Lassus Wherley ...a view from the top

Building Better Futures

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# Let's Take a Deep Breath!!!!

## Food for Thought

Sometimes it's hard to figure out where to start writing one of these newsletters. There are so many things I want to review and discuss and share that I struggle with where to begin in deciding how to overview the world we are seeing and how it will impact the economy, the markets and us as individuals.

I approved a press release for NAPFA (National Association of Personal Financial Advisors) the other day to provide guidance to consumers on how to deal with problems with their financial advisors. The reality is that most problems are misunderstandings or a lack of communication but the Madoff case and other stories in the news have raised consumers' concern about what they can or should do if they feel uncomfortable in their current situation. The most critical point is to stay engaged. This isn't just with financial advisors but also with other types of professionals such as lawyers and even doctors. Professionals can only do so much if their clients don't make the commitment to stay engaged.

We continue to see the fallout from Madoff and other fraud schemes that are being discovered by the SEC and other regulatory authorities. This is both good news and bad news. The good news is they are being caught but the bad news is how long it took the authorities to identify the fraud. There is a moral to this story and it really goes back to the Reagan era. President Reagan said, "Trust but verify." I think that is something we all need to embrace.

I draw the parallel to supervision of employees in a company. Obviously, we trust our employees to do the right thing and to make decisions based on our code of ethics and the same moral values that we as individuals endorse. But that trust does not relieve us of the responsibility to establish tracking systems and to verify that they are in fact doing what we expect them to do. The same applies to individuals who work with professionals. If the clients of Madoff's firm had tried to verify what he was doing—the red flags would have been raised much earlier. Many of the cases of fraud recently identified would have surfaced much sooner had the individuals been reviewing their statements and noticed the unauthorized withdrawals being made.

"Trust but verify" is a good way to work with professionals and others. It is another way of controlling those things that we can control. It doesn't just apply to brokerage statements and financial advisors. It applies to your bank account, your mortgage statement, and your credit card statements. How closely do you review the bills you receive to make sure they are accurate? Do you verify your credit card charges to make sure you aren't charged for something you didn't authorize?

So…………if you don't currently take the time to check these things, please find a way to start. It is only through this type of diligence that we can each identify and correct errors

and potentially fraud. I had an experience last year on vacation. I had a $500 cash withdrawal made to my credit card. I knew it wasn't mine for two reasons. First, I never take cash from a credit card and second, I had not recently been in Moscow where the transaction was processed. I quickly reported it and was credited the dollars. However, if I had not been verifying my statements, it might never have been caught. So………..“Trust but verify.”

**Does the Good Outweigh the Bad Yet?**

I was reviewing a calendar I keep on my desk the other day and was amazed at how much economic data is published on a weekly basis. It is no wonder we have almost as many economists as we have advisors. It takes most of them full-time analyzing the numbers to try to make sense of the data and then it takes the rest of us a huge block of time to analyze and understand their analysis. I have many friends in the wealth management or money management business and I spend a lot of time reviewing their thoughts also. We have a speaker at many of our conferences who is an anthropologist and she says you only have room for a certain number of ideas that come in the front of your head. When it gets full, the overload goes out the back. I have spent a lot of time recently trying to figure out which of those data points went out the back.

Our basic conclusion is in line with many others today which is that the results of many of the numbers is “less bad” and actually getting better. So, we have gone from the world coming to an end but we didn't know exactly when, to, we know it isn't coming to an end and we know it is less bad but, ……….we aren't quite sure when it is going to move into positive territory.

Maybe we have come too far too fast. If that is true, we should expect some pullbacks which will include profit-taking based on the recent positive run in the markets. We have seen some of this type of negative returns over the last few days. We continue to see positive and negative news come out on a daily basis and the bottom line result in the markets for the day are really determined by how positive or how negative the news has been.

Industrial production is still pretty anemic and the downsizing of the auto industry will be felt throughout the manufacturing system in the US and around the world. Dealerships are going bankrupt and many manufacturers of auto parts are being impacted by the closing of plants around the country. It will take quite some time to see the ultimate impact from this industry restructuring.

Commodity prices have certainly come back strongly from earlier in the year but seem to be backtracking recently. Many times the prices are moved by people looking into the future with a crystal ball rather than by current demand, so increases in price aren't necessarily a good indicator of increasing demand. What we want to see is increasing demand based on production beginning to edge up.

Europe probably could use some of our bank stress tests. They need to rebuild confidence in their banking system as we have done in the U.S. and they haven't yet succeeded in doing that. Our expectation was that Europe would be slower to come out of recession but not as slow as it now appears. Great Britain is still struggling but Germany seems to be making more progress.

