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DID THE 2008 BEAR MARKET PUT AN END TO DIVERSIFIED PORTFOLIOS?

The bear market of 2008 has raised some serious questions: Do stocks really outperform bonds in the long-term? Is asset allocation dead?

The Standard & Poor's 500 Index fell 37 percent in 2008, and other groups of stocks, especially foreign stocks, fell even more.

The 2008 bear market came just five years after the end of another bear market early in the decade. The two events pushed stock market returns well below average. The S&P 500 Stocks index, for instance, lost an average of 0.2 percent per year over the past 10 years.

Meanwhile, long-term government bonds gained 8.0 percent per year in the same period, well over their historic average of 5.5 percent per year going back to 1926.

Bonds even beat stocks over the last 20 years, gaining 8.8 percent per year, while stocks gained 8.0 percent per year.

Diversification dead?

Meanwhile, some investment experts say asset allocation is dead, because it didn't protect diversified portfolio owners from loss in 2008, when nearly every asset class except for cash and short-term Treasury securities fell in value.

Does this mean the long-accepted wisdom that you should have a portfolio diversified among different asset classes—including bonds, stocks, and cash—no longer works? Don't give up yet, because even last year a well diversified portfolio went down less than the stock market did. Yes, it declined, but this was no surprise: asset allocation advocates have always said that it is possible for pretty much everything to move in lockstep for a short time during a panic or a mania.



A portfolio solely consisting of high grade bonds did better than the stock market over the last 10 years.

However, the diversified portfolio did offer some protection. Consider a balanced portfolio of 60 percent stocks, spread among large and small stocks both foreign and domestic, and 40 percent among various short term bonds. It lost only 24 percent in 2008 compared to the market's 37 percent loss, according to Dimensional Fund Advisors, an institutional mutual fund company.

Long-term results

In the longer term, however, the diversified portfolio did well. The sample DFA portfolio has returned 6.5 percent annually in the ten years through September, compared to a loss of 0.2 percent on the S&P 500.

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DON'T EXPECT MORE THAN THE CURRENT YIELD FROM BONDS

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That return beat the returns of cash and medium-term government bonds, and was over twice the rate of consumer inflation. Long-term government bonds still beat the diversified portfolio by about 1 percentage point per year.

Yield is all you get

Those who tout the higher long-term returns of bonds over the last 20 years may not see those returns repeat over the next 20.

The old saying in the bond market is that you “earn your yield,” in other words, the yield on a new bond is about



all you can expect to earn during its lifetime. Twenty years ago yields were much higher. Since then, interest rates have fallen, creating capital gains for older bonds and contributing to their good returns.

Today the yield on a 30-year Treasury bond is a little over 4 percent, not 8 percent as it was 20 years ago. Since no one can predict the next year or 10 years, it still seems wise to maintain a mix of stocks and bonds so that you can benefit from either asset when they rise.

SUCCESSFUL INVESTORS AVOID PICKING INDIVIDUAL STOCKS

One of the most dangerous temptations for investors is the potential for buying the next big hit stock, a stock that will grow at supersonic speed, far in excess of the overall market's growth.

The hunt for the next Microsoft (a few generations ago it was the search for the next IBM) has probably been responsible for more wealth destruction than any other investment fallacy.

Consider this:

- Although the U.S. stock market has survived periodic crises and thrived over time, the majority of stocks that make up the market vanish in any 10-year period, to be replaced by new stocks.
- Although successful investing is a long-term game, buying individual stocks shortens an investor's time horizon, forcing more decisions and increasing the risk of a bad decision.
- Using intuition or analytical skills to pick a stock often does not work because our intuition leads us to growth stories, while the market leaders year-to-year are often the counter-intuitive losers, the so-called value stocks.

Irresponsible investing

Much evidence exists to show that individual stock investing loses out to diversified market investing. Investors who ignore that evidence should be considered irresponsible, gambling with their own money or with the legacies they intend to leave to loved ones.

In the short-term, investing in a broad basket of stocks that resembles the market and investing in one or two individual stocks may have equal chances of success or failure. In fact, buying the “right” individual stock in this scenario may give the individual investor a slight advantage of beating the market. But studies have shown that over longer periods of time the diversified market investor has a much better chance of beating the individual stock investor.

One doesn't need a statistical analysis to intuit that result: since individual stocks can and do have larger declines than the overall market—or may cease to exist altogether—a certain percentage of individual stock investors are guaranteed a much worse experience than the market.



Picking individual stocks, rather than investing in a broad-based stock market index, carries a whole set of particular dangers.

Consider the bear market of 2008, when a diversified market investor lost 37 percent or more in American stocks. Yet individual stock investors who had been enjoying years of outstanding returns in some financial stocks like insurer AIG, Washington Mutual Savings Bank, or mortgage company Fannie Mae saw their investments sink nearly to zero. Meanwhile, investors in Lehman Brothers did see their holdings vanish.

Diversified wins out

One study by Dimensional Fund Advisors, a California-based investment company, simulated returns on a concentrated stock portfolio and a diversified market portfolio over a 25-year period.

It found that the majority of potential diversified returns far outpaced the potential concentrated stock returns. The worst 5 percent of cases saw the market portfolio nearly double, while the worst concentrated stock returns resulted in a loss of 91 percent.

THE BEST TIME TO INVEST COMES AFTER BIG ECONOMIC RECESSIONS

The easy money in the stock market comes in the first two to three years after a recession ends.

During the 10 recessions preceding the one that began in December 2007, the U.S. stock market on average was up 33 percent a year after the economy bottomed. Within three years the market was up an average of 59 percent.

Those figures were compiled by Tweedy, Browne Co., manager of three value stock mutual funds, based on data from the National Bureau of Economic Research and Standard & Poor's.

The figures show that investors who try to buy into a market at the low point need impeccable timing: much of the gains after a recession come within the first year after the low point.

For instance, after the recession that ended Dec. 31, 1970, the market gained 44 percent in the first 12 months. The market's gain was 60 percent in two years.



Don't cry when the stock market is deeply depressed; instead, open up your wallet and buy.

The biggest gains historically came after the biggest recessions. After the dismal recession of 1981-82 the market was up by 58 percent 12 months later and 83 percent three years later.

Likewise, a year after the recession of 1973-74, which rivals today's recession and recent bear market, stocks gained 38% and were up 67% in two years.

Many economists speculate that the recent recession has already ended. However, it may be some time until the National Bureau of Economic Research

determines the end date.

In the meantime, the S&P 500 Index in late October was up 58 percent from its low point on March 9.

Tweedy, Browne's managers warn that investors can't wait until the end of a recession is officially determined. "There is no starting gun signaling the beginning of the next bull market," they wrote in April. "It has been our experience that the low hanging fruit gets picked early and fast."

The most important realization is that investing should not be an all or nothing game. At all times a rational investor should have a balanced portfolio with some cash, bond, and stock holdings. A balanced allocation will reduce the regret over suffering losses and missing gains, and give an investor confidence to keep investing new money regularly.

ROTH IRA CONVERSION HAS ITS BENEFITS, BUT DECIDING IS TRICKY

Financial services companies are using a temporary change in Roth IRA conversion rules to roll out a marketing juggernaut to convince you that conversion is the greatest opportunity ever. Coincidentally, they also hope to convince you to use their services.

Temporarily next year anyone can convert a traditional IRA to a Roth, regardless of income. Currently only those with incomes of less than \$100,000 can make the switch.

Is a Roth conversion a wonderful opportunity? Maybe for some retirement account holders, but certainly not for everyone. The decision to convert is also very complicated and needs to take into account an individual's taxes, estate planning, retirement income needs, and predictions of future tax rates.

