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MANAGEMENT

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BONDS HAVE TRUMPED STOCKS, BUT WHICH WILL WIN IN THE FUTURE?

The historic bear market of 2008 has shaken a foundational faith of many investors. It has long been believed that stocks offer the best returns over lengthy periods of time.

Instead, the latest statistics show that long-term U.S. government bonds have offered higher nominal returns than stocks over the last 20 years, 10 years, 5 years, and 1 year through June.

Some investors may be kicking themselves for ever investing in stocks and suffering through two major bear markets and one minor bear market over the last 20 years.

Since June 1989 the Standard & Poor's 500 Index has offered a 7.76 percent annualized return. The Ibbotson and Sinquefeld index of long-term government bonds, however, has gained 8.62 percent a year on an annualized basis.

Indeed, government bonds gained 7.55 percent per year over the last 10 years, beating stocks by almost 10 percentage points annually. Stocks lost 26.22 percent over the year ended in June vs. a gain of 7.67 percent for bonds.

The great deflation

The reason bonds did so well is easy to see: interest rates hit their highest peaks of the 20th century back in the early 1980s as the Federal Reserve Board pushed up rates to fight double-digit inflation. Twenty years ago government bonds with 10 years or more to mature yielded 8.2 percent, according to the Federal Reserve Bank of St. Louis.



Since then bond yields have steadily fallen as inflation has declined. As yields on new bonds decreased, older bonds with higher yields commanded higher prices. Thus investors who bought bonds at the peak of the yield cycle 20 years ago have enjoyed capital gains on their investments.

An investor looking at past performance statistics might draw the conclusion that bonds are a better bet than stocks.

No repeats?

That is not very likely, however. Long-term government bond yields today stand at around 3.6 percent, and offer little room for further declines that would lead to capital gains.

Indeed, the president of Ibbotson Associates has warned that investors probably won't get the returns from bonds that they need to keep up with inflation going forward.

"This is the worst time to put all of your money into bonds,

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BOND MARKET RETURNS GOING FORWARD MAY BE FAIRLY MODEST

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given the low-yield environment,” said Peng Chen upon release of a report by his company on stock and bond returns over the last 40 years.

Ibbotson forecasts that bond returns going forward will average about 3 percent to 4 percent annually. Stocks, which hit bargain levels at the market’s low on March 9 of this year, may have better prospects.

Indeed, through June of this year the S&P 500 gained 3.2 per

cent since Jan. 1 while long-term government bonds lost 13.7 percent.

Ibbotson’s study showed that the best bet is to avoid a choice between stocks and bonds. Instead, it is better to own both.

It constructed a portfolio of 60 percent stocks and 40 percent bonds and tracked its performance over the last 40 years. It had an average return of 9.1 percent, beating the 8.8 percent return on bonds and the 8.7 percent return on



common stocks. The diversified portfolio also offered a more stable return than the stock market over the years.

STICK WITH THE STOCK MARKET IN ORDER TO RECOVER FROM 2008

The stock market plunge of 2008 has workers in their forties and older wondering whether their potential retirement incomes will be permanently impaired.

Retirement savings accounts lost an average of 32 percent of their value last year, according to a study by the Urban Institute.

But there is good news from a more recent study by the non-profit research group: retirement savers who keep adding to their accounts and maintain appropriate exposure to the stock market should come out even, or, at worst, with minor declines in retirement income.

The Institute looked at three scenarios: One in which the stock market does not recover from the 2008 crash but resumes its long-term historical average gains; one in which it fully rebounds over 10 years and then continues to gain at average historic levels; and one in which it rebounds halfway.

Buying and rebalancing

In order for workers to recover, they need to keep saving at their current levels, putting away an average of 8 percent to 9 percent of salary.

Also, they should maintain an allocation to equities. The Institute says those who have changed their allocation for new investments and are not buying



stocks at today’s lower prices will not be able to recover, no matter what the stock market does.

If workers keep putting new savings into stocks, then future stock market performance will determine whether their potential retirement incomes will recover from the 2008 crash.

Those born in 1951 through 1955, for example, will see an average decline in retirement income of 9.9 percent if the stock market does not recover, the study found.

If the market partially recovers, the average decline in income will be 3.8 percent.

