



First Quarter Investment Commentary April 2010

“The more you observe politics, the more you’ve got to admit that each party is worse than the other.” - Will Rogers

The Quarter in Review

- Congress approved a package of final changes to President Barack Obama's landmark healthcare overhaul, and Obama dared Republicans to try to repeal the new law. The House of Representatives put the finishing touches on the overhaul by passing a companion package that would make insurance more affordable, raise taxes on the wealthy and close a gap for prescription drug coverage for seniors.
- The Employee Benefit Research Institute issued its annual Retirement Confidence Survey in March. As we have said in the past, reading this full report is like reading a Stephen King novel – it is scary enough to keep you up at night. According to the report, 27% of workers surveyed say they have less than \$1,000 in savings, while 54% report that the total value of their household’s savings and investments, excluding the value of their primary home and any defined benefit plans, is less than \$25,000. If you are brave enough, you can read the entire report at www.ebri.org.
- The U.S. stock markets continued to push higher, inching closer to pre-Lehman Brothers collapse levels, as the economy slowly begins to recover.

Investment Implications of Health Care Reform

After almost a year of heated debate, the President has achieved his goal of a major reform to the health care system. So what does this mean for investors?

Tax rates, particularly on investment income, will increase for upper income Americans. Starting in 2013, the Medicare tax rate on households with income over \$250,000 will be increased from 1.45% to 2.35%. In addition, a new Medicare tax on investment income will be introduced for the same group. Currently the tax rate on dividends and long-term capital gains is 15%. In 2011 those rates are expected to rise to 20% for households earning over \$250,000; with the new Medicare tax, these rates will rise to 23.8%. Under the new law investors in this group will get to keep 76.2% of the value of the income stream, compared to 85% currently. It is worth noting that roughly half of U.S. stocks are owned by households with income under \$250,000, and roughly half are held in non-taxable accounts. Also, over the past 40 years the maximum federal tax on capital gains was 24.7% and the maximum tax rate on dividends was 44.6%.

According to the Congressional Budget Office, the passage of legislation would reduce federal deficits by a cumulative \$143 billion between 2010 and 2019 and by greater amounts in the following decade. It is obviously very hard to estimate what total federal health care spending

will be over the next decade, and these estimates should be taken with a grain of salt. PIMCo's Bill Gross said that health care reform will add to rather than subtract from future U.S. deficits and unfunded liabilities. There is nothing in the bill to suggest a reduction in either the quantity or prices of health care services consumed.

- There is no meaningful malpractice reform.
- There is no reduction in drug patent lives.
- There is no compulsion to force insurance companies to compete across state lines.
- There is no movement in the direction forcing consumers to confront the cost of services at the point of purchase, and
- There are no meaningful incentives to force the insured to take better care of their own health.

Despite dire predictions, it is not clear that health care reform will really slow economic growth that much. Most of the tax provisions do not kick in until 2013 and the mandates on businesses and individuals don't begin in a big way until 2016. It may be that businesses will, in the end, be forced to pay more for the health care of their workers; however American business is capable of limiting wage increases to add to benefit costs. To the extent that the government incurs more debt to pay for higher health care costs, it does probably mean higher long-term interest rates.

The Perils of the Financial Media

There is quite a bit of mass media devoted to "do-it-yourself" investing. You can find personal finance columns in all major newspapers and websites, there are dozens if not hundreds of investment newsletters, and of course CNBC and/or Fox Business News plays on the television screens of many a bar, health club, or airport departure lounge around the country.

These media sources seldom if ever mention that the odds of being a successful "recreational" investor are about the same odds as being a successