Lassus Wherley ...a view from the top

Building Better Futures

Issue 21: September 3, 2009

Nothing Like a Good Roller Coaster in the Summer!!!!

Food for Thought

One of my favorite things as a child (and even today) was riding roller coasters and high speed rides that created a huge adrenalin rush and made me feel really alive. The last year in the market has reminded me of those roller coasters. First we did up and down on a very short ride day to day, in the dark, kind of like Disney's Space Mountain where it is so dark you really can't see where you are going. Then it was pretty much downhill like the Tower of Terror that drops really quick and leaves your heart in your throat. Now we have just experienced that uphill part of the ride that went up so fast it leaves you holding your breath waiting for the next leg of the ride. You can only predict that next leg if you have been on the ride before. Unfortunately, we can't do reruns in the financial markets or the economy. There may be similarities but they are never identical. So…………..it has been a great ride over the last few months but we all know that markets don't normally go straight up. We do expect more negative days or even weeks over the next few months.

Does the Good Outweigh the Bad Yet?

This is a question we continue to ask ourselves on a weekly basis. Let's review a few of the headlines we have been seeing lately.

Stable Value Funds Regaining Stability WSJ 8/19/2009—This is good news. We have been monitoring these funds for our clients with 401(k)s since they are used for safety in many of these plans. Concerns about the risks taken by some of these funds had us on a heightened alert for a while.

The recession is over according to many including Jerry Webman, Ph.D, CFA, Chief Economist for OppenheimerFunds. He bases this on the most recent results from The Conference Board's Index of Leading Economic Indicators. Historically, strong increases in the index have correlated with the end of recessions.

Other good news includes much improvement in the credit crunch with Interbank lending rates reaching a much more normal level indicating a greater willingness among banks to lend. This is definitely better news.

Existing home sales rose 7.2% in July, the biggest one-month gain since 1999. The housing market still has room to fall but seems to be stabilizing in many areas of the country. There are several positive indicators here including distress sales are now down to about a third of sales of existing homes instead of the fifty percent we were seeing a few months ago.

Demand for consumer goods is improving slightly but primarily due to a combination of pent-up demand and manufacturers aggressively reducing inventory. As these inventories are depleted, they will have to be restocked at some point. We can hope that point will be sooner rather than later.

There has been much debate recently about the impact of the TARP and whether it was too much or not enough. It will be a few years before we can really answer that question. Another question is how long will it take to truly put those dollars to work. We have seen

little impact so far but it looks like we could soon begin to see more impact with dollars flowing into the economy through more bridge and road construction projects. The federal government hasn't spent much of the money allocated for infrastructure yet but we should begin to see those dollars move late this year and into 2010.

Possible bad news items which could limit the economic recovery include:

Continued high rates of joblessness
Expiration of the Bush tax cuts
Continued pressure on small business
Weakness in commercial real estate
Consumers are saving vs. spending

All of these factors could lead to slower growth and potentially a slower recovery over the next year or so. So……….we continue to see more good news but all the bad news may not yet be totally behind us.

- - - - - - - - - - - - - - - - - - - -

Here are some of the representative returns for the 12 months ending 8/28/2009.

US Large Cap	- 18.17%
US Small Cap	- 19.82%
Intl Large Cap	- 16.21%
Global Real Estate	- 17.86%
Short-Term Bonds	4.09%
Inter-Term Bonds	6.07%
Muni Nat'l Inter	4.32%
Muni Nat'l Short	2.99%
Long Short	- 6.02%

Source: Morningstar Fund Category Returns.

Here are some of our core funds and how they have performed for the same 12-month period ending 8/28/2009.

Harbor Bond	11.90%
Vanguard Short-Term Corp	4.69%
Vanguard Interm Tax Exempt	5.47%
Vanguard Ltd Term Tax Exempt	4.02%
Thornburg Ltd Term Muni	5.35%
Hussman Strategic Growth	- 7.72%
Vanguard Div Growth	- 14.98%
Vanguard GNMA Fund	8.42%
JP Morgan Core Bond	10.10%
Stratton Small Cap	- 22.38%
Cohen & Steers Global RE	- 16.73%
EAS Genesis I	- 5.46%

Source: Morningstar Individual Fund Returns.

Here are some of the questions you have asked over the past month.

Question: *I have noticed that you have made several trades in the bond mutual funds held in my account. Can you tell me what the thought process is behind these changes?* **Answer:** There are several aspects to the changes we have made this year. We are in a very low interest rate environment right now and one consequence of the Federal Reserve keeping short-term rates low is that yields on money market funds are only slightly better than keeping it under your mattress. This makes keeping large cash balances costly in terms of foregone returns. Even with these very low returns, it still may make sense to keep higher than normal cash reserves given the uncertainty in our economy.

The two short-term taxable bond funds which we currently use, Vanguard GNMA (Ginnie Mae or VFIIX) and Vanguard Short Term Investment Grade (VFSTX), were yielding 4.51% and 4.41% as of August 28, 2009, respectively. These funds are not very sensitive to changes in interest rates, with duration 2.2 years for VFIIX and 2 years for VFSTX. Duration is useful primarily as a

measure of the sensitivity of a bond's market price to interest rate (i.e. yield) movements. The shorter the duration the less sensitive the price of the bonds will be to a rise in interest rates.

On the tax-exempt side, we are in the process of making a swap from some of our tax-exempt funds such as the Vanguard Limited Term Tax Exempt Bond Fund (VMLTX) into taxable funds such as Vanguard GNMA (VFIIX). We make these decisions based upon analyses comparing the taxable equivalent yield on these funds. When the after-tax return on the taxable fund is higher than the tax-exempt, we make the switch between funds. We will continue to monitor the relationship between the yields on our taxable vs. tax-exempt funds.

VFIIX is an example of a short-term bond fund that we use for current yield at a low relative risk. It is invested primarily in Ginnie Mae pass-throughs. Ginnie Mae is the only government agency backed by the full faith and credit of the US government. There is thus no credit risk in investing in Ginnie Mae securities. Interest rate risk is low due to the very low duration of the fund. The fund's managers use a conservative, buy and hold strategy and returns are bolstered by its very low expense ratio.

Another move we are making is to swap out of DFA One-Year Fixed Income Fund (DFIHX). The average maturity on DFIHX is about 10 months. Given the decline in rates this year, the yield on DFIHX has recently declined to slightly higher than a money market return. We have decided to hold some of our short-term municipal bond funds such as the Thornburg Limited Term Muni Fund (LTMIX) based upon the higher yield of 3.82% as of August 28, 2009.

We continue to look for the best fixed income vehicles in which to invest in a climate that still holds a fair amount of uncertainty. We believe that interest rates will be moving higher as the economy recovers, but we are not sure how long that will take. We do know, however, that in an environment where rates are so low, we must keep our focus on funds with low sensitivity to rate increases as well as with low expenses.

Question: *How do we protect ourselves against a falling dollar?* **Answer:** We are in the process of investing a small percentage of portfolios (up to 3% is the current target) in a short-term global bond fund called DFA Global Selectively Hedged Fixed Income Fund (DFSHX). This fund offers us a way to capture some return from a potential decline in the US dollar without taking on a lot of foreign interest rate risk. At present, since interest rates are higher in the foreign developed countries in which the fund invests than in the U.S., the currency exposure of the fund is totally unhedged. This means that the fund will benefit if the dollar declines in value. As the name implies, however, the currency exposure of the fund can be hedged if the fund management sees higher rates in the U.S. than overseas. Dimensional Fund Advisors (DFA) looks upon fixed income as a portfolio diversifier away from equities and seeks to keep the volatility low in their bond offerings. We think that approach makes sense in this, our most recent entry into the international bond arena. As with all DFA funds, this is a passively managed (index) fund with a very low expense ratio.

Question: *Is asset allocation dead like the Wall Street Journal stated in the article by Tom Lauricella on July 10th?* **Answer:** This is a really great question and one that many of us in the financial services business continue to have active discussions about. The reality is that for many years we would define an asset allocation

when we first started working with clients and that allocation would only be fine-tuned over a long period of time. Today, we define the asset allocation based on your overall objective, your need for cash flow, what is happening in the world today, and what we believe is going to happen over the next 5 to 10 years. So…………...it truly has evolved from establish the allocation, rebalance quarterly and replace funds where needed to ……………………. establish the allocation, make changes to asset classes as needed, review for tactical changes based on other factors, continue to fine-tune based on the world, review for rebalancing on a monthly basis and replace funds as needed.

We have always viewed what we do as buy and manage vs. buy and hold but today it is much more. We are constantly challenged to study and understand what is happening around us and then try to determine how changes will impact overall financial markets. It is far from a science but we are more determined than ever to focus on learning more and applying that knowledge to managing risk in a very challenging world.