However, if the market delivers above-average returns over the next 10 years, fully

recovers and then delivers average returns thereafter, the average worker in this age group will end up with 2.8 percent more income at age 67, the Institute said.

New stock gains

In the latter scenario gains on stocks purchased after the crash will make up for the 2008 loss in market value.

However, that requires holding onto current stocks and buying more. A worker who sells his stocks before the market recovers will end up with lower income in retirement, no matter what the market does, the study found.

Those workers who were born between 1961 and 1965 will experience smaller retirement income losses, even if the market does not regain ground.

That’s because they had less wealth to lose in 2008 and have more years to make up for the losses by buying new stocks.

Eighty percent of these late Baby Boomers will see a decline of less than 2 percent in their retirement incomes, the Institute predicted.

WHAT CAN INVESTORS EXPECT AFTER THE MARKET BEATING OF 2008?

U.S. stocks rallied nearly 50 percent from March 9 through the end of July but investors who had suffered through a historic 16-month bear market remained defensive. What did it mean and what are the chances for recovery?

Current economic conditions make the picture even more cloudy. Homes continue to go into foreclosure, jobs continue to be lost, and unemployment hovers at 10 percent—in some communities as high as 15 percent.

Inflection point

Morningstar, the investment research company, says a rally at this point seems normal, because the investment markets pick up sharply at the “inflection point” when an economic slowdown has appeared to bottom. Such rallies occur before it becomes apparent that the economy

is recovering.

“Think of the market’s drastic turnaround in March,” wrote Bradley Kay, a Morningstar analyst. “The signs of hope that incited the rally did not show a growing economy. Instead, the important news merely showed a slowing of the economy’s rate of decline, or an inflection point.”

He analyzed past recessions and studied stock market returns during the 12 months following these inflection points, and found that stocks on average returned 2.2 percentage points more than cash per month after it became apparent that the economy had bottomed.

The next 10 years

The potential for stocks over the next decade may also be encouraging.

The returns on U.S. stocks over

the last 10 years have been next to zero. This has only happened twice before in modern market history: The 10-year period ending in 1935 and the 10 years ending in 1974.

This has been a traumatic change for investors who were used to the 20-percent plus returns of the late 1990s.

However, the abnormally low decades of poor returns in the 1930s and 1970s were followed by long stretches of steadily rising returns as the stock market recovered.

Each year after those decades ended, 10-year average returns on U.S. stocks steadily climbed, reaching a peak in the 20 percent range about 20 years later. The lesson: don’t give up on stocks yet.

BE WARY OF ANNUITIES WHEN RATES ARE LOW

The market turmoil of 2008 and 2009 convinced some investors to yank their money out of a volatile stock market in favor of something more staid.

Insurance and investment salespeople have been touting fixed, tax-deferred annuities as alternatives to the stock market and to low savings rates offered at banks and money market funds.

Fixed annuities pay a specific interest rate each year and the interest accumulates tax-free until withdrawn or the annuity is surrendered.

A form of insurance

Insurance companies sponsor the annuity contracts, and also promise to pay at least the original principal value—or the principal plus interest—to beneficiaries if the annuity owner dies.

But the main attraction for buyers is “safety” of principal and an attractive interest rate. Recently some insurers have offered rates as high as 4.5 percent during the first

year the annuity is held. That rate is far higher than the certificate of deposit and money market savings rates offered by banks.

However, usually the initial interest rate is a “teaser,” and the rates paid in subsequent years may be much lower.

If you could easily get out of the annuity and reinvest elsewhere when rates rise there would be no problem, but you can’t.

Virtually all annuities charge a surrender penalty if you cash out within the first five to seven years. That penalty is steep in the early years, often equal to 7 percent of your investment.

Some annuities allow you to withdraw up to 10 percent of your principal each year without penalty, but the remainder stays locked up.

Inflation hurts

Right now we are in a period of low inflation and abnormally low short-term interest rates. The Federal Reserve has pushed short-term rates nearly to zero in order to combat the



It may not be wise to tie up your nest egg right now in a fixed rate annuity. Surrender penalties could hamper you when interest rates rise.

recession.

This state of affairs will not last forever. Economic experts predict that as we move out of recession, inflation will pick up and interest rates will increase.

Fixed annuity owners may be stuck with interest rates that are less than inflation and no ability to reclaim their investment and put it elsewhere. A good alternative right now would be short term corporate or municipal bonds, which pay high rates and are more flexible.

NOT SURE HOW TO INVEST? USE INTEREST RATES AS YOUR GUIDE

Ok, so last year your retirement account matched the national average decline of 32 percent. That's a big chunk of change to lose and you are agonizing over the best way to make it up.

Like many Americans who lost faith in the stock market last year you might be considering keeping everything in a fixed income account or investment. Good luck.

Interest rates today are pitiful, due to a decision by the world's central banks to keep short-term rates low in order to help the economy recover. The U.S. Federal Reserve has kept short-term rates at nearly zero for months now, and has said it expects to do so for the foreseeable future. The futures markets expect the influential Federal Funds rate to stay near zero until at least next spring, and at that time expect a paltry increase to 0.25 percent.

Banks are offering an average of 1.2 percent on money market accounts, 1.8 percent on one-year certificates of deposit,

and 2.2 percent on five-year CDs. The U.S. Treasury is paying just 2.7 percent on its five-year securities. At a 2 percent interest rate, it will take you almost 20 years to recover to your pre-2008 account balance. However, that number doesn't take inflation into account: if inflation returns to its long-term average of 3 percent, it will take even longer to recover in real dollars (this assumes interest rates rise with inflation).

There is another option: sticking with the stock market. Over the last 10 years fixed income investments have beaten stocks.

When that has happened in the past, stocks ended up returning 12.6 percent to 13.7 percent over the next 25 years.

At a 13.7 percent rate you would recover your losses of last year in about 3 years, and would then go on to beat inflation in subsequent years.

WILL A CONVERSION TO A ROTH IRA BE ADVANTAGEOUS TO YOU?

Tax planning may be in your future for 2010. If you currently have a qualifying traditional IRA, 401(k), 403(b), or 457(b) plan, you may want to consider converting it/them to a Roth IRA in the year 2010. The \$100,000 modified adjusted gross income limits that may have precluded you from doing this in the past will be lifted in 2010, and you will have the option of reporting the conversion amount in 2010, or spread it ratably over 2011 and 2012.

This may be very advantageous to you especially if you think that your taxable income will actually be larger in your retirement years, and/or if you expect the income tax rates to increase with you being in a higher tax bracket in your retirement years than what you are currently.

Remember that Roth IRA's do not allow you an income tax deduction, but if you continue holding your Roth IRA for at least five years from your initial contribution and you are over 59 ½ years old when you take any distributions they should be completely tax free to you. Also, unlike traditional IRA's there is no required age for when you must start taking distributions, and there is no required amount that needs to be distributed. In fact, Roth IRA's are an excellent way to pass wealth to the next generation, since they are not subject to income tax when distributions are taken. However, distributions are required to be withdrawn by the next generation over their life expectancies.

Now is the time to start planning for this limited-time income tax benefit. It could prove to be one of the best financial moves that you will ever make.

RETIRED, BUT YOUR 401(K) IS STILL WITH YOUR EMPLOYER

If you are retired and you still have your 401(k), 403(b), and/or 457(b) plan with your employer, you should consider moving it (rolling over) to a traditional IRA. Many times your investment options are very limited in these types of plans, and it is very difficult to diversify the investments within the plan. Also, unless you are watching the plan closely no one is actually watching the investments within the plan for you. We would be happy to assist you in rolling over your 401(k), etc. to a traditional IRA, and discuss your investment options and retirement goals with you.

Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:

- ◆ Fee-only investment management
- ◆ A disciplined investment strategy
- ◆ Access to institutional no-load passive asset class funds
- ◆ An academic Nobel Prize-winning investment approach

- ◆ Continued access to academic research
- ◆ A tax-efficient focus with valuable tax- and estate-planning ideas
- ◆ Risk tolerance assessment
- ◆ Periodic portfolio rebalancing
- ◆ Regular communications and state-of-the-art reporting
- ◆ No front-end loads, no back-end loads, no surrender fees, not locked in
- ◆ **MOST IMPORTANT ...**
A TRUSTED ADVISOR RELATIONSHIP



INTRODUCTIONS—REFERRALS ARE ALWAYS APPRECIATED.