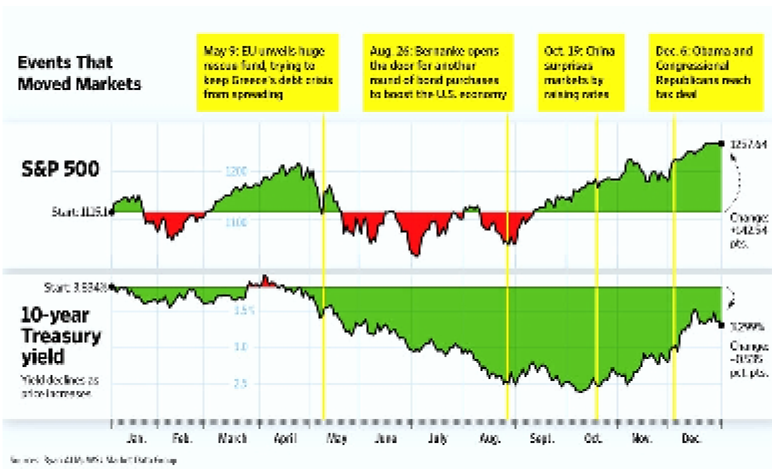
2010 in review: "Less Bad News is Good News"

The stock market and the bond market were as dissimilar as possible this year. Stocks had a rough first half (down 7%) whereas bonds turned in a solid performance (up 5%) – especially long-term U.S. government bonds which were up 15% through June. Much of this difference in performance reflected the credit troubles in Europe and the worries over the global impact of the sovereign debt crisis. Bond investors flocked to safety, driving U.S. government bond prices higher, irrespective of the U.S. devaluation of its currency through "Quantitative Easing" – essentially printing money to juice the U.S. economy.



The second half of 2010 was the opposite with worldwide stock prices on a rampage and bond prices under pressure. From June to December, U.S. stocks reacted to 2 catalysts: the "easy money" policy of the Federal Reserve and the improving economy. While not robust by any means, the U.S. economy showed that throwing billions of dollars out of helicopters to boost the economy, really does work (at least in the short-term). For the 2nd half of 2010, U.S. stocks turned in an impressive 23.2% return, outpacing U.S. treasury bonds (down 5%) and gold (up ~15%). Government bonds reacted negatively to the "Quantitative Easing #2" that the Federal Reserve announced in early November even though the intention was for the Federal Reserve to continue to purchase U.S. government debt to keep long-term interest rates low. Bond investors calmly gave a thumbs-down to improving economic data by selling U.S. government bonds, as they envisioned a stronger economy driving higher inflation in the near future.

The fourth quarter of 2010 was a challenging one for me as I "de-risked" clients' portfolios with the intention of holding on to the hard-fought gains we had achieved through the first nine months of the year. This shift to less volatile portfolios was a large drag on performance for the fourth quarter. All clients showed gains in the December quarter, just that the gains would have been quite a bit higher if not for the hedging that was put in place in late September. In the future, risk reduction is going to take place in a more incremental way to minimize the impact over any specific quarter. No one likes to make less money but it is 100% preferable to losing money.

Outlook: Hoping for a boring 2011

"It is better to be a dog in peaceful times than a man during turbulent times"
- Chinese Proverb

Millions of Americans are asking themselves the same question: "Is this time different?" Whether it is the unemployed job-seeker, the financially-challenged house-seller or the twice-burned investor, everyone is looking for the answer to that age old question. No future outlook is possible unless you decide which camp you are in. As an advisor who looks to minimize risk and maximize profits for his clients, I have been exceedingly focused on this question over the last three months.

As I have mentioned repeatedly in the past, I have been of the belief that over the next 10 years or so, the stock market will return somewhere on the order of 6% per year. It would be great if it was a nice, steady 6% every year but it is more likely to be a roller-coaster of a ride with dramatic ups and downs in between. While the calculations to arrive at this 6% gain per year are fairly simple, the assumptions are much more involved.

