Lassus Wherley ...a view from the top
Building Better Futures
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Dr. Doom Rides Again!

Food for Thought

Many of you know that Nouriel Robini, otherwise known as Dr. Doom, is not one of my favorite prognosticators. But the reality is I just have trouble with many of these "talking heads" who spend a lot of time on national television telling us what their crystal ball says is going to happen in the world. We spend a lot of time analyzing the same numbers and trying to figure out where the world is headed. The difference in our view and theirs is that we don't believe anyone should make a major bet in or out of the market based on someone's "opinion" about the world. First, there are just too many variables for predicting the world is coming to an end or that the world will return to being a happy place. We certainly hope for the second part but recognize there are going to be some bumps in the road along the way. Based on the last few weeks, they are pretty big bumps.

Will the markets recover quickly from this latest meltdown? Maybe or maybe it will take us a while. Either way, the discussions about there being a "new normal" may be a little premature. Financial regulatory reform is on its way, but we still don't know what we will be looking at when the dust settles. Europe is still pretty rocky but I have a hard time believing that after surviving as long as they have (they have been around much longer than the US) that they aren't going to be able to work their way out of the current "debt mess." So……….the questions we continue to ask are more in terms of how long it will take, not whether it will occur. And yes, it does get pretty scary sometimes. The latest posturing from North Korea certainly is making us all pretty nervous, but all we can do is pray that our leaders keep level heads and put one foot in front of the other as they work through this mess. We know that the markets are reacting very negatively to what is happening in North and South Korea, but what we don't know is what will ultimately happen and what the impact on other parts of the world will be. At this stage we can only stay tuned.

It does sometimes feel pretty overwhelming with so many things happening at one time. I spent last week at the National Association of Personal Financial Advisors National (NAPFA) Conference. We had many discussions around what is happening in the world and different countries today, including our own challenging health care reform. The one thing everyone agreed on is that this too shall pass. Will the issues in the international arena impact us? Yes they will. Will it cause a double-dip in the US? We don't believe it will. But that is, of course, "my" crystal ball view vs. that of Dr. Doom and his Deputy.

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Here are some more thoughts about what is actually occurring in the world. A confluence of factors, including the European debt crisis, politically-inspired violence in Thailand and a lack of a clear explanation for the May 6 stock "flash crash" in the US, have prompted investors to reconsider how much risk they are

willing to accept in dealing with their investments.

As we come to grips with all of these issues, it makes sense to take a step back and look at what has changed in the past couple of weeks. As we mentioned in our last issue, stock markets had been balancing good news on the economic front in the US with negative news on the European debt crisis. Last week, events conspired to cause investors to assume the worst possible outcome in Europe and to ignore the good news which we continue to have on the US economy.

The plan announced by the European Union, the International Monetary Fund (IMF) and central banks on Sunday night, May 9th, did reduce the danger of extending the issues from Greece and the other heavily indebted European countries by providing a major package of government-backed loans. This effectively gives Greece and other Euro-zone countries about 2 years of breathing room to work out their debt issues.

Meanwhile, economic data releases support the idea that the US economy is recovering. As we review the fundamentals of the US stock market in terms of the framework of Dr. David Kelly, Chief Market Strategist of JP Morgan Asset Management, we see that much progress has been made.

Here are some of the factors we study to determine the basic direction of the economy:

Growth – Q1 2010 GDP came in at a 3.2% annual rate. Recent retail sales and housing numbers indicate that Q2 growth may be as high as 4-5% in Q2 2010. Growth now seems likely to trend more in the 3-3.5% range into 2011, since we will feel some impact from events in Europe.

Jobs – 483,000 new *private sector* jobs have been created through April of this year, with 231,000 created in April alone. While it will take years to get back to full employment, and some jobs may never come back, the worry that this recovery would not produce jobs was wrong.

Profits – Q1 earnings came in very strong, beating recent expectations by a good 10%. With 90% of the S&P 500 having reported, S&P 500 operating earnings for Q1 2010 look to come in at $18.90. Estimates are still rising, even with the dampening effect on exports of the strong dollar and some caution regarding the impact of the new financial regulation.

Inflation – The year-over-year rate of core inflation as expressed by the CPI is now running .9%. This is the lowest rate since the 1960's. This very low rate of inflation is enabling the Federal Reserve to keep rates low for longer than had been expected.

Rates – We expect the European Central Bank will also pause before instituting any rate hikes. Recent events have caused rates on the 10-year US Treasury to fall from 4% to 3.1%. Logic suggests that the economic recovery will cause rates to rise as market participants reassess the value in this trade.

Risks – As always, risks do remain. In a worst case scenario, the EU could allow some nation to default or leave the EU. We could see some geopolitical event which might impact the world's oil supply. Financial regulation could end up tightening credit. Our crystal ball does not show clear sailing ahead, and there is always the risk that unexpected events will occur or we could have unintended consequences of actions taken by various governments.

Opportunities – As important as it is to be aware of the risks, it is equally important to focus on what opportunities may be present in the current situation. In David Kelly's words, it is important to distinguish between the possible and the probable. While it is *possible*

that the recovery could be derailed, it is more *probable* that the incipient expansion will continue. The forward price/earnings multiple on US stocks has declined recently from 15.2 times to 13.5 times. This compares to an average p/e multiple of 16.7 times over the past 20 years. This indicates to us that stocks are pricing in many of the risks in the current situation. At the same time, US Treasuries are looking quite expensive given the fall in yields which has occurred while the US debt burden is growing. Given recent indications that the US economy continues to improve, and the strong fundamentals of US corporations, it seems to make even more sense to add to stocks here than it did at the beginning of the quarter.