U.S. housing starts bounced back in May with an increase of 17.2% to a seasonally adjusted annual rate of 532,000 after dropping 12.9% in April, the Commerce Department estimated. This surprise was led by a 62% gain in new construction of multifamily dwellings. The starts of single-family homes rose 7.5% to

a 401,000 rate, the highest number since November (data taken from MarketWatchMail.com daily email dated June 16, 2009).

We are seeing increased sales in residential housing but the prices in many areas are still coming down or just beginning to stabilize. That may be reflecting the fact that many homes stayed on the market a very long time with artificially high prices because owners weren't willing to give up on the price they had in their head. Once they give up, prices fall quickly as they are set at more realistic levels.

Another possible topic and update to think about is the yield on the 10-year treasury note. It has risen as high as 4% before coming back down to around 3.79%. If this rate rises much higher, it would further increase mortgage rates and could have an impact on the recovery of the housing market. It is something we need to pay attention to in the coming months.

Retail sales were in line with expectations and slightly higher while initial jobless claims for early June were under analysts expectations. One of the primary things we would like to see is falling jobless claims which will mean that layoffs are slowing and the economy is becoming more stable before starting the next growth phase.

Remember those LIBOR rates we used to talk about so much? Well, they are sitting at very low levels these days which is continuing good news for liquidity within our banking systems.

And according to a report on CNN.com, the June University of Michigan/Reuters consumer sentiment index came in at 69.0 with a slight gain. Also they noted that the index of current conditions (which measures personal financial situation and interest in major purchases) rose to 74.5 from 67.7 in May. This is another good sign that all that pent-up demand we have been talking about may be starting to be converted to spending.

The regulatory reform move in Washington is a little worrisome. We believe there is a need for significant reform and we are looking forward to reviewing some of the recommendations this week. The Obama Team is going to have to walk a tightrope between closing the gaps and protecting against insanity. We just hope the reforms don't go so far as to discourage the creativity that has created so many entrepreneurs in this country. We are keeping our fingers crossed on this one and staying positive in our expectations. As the details roll out we will try to unravel the underlying message and figure out where we are heading.

This first proposal is supposed to target control of the systemic risk and the prevention of another cataclysmic fall happening in the economy and the markets. Unfortunately, most regulatory reform efforts have to be based on the past and we know how incredibly creative Wall Street entrepreneurs have become so there are no guarantees on the future. Greed is a great motivator. So…..here's the open-ended question—can Wall Street create new products (that confuse the public) more quickly than the government can figure out ways to regulate them? I know I sound a little frustrated. I guess I am. My frustration comes not from regulatory reform but from the organization that is supposed to regulate the brokerage world known as FINRA. These are the folks who are charged with regulating the distribution of brokerage products and who have been missing in action during much of the insanity over the last year.

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Here's a breaking story as we go to press with this issue. HR 882 proposes to increase the required age for distributions from qualified

retirement plans from 70 1/2 to 75. The bill would also provide for contributions to traditional IRAs up to the year prior to age 75. Another bill, HR 883, proposes to repeal the income tax on Social Security benefits. This bill would include only 50% vs. the current 85% rate. One other bill in the Senate, S 978, proposes to increase the capital loss you can take against ordinary income from $3,000 to $10,000. This would at least help utilize those carryover losses more quickly and save more tax dollars. We're bracing for lots of tax related changes this year!

**Here are some of the representative returns for the 12 months ending 6/15/09.**

| | |
|---|---|
| US Large Cap | - 30.08% |
| US Small Cap | - 29.89% |
| Intl Large Cap | - 34.64% |
| Global Real Estate | - 37.81% |
| Short-Term Bonds | - .58% |
| Inter-Term Bonds | - 1.64% |
| High-Yield Bonds | - 9.43% |
| Muni Nat'l Inter | 1.94% |
| Muni Nat'l Short | 2.24% |
| High-Yield Muni | - 11.69% |
| Long Short | - 11.26% |

Source: Morningstar Fund Category Returns.

**Here are some of our core funds and how they have performed for the same 12-month period ending 6/15/2009.**

| | |
|---|---|
| Harbor Bond | 8.67% |
| Vanguard Short-Term Corp | 1.91% |
| Vanguard Interm Tax Exempt | 3.10% |
| Vanguard Ltd Term Tax Exempt | 3.44% |
| Hussman Strategic Growth | -4.03% |
| Vanguard Div Growth | - 21.58% |
| Vanguard GNMA Fund | 9.61% |
| JP Morgan Core Bond | 7.92% |
| Stratton Small Cap | - 33.43% |
| Vanguard High-Yield Corp | - 5.06% |
| Vanguard High-Yield Muni | - 1.37% |

Someone asked me why we don't list more of our recommended funds. Many of the funds we use are Index Funds and their performance is reflected by the market minus the low fees that they charge.

There are still many unknowns in our discussions today and some of them are covered in the questions we answer below. Many will probably not be answered for many months yet.