Diversification does still work very effectively today. It certainly didn't work as well as we expected it to during the financial meltdown that began in September, 2008 but it did work. The real difference is that "how we define a well diversified portfolio" does change over time depending on many other variables. Some examples of this can be found in this newsletter. In the answer to one of the questions, we talk about the addition of global bonds to our asset allocation. This is a change. In recent months we have also eliminated international small cap from our asset allocation models. There are many reasons behind these changes, but my point here is that the changes are being made.

We continue to establish a core portfolio of index funds and add active funds to add value. Hedge strategies, commodities, TIPs, and other asset classes are added when we believe it makes sense to have them for risk management purposes. They may be eliminated if we believe they no longer serve the purpose for which they were added.

So………diversification and asset allocation is still the preferred base to start from in managing overall investments. Is it perfect? No, but it is still, by far, the most effective way to manage risk and to manage investment programs. The critical variable to monitor is how the different asset classes work together over time.

When you build a diversified portfolio, your objective is to combine many different asset classes that work differently in different markets. In a very simplistic view—stocks go down and bonds go up. We know things are much more complex than that but that is the basic assumption upon which we build portfolios. Another piece of our allocations has been the addition of what we call a "go-any-where-fund" with EAS: Genesis I. We classify this as one of our hedge strategies funds because they tend to have a defensive position vs. other funds.

The bottom line is that we don't believe that anyone is capable of predicting markets on an ongoing basis and getting it right. Therefore, we don't make major moves in and out of the market. We do believe that we can manage risk through use of different asset classes including bond funds, hedge strategies funds and even cash in some instances.

A friend of mine (Harold Evensky) wrote an article recently about Modern Portfolio Theory (MPT) which is what we focus on in building asset allocations and portfolios.

Harold made a statement which I thought was effective in getting the point across. He was discussing MPT, market timing, absolute return (hedge), and tactical allocation. "As for market timing, I can make this argument short and sweet. Name the ten most successful market timers of all time. How about the top five? The top one?" (Excerpt from *Financial Advisor Magazine*, "*The Big Picture*," August, 2009) Harold's point is that market timing doesn't work or there would be more famous people getting credit for this.

Much of our time is spent doing research and studying the work of others in our field because we know that no one has all the answers. As soon as you think you have all the answers………..the questions change.

Question: *Why are you buying shares in Cohen & Steers Institutional Global Realty Fund (GRSIX)? Isn't there still a lot of pain to come in commercial real estate?* **Answer:** We are buying shares of GRSIX for several reasons. The first is the quality of the fund manager. This well-established firm manages about $16 billion in income-producing equity portfolios with a specialization in real estate securities, large value stocks and utilities. Cohen & Steers has offices in the United States, Belgium, the U.K. and Hong Kong.

We focus on just what you get when you buy a REIT – a portfolio of properties, a management team and a balance sheet, and we invest our real estate dollars with a firm which shares our emphasis on quality in these areas.

Starting in March of this year, Cohen & Steers began to take a very pro-active role in the recapitalization of the U.S. REIT industry. They are known for investing in the strongest publicly-traded REITS, firms that will be able to navigate through the rest of the recession due to their strong management teams and quality portfolios. Cohen & Steers was instrumental in the recapitalization of major U.S. REIT companies such as Simon Property, AMB, Kimco and ProLogis, among others.

We started to add to GRSIX in April 2009 after several of the property REITs in which it invests had successfully negotiated capital raises. At this point, we felt that the market was discounting the slowing economy but not the good news that REITS had access to capital. US REITS raised $16.6 billion in public debt and equity in the second quarter of this year. This followed significant recapitalizations which had already taken place in the U.K., Australia and Singapore.

We made the decision to concentrate our REIT exposure in GRSIX after earlier having invested in both Cohen & Steers Institutional Realty Shares (CSRIX) and Cohen & Steers International Realty Fund (IRFIX). We want the global exposure offered by GRSIX, and it made sense to invest in one fund rather than in three with the overall reduction in expense with lower trading costs and possible overlap in holdings. This allows us to benefit from the improvements in worldwide real estate markets as they occur on a rolling basis. We will be gradually shifting dollars from the other two funds to the GRSIX.

The recapitalization phase is the first of three phases. This process should take about a year overall and is going on now in Europe. In the second phase, the strong, recapitalized REIT companies, such as those in GRSIX, will go on the offensive to acquire properties from the heavily-indebted private owners of commercial real estate. We would expect this to occur over the next three years or so.