Immediate tax bite

Marketers are touting all the advantages of a Roth IRA: tax-free growth and withdrawals, tax-free inheritance, and no required distributions after age 70.5. But they don't emphasize the immediate tax hit, which discourages many IRA conversions.

The owner of a \$250,000 IRA who is in the 25 percent federal tax bracket and a 6 percent state tax bracket, for instance, would have to pay \$77,500 in additional taxes to convert. And that money cannot come from the IRA: it has to come from another source, such as a bank or broker account.

Estate benefits

Some conversion benefits only apply to the rich. Those who are leaving behind millions of dollars and worried about estate taxes might do better

converting now and paying state and federal income taxes, because the state income tax is deductible for federal tax purposes.

Leaving the money behind in a taxable IRA instead would cost more, because there is no deduction for state estate taxes after death.

Also, high income taxpayers who have big income tax deductions that they can't take in 2010 would benefit by creating taxable income through a conversion, allowing them to use the deductions.

IRA owners who do not plan to spend any of their IRAs in retirement may also want to convert to a Roth in order to avoid required distributions at age 70.5 and so that heirs get their IRAs tax-free.

STOCK MARKET NEWSLETTERS DIDN'T SEE BEAR COMING EITHER

"We've long felt that the only value of stock forecasters is to make fortune tellers look good," billionaire investor Warren Buffett has written.

That pretty much described how newsletters devoted to giving readers tips on the market fared in the fall of 2008.

The Hulbert Financial Digest, a newsletter that tracks the performance of the investment newsletter industry, looked back at what newsletters were saying in September 2008 and found that they did a poor job of alerting readers to the disaster that occurred in October.

Editor Mark Hulbert said many of the major newsletters seemed "strangely complacent" on the eve of one of the worst-ever months for stocks.

Bullish forecasters

He notes that Jeffrey Hirsch, editor of *Almanac Investor*, said he was "ready to be a bull again."

Bob Brinker of *Brinker's Marketimer* predicted the Standard & Poor's 500 Index would top its previous record of 1565 in 2009 (it is now at about 1060).

Mark Skousen of *Forecasts and Strategies* predicted a "Santa Claus rally" at the end of the year, while Stephen Leeb of

The Complete Investor said that the credit crisis had neared a conclusion and the downside risk in stock prices had been reduced.

Best of the bunch

A handful of writers seemed to get it right, but their forecasts were deceiving, Hulbert said.

The Elliott Wave Financial Forecast said the market was building toward its "strongest decline of the bear market to date."

The only problem with that forecast was that the newsletter had been overwhelmingly bearish for 20 years, and investors who followed its recommendations would have missed out on the big gains of the 1990s and mid 2000s.

Hulbert found two other newsletters that indicated more stock declines, but strangely enough the model portfolios they published stayed heavily in stocks.

As Buffett concluded: "I continue to believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children."

STICKING WITH 401K PLANS

American workers have remained committed to their 401k plans despite the financial upheaval of 2008, the Investment Company Institute says.

The mutual fund trade group says its latest statistics show only a slight increase in savers who ended their contributions during the first half of 2009.

Only 1.8 percent of participants took withdrawals from their plans during the first half of the year, while 7.7 percent changed their investment allocations, the Institute said.

SEASON'S GREETINGS

We want to take this opportunity to wish you and your family a very Happy, Healthy, and Prosperous New Year!

Marketwise—the last year has had its ups and downs. The first few months made everyone wonder when the market was going to bottom out and at what level that would be, but since then we have enjoyed at least a partial comeback in the market. As sure as we are that the market does go up, we also know that there will be periods when it goes down. It is a fact of life. You are normally compensated for your market risk taken over the long haul, and that is why you are willing to invest in the market.

We are here to help guide you through the bad as well as the good times. We do not want you to worry about the day-to-day activities of the market. Your time should be spent enjoying your family and friends. Memories of time spent with them will last much longer than remembering what happened in the market. We hope that your holiday season with family and friends is memorable.

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.