**Question:** *Why don't we buy individual bonds and just hold them to maturity?* **Answer:** The major reason we don't buy individual bonds is the increase in risk. If you hold individual bonds and there is an issue with one like the General Motors bonds, or even a municipal bond, it has a very high impact on your overall portfolio. There are also high costs involved with trading individual bonds and big differences in the cost to purchase a bond vs. the cost to sell one. It can be a very large spread between the price you could sell it for and the price that you would pay to purchase a very thinly traded bond. We have run into this many times in recent days in trying to sell individual bonds that clients bring into their accounts.

When we use bond funds, there is a much more diversified portfolio of bonds and an active manager that is paying attention to the risk level of the bonds they are holding. One other advantage of funds is that they have bonds coming due all the time so if interest rates are rising, they are able to continue to purchase new issues to increase the income for

the fund. Since our number one objective for holding the bond funds we use is safety, broad -based diversification is a really good thing. We are also very focused on making sure we have shorter maturities in the funds we are using for the same reason. Bonds with shorter maturities are not as negatively impacted by rising interest rates.

**Question:** *What is the real difference between asset allocation and market timing?* **Answer:** This is a really great question and one that many of my friends in the same business as we are continue to have active discussions about. One friend, who shall remain nameless, asked me the following question, "What is the difference between market timing and tactical allocation decisions?" I immediately answered that tactical allocation decisions were based on risk management, not market timing. His response was, "do you make decisions on when you are going to add dollars to the market?" I said—yes. We may move dollars in more slowly in a volatile market environment. He said, "I rest my case."

I had to think about that for a while. He does have a point. We do make what we define as tactical decisions about how we invest during different periods. We allowed bonds, hedge and cash to build during the worst part of the down market. We then made decisions to increase hedge and to not rebalance out of the hedge strategies funds yet to protect against a possible new downturn.

However, having reviewed all of this, the bottom line is that market timing is about making major shifts in and out of the market, and that we don't do. We don't bet the ranch by going all to cash or to bonds or to stock. Market timers have historically done just that. So……...I informed my friend that although it may seem similar, it truly isn't. We maintain overall asset allocation based on long-term perspectives and forecasts. We make tactical shifts primarily focused on risk management and that isn't market timing.

**Question:** *If you believe the US markets will recover more quickly than the rest of the world - why wouldn't you invest everything in the US markets?* **Answer:** If my crystal ball could confirm that hypothesis, I would certainly move on it. The reality is that we are always looking down the road to predict the next shoe to drop or the next positive thing happening in the world, but not to the extent that we make large asset shifts based on them. Example: We have recently approved a new Global Bond Fund to help us build a hedge against a future falling dollar. Do we believe that is going to happen right away? No, but we want to begin to position to hedge against that occurrence. We will begin to add gradually to this fund over the next few months.

**Question:** *Have we finally turned the corner based on some of the good news?* **Answer:** We have turned the corner in some ways but not others. The credit markets seem to be relatively stable. The real estate markets appear to be bottoming but may still have some room for prices to go down further in some parts of the country. The economy is beginning to show some positive signs in terms of unemployment.

There are still issues. We don't yet know the impact of regulatory reform or the unintended consequences of the downsizing of the auto industry or the ultimate impact on Wall Street of the reshuffling of the banks or where small business will come out of this recession.

So…………..we do believe we have turned the corner but we will continue to remain more defensive than we have been in the past because there are still questions that haven't

been answered in terms of possible unintended consequences.

So if you take Dr. Doom who still sees the end of the world approaching and Abby Joseph Cohen who sees a strong growth in earnings for companies in the third and fourth quarter—we're somewhere in the middle. We think we will see growth but continued slow growth for the next year or so until we work through the many issues created by the credit debacle we have been through. There is still an open question concerning the handling of the toxic assets that remain on the books of most banks. I have not seen a good answer to this yet but think there needs to be one soon or it could stall this recovery later in the year.

### Much Food for Thought

The challenges in 2009 continue but at least we have some sunshine with which to view them. A few weeks of positive market results does not a bull market make but it certainly has improved my disposition. My crystal ball has been working a little better lately but it still clouds up quite a bit. We are continuing to edge dollars back into the various markets but are doing a tortoise style of slow and steady.

Keep those questions coming in. If you are wondering about something, the odds are pretty good someone else may also be thinking about the same topic. When you ask—we get the chance to share our thoughts on the topic with others.

If you are into that new media stuff like Twitter and blogging—stay tuned. We are working on starting a blog and I am already learning about Twitter and doing some postings there. We continue to look for better ways to communicate with you and keep you up to date on our thoughts and the important articles and things we want to share with you.

Please let us know if you have any questions or concerns. We are definitely looking forward to a continued recovery in the markets and the economy. Hopefully sooner rather than later. Have a great Summer!

*Diahann*

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