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Thank you, as always, for the great questions you send our way. Here are some of the questions with our responses:

Question: *What about my international investments? They have come down pretty quickly.*
Answer: We believe that in a global economy, it continues to make sense to diversify internationally. We would all like it if markets only went one way, i.e., up, but that is not the case. Recent events in Europe are unsettling, but for long-term investors, opportunities have been created. If stocks in the US now represent better value than they did in late April, the same is certainly true outside the US. Keep in mind that the drop in the euro greatly improves the competitive position of European exporters.

The growth path in Europe may be slower going forward as several of the peripheral countries deal with austerity and cutting their debt burdens, but a lot of this lower growth rate has been priced into assets at this point. Our primary investment in the International Large Cap asset class is DFA Large Cap International Portfolio (DFALX). This is a mutual fund which invests in stocks of large, non-US companies. The fund invests in large companies in the developed world. DFALX is a very diversified fund, with 1236 holdings. The top 20 holdings account for just 15.75% of the total market value in the fund. 84% of the value in the fund is invested in the top 8 countries. Their allocation in order of importance is: Japan – 20.35%, UK – 19.56%, Canada – 9.32%, France - 9.2%, Australia – 7.84%, Switzerland – 7.2%, Germany – 7.01% and Spain - 3.61%. We continue to find DFALX attractive given its wide country and sector diversification, its long-term record and its very low (0.32%) expense ratio. DFALX remains a way to benefit from the long-term growth of large, non-US companies.

Our primary investment in the Emerging Markets asset class is DFA Emerging Markets Core Portfolio (DFCEX). Here again, growth rates this year may be lower than had been expected just a few months ago, but markets have declined to reflect this change. Once again, we are talking about a very diversified fund that has been and will continue to be an excellent way for us to provide our clients with exposure to the fastest growing countries in the world. DFCEX invests in 2952 holdings and the top 20 holdings account for just 16.27% of the total market value in the fund. 84% of the value in the fund is invested in the top 9 countries. These are, in order of importance, India – 12.50%, China – 12.20%, Taiwan – 12.04%, South Korea – 11.99%, Brazil – 11.71%, South Africa – 9.57%, Mexico – 5.46%, Russia – 3.99% and Malaysia - 3.93%. Close to 59% of the fund is invested in the Asia Pacific region, and over 19% is invested in Latin America. We like DFCEX for the same reasons we like DFALX – diversification and a great long-term record. The expense ratio here is 0.67%, which is very

reasonable considering the level of diversification in the fund and the difficulties involved in investing in some emerging markets.

Question: *What should I be focusing on as I read the scary headlines and watch the news?* **Answer:** Please try to keep in mind the following as you read or watch the financial press:

Market corrections are never pleasant but serve to create better values that allow us to invest dollars at more attractive prices. It makes sense that the US stock market would correct, for whatever reason, given the long up trend that had been in place since the bottom on March 9, 2009.

As we point out in our investment plans, the primary determinant of investment returns is asset allocation. We create individualized asset allocations for Consolidated Portfolios that we manage based on an assessment of each client's time horizon, risk tolerance, investment objectives, and need for income. If there is any significant change in any of these factors, please let us know.

It is generally a good idea to stick with your investment plan and not make major changes based on an increased level of anxiety in times of market turmoil. It is also very helpful for us if you can let us know about any upcoming "extraordinary" cash needs sooner rather than later. This is particularly important in times of market volatility as it helps us to plan for these withdrawals and to raise any cash needed at the most opportune time.

If your asset allocation reflects your needs and objectives as explained above, then it is best in times of market volatility to try to tune out some of the most hysterical financial "reporting." Much of this is designed to keep you glued to the tube rather than to enlighten and, in fact, generates more heat than light.

It is easy to forget about the need for long-term growth from your portfolio in times of crisis but that need will be there for years to come.

Finally, we would just point out that there are major issues regarding sovereign debt levels which need to be worked through by policymakers both in the US as well as overseas. Debt levels in several developed countries are quite high, including in the US and Japan, even though these two countries have been the beneficiaries of most of the money flowing out of the euro recently.

Countries with high debt to GDP ratios will need to find a way out of this situation through a combination of austerity, growth and inflation over the next few years. There will be bumps along the way, but for now, any sign that European leaders are acting in a coordinated manner to help resolve the problems in the euro zone would go a long way towards diminishing the current crisis of confidence that is impacting all markets.

Question: *I am concerned about these markets giving back all the gains and ending up back where we started. Is there any way to hedge the risk more effectively?* **Answer:** The volatility in the financial markets has certainly increased the risk and the headlines which increase the stress we are all feeling around the markets. I know we hear a lot about hedging in terms of options and many other strategies that are designed to reduce the amount you can lose in a downturn. The problem is they reduce the gains on the other side and sometimes even more than they reduce the losses. The reality is that the best way to control volatility and risk in a portfolio is through the asset allocation. I know there has been much discussion about diversification no longer

working but that isn't true. Diversification works very well over time. It is less effective during violent downturns when everything is being sold based on panic vs. selling through a reasoned process. So………...if this market is keeping you awake at night, maybe we need to add a little more of the hedge strategies or short-term bond funds. This can help reduce the volatility and reduce the potential losses in a crazy market.

Looking Forward

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 restarting the recovery in the markets soon. Enjoy the nicer weather (hopefully)!

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