In simplest terms, we can expect the gain or loss on stocks to be related to 3 things: 1) how much stocks on average pay in dividends every year, 2) how fast they grow their profits (earnings) and 3) how much investors are willing to pay for each $1 of profits. Part 1) is straightforward – the average dividend yield on all of the stocks in the S&P 500 index is currently 1.8% per year. Part 2) is more complicated and depends on your view of economic and corporate profit growth in the U.S.. This is where the "is this time different" question comes in. *If* this time *is* different and the U.S. economy grows substantially slower than it has in the past because of high levels of debt, the weak housing market and high unemployment, then corporate profits are likely to grow at 1-2% pre year (with a high risk of a "double-dip" recession). However, if this time *is not* different and this is a typical post-recession recovery, then we can expect profits to grow at 6-7% per year. Likewise for Part 3) – in a slow-growth environment, investors usually pay less for the same level of profits whereas they are willing to pay higher prices for higher growth.

A Tale of 2 Views

	Corporate Profit Growth	Average P/E Multiple	Projected Stock Market Return (% per Year)
Historical High Growth	6.5%	20.6	10.1
"New Normal" Growth	1.7%	16.6	3.2
Weighted Average (33% Historical, 67% "New Normal")			**5.5**

Regardless of one's view of the current economic environment, there are other warning lights urging caution in today's markets. 3 signs of increased stock market risk are the following:

1. **Stock market gains of 60% above the previous low point**
   March 2009 was the low point for the market with the S&P 500 at 676. Today the S&P 500 is at 1,293 – a gain of 91%.

2. **Rising interest rates**
   The yield on 30-year U.S. government treasury bonds has moved from 3.5% in September 2010 to 4.5% as of today. While a 1% movement does not seem overly dramatic, if you had purchased a 30-year government bond in September, you would have lost 14% in less than 4 months.

3. **Exuberant investor sentiment**
   There are a number of surveys that show current investor sentiment is as optimistic as it has been at any time since 2007. The AAII survey reported that as of December 30th, 63% of respondents were "bullish" and only 16% were "bearish". A difference this great has not been seen since January 2006. Other surveys also reflect increased optimism by investors and USA Today published a front-page article in December titled **"Experts agree: Get over your fear and get back into stocks"**.

Even if this recovery is the same as previous recoveries, the historical record also points to the need for caution. Since 1950 there have been 12 major stock market cycles with high-point to low-point losses of greater than 15% and 4 minor cycles with high-to-low losses of 10-15%. On average, a complete cycle (from low-point to low-point) takes about 3 ½ years with the decline from the peak starting approximately 15 months before the new low. **From the low-point of March 2009, 3 ½ years would imply a new low around August 2012 with a peak in May 2011.** On average the gains from the low to the peak have been around 77% before the "correction" started. As noted before, we are currently at 91% above the low in March 2009. This is not to say that every bull market lasts for exactly the same amount of time, just that if we are to believe that this recovery is an anomaly then, for us to take more risk we would need to believe that it is going to last for longer (and go higher) than the average "bull market".

Going forward we are going to be patient to take advantage of market opportunities as they arise. A rising interest rate environment is actually a good thing for us as it gives us more options when comparing our 5.5% expected stock market return with potential bond returns. When U.S. 30-year treasuries were yielding 3.5%, it was difficult to justify ownership of a government bond vs. a high-quality stock. Now that 30-year treasuries are at 4.5% and municipal bonds have topped 5% after-tax yields we have more choices of where to invest your money. While we are still in the early stages of interest rates increasing, having more choices is not a bad thing.

Personal Note:

I would like to thank all of my clients for placing their trust in me. As I have worked with my clients to reach their financial goals, I hope that I have reached one of my goals: to do what I said to my clients that I was going to do. This includes mundane items such as tax forms and reporting but also things that take judgment and expertise such as future projections of retirement needs. Most importantly, I have managed my clients' portfolios consistent with the intention of minimizing risk and maximing profits. As always, I would like for my clients to consider me as a friendly resource that can help them solve their problems and worry less about their financial future.

Best wishes for the New Year,

Steven Rountos
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