willing to forfeit long-term growth potential for more immediate inflation protection.

In a *total return strategy*, an investor attempts to outpace inflation by holding assets that are expected to earn higher real (inflation-adjusted) returns. This investor is willing to give up short-term inflation protection for an opportunity to grow real wealth. Younger investors are typically well suited for this strategy because they have many years until retirement and expect their earnings to advance faster than the inflation rate. As they save and invest for the future, they can accept more risk through greater exposure to higher-return assets, such as stocks.

To insulate a portfolio from unexpected inflation risk, both strategies may employ some combination of stocks, short-term fixed income, and Treasury Inflation-Protected Securities (TIPS). Each asset class is considered below:

Stocks

Equity securities have provided a positive inflation-adjusted return over the long term. From 1926 through 2008, the total US stock market, as measured by the CRSP 1-10 Index, outpaced inflation by an average of 6.16% per year.[1] To achieve this higher expected real return in stocks, however, an investor had to accept more risk, as measured by greater volatility in returns, and endure periods when stocks did not outpace inflation. As a result, stocks may be less effective for hedging short-term inflation and more suitable for investors who want to beat long-term inflation by earning a higher total return.

Some investors assume that high inflation leads to lower stock market performance, while low inflation fuels higher stock returns. In reality, inflation is just one of many factors driving stock performance. US market history since 1926 shows that nominal annual stock returns are unrelated to inflation.

Fixed Income (Bonds)

Higher inflation can hurt bondholders in two ways—through falling bond market values triggered by rising interest rates, and through erosion in the real value of interest payments and principal at maturity. This inflation exposure tends to impact the prices of long-term bonds more than those of short-term bonds, and investors can mitigate the effects of rising interest rates by holding shorter-term instruments.

Many types of investors may benefit from holding short-term bonds. When interest rates are climbing, a portfolio with shorter-term maturities enables an investor to more frequently roll over principal at a higher interest rate. This can help inflation-sensitive investors keep up with short-term inflation and enable total return investors to reduce portfolio volatility, which can lead to higher compounded returns and growth of real wealth.

Treasury Inflation-Protected Securities (TIPS)

Issued by the US government, TIPS are fixed income securities whose principal is adjusted to reflect changes in the Consumer Price Index (CPI). When the CPI rises, the principal increases, which results in higher interest payments. At maturity, an investor receives the greater of the inflation-adjusted or original principal. The inflation provision enables TIPS to preserve real purchasing power and hedge against unexpected inflation.

TIPS are generally a good short-term inflation hedge since principal is adjusted for changes in the CPI. They are also a good portfolio diversifier for some long-term investors due to their negative correlation with equities and relatively low correlation with most types of fixed income assets. TIPS were introduced in 1997, so these correlations are based on a relatively short sample period.

However, keep in mind that TIPS prices also have been affected by changes in real interest rates, so TIPS may not track inflation one-to-one in the short term or over longer periods of time. In fact, TIPS can lose market value if real interest rates increase.

Commodities

Commodity futures, as well as gold and oil, are perceived as effective inflation hedges because their returns are positively correlated with inflation. But commodities are more volatile than stocks, and their returns do not always rise with inflation because of this significant volatility. So adding these assets to a portfolio may increase real return volatility, which could offset the benefits of hedging.

Summary

While the media have featured divergent opinions and theories about the effects of recent government actions on inflation, no one really knows how consumer prices will respond to the complex forces at work in the economy and markets. Investors should carefully review their financial circumstances and investment goals before making changes to their portfolio.

Even with the prospect for higher inflation, investors who take a total return approach may be better served than those who choose assets based on correlation with the CPI. By choosing assets with higher expected long-term returns and maintaining broad diversification, investors can seek to grow real wealth and preserve the purchasing power of their dollars.

Endnotes

1 Real return calculation: (1+CRSP 1-10 Index return)/(1 + US CPI)-1. The CRSP 1-10 Index is a market capitalization weighted index of all stocks listed on the NYSE, Amex, NASDAQ, and NYSE Arca stock exchanges. CRSP data provided by the Center for Research in Security Prices, University of Chicago.

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.