Finally, in the third phase of the recovery, we expect to see REITS reap the benefit of the acquisitions they made in the lean years as

occupancy moves up and rents begin to improve.

At present, the top country allocations in GRSIX are as follows: United States - 34%, Hong Kong – 17%, Europe – 13%, Japan – 10%, Australia – 10%, and China – 7%. We expect that this allocation to different regions of the globe will provide good returns for some time to come. Global real estate securities rallied strongly in the second quarter of 2009 with a 36% total return. Asia Pacific was the best performing region, with a gain of close to 45%. This rally occurred as worldwide monetary and fiscal stimulus efforts began to take hold and as investors were cheered by signs of economic stabilization.

We expect that Cohen & Steers' focus on REIT companies, with the strong balance sheet capacity to take advantage of buying opportunities in the private real estate market to stand GRSIX in good stead as the global economic recovery unfolds over the next few years.

Question: *Should we be worried about inflation? If so, why aren't we buying TIPS like I keep reading about?* **Answer:** We have been discussing this quite a bit recently in our weekly investment meetings. We made the decision just over a week ago to begin to add to our inflation protection by buying an ETF called TIP (iShares Barclays Treasury Inflation Protected Securities Fund).

Treasury Inflation Protected Securities (TIPs) were created in 1997 to protect investors' purchasing power over time. Although our current holdings of commodity funds and real estate (REIT) funds provide some level of protection against the eventual return of inflation, we feel it is important to begin to add to this protection. At some point in the next few years, inflation is likely to return. We are probably early in our efforts to add more inflation hedge but prefer to be early and add to the position over time.

We believe it is time to start for a couple of reasons: (1) the monetary policy conducted for the past year by the Federal Reserve has been using an easy monetary policy since the Fed wanted, above all else, to prevent a major collapse of the financial system. This was necessary, but it will be difficult to precisely time the moment when this stimulus is no longer needed; (2) the easy monetary policy of the Fed has been paired with a stimulating fiscal policy by the Obama administration. This was another case of Washington being very proactive in order to get the economy righted; (3) the size of the federal budget deficit continues to increase due to increases in the three largest entitlement programs – Medicare, Medicaid, and Social Security and; (4) the ever-present threat of a potential spike in oil prices due to some unexpected geopolitical event.

Over the very near term, say the next 2 to 3 years, we do not see an inflation threat, and may even see some level of disinflation. Disinflation means a slowing in the rate of price inflation. We see the continued impact of the increases in unemployment and factories which are underutilized. As the economy slowly recovers however, we expect prices will start to move up.

Since we do see the economy recovering, we are not in the camp that looks for outright deflation or an across-the-board decline in prices.

By buying TIPs now, we are choosing to spend some money to buy insurance against the eventual return of inflation. TIPs are reasonably priced right now since the threat of inflation does not appear imminent. The

principal of TIPS is tied to the Consumer Price Index (CPI). The principal increases with inflation and decreases with deflation. TIPs are structured to adjust their coupon payments and underlying principal amounts to keep pace with the CPI.

We look at the difference between the yield on 10-year Treasuries (currently 3.48%) and the 10-year TIPS (currently 1.84%) to determine what inflation rate the market is currently pricing into the price of TIPS. The difference between the two is 1.64% right now. By buying TIPS at these levels, we are saying that we think that inflation will be above 1.64% over the next 10 years. We consider that a very reasonable assumption.

Buying TIPs is similar to buying homeowners' insurance. You don't wait until your house is on fire to buy insurance. Similarly, you don't wait until inflation has returned to buy TIPs. We may be early, but we would rather be early than late in buying this protection against the erosion of purchasing power. This protection is particularly important given the increased exposure to bonds which we have in client portfolios. Stocks can appreciate with low to moderate inflation because companies can raise prices and thus benefit earnings. Bonds, on the other hand, are fixed income securities and there is no way to protect them from rapidly increasing inflation.

Looking Forward

The challenges in 2009 continue but at least we have a little sunshine for a change with which to view them. A few months of positive market results does not a bull market make, but it certainly has improved my outlook for the rest of the year.

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.

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 end of Summer and beginning of Fall!

Diahann

Compliance Disclosure

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this newsletter, will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio. Due to various factors, including changing market conditions, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Lassus Wherley or any other investment professional. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her situation, he/she is encouraged to consult with the professional advisor of his/her choosing. A copy of our current ADV II is available for review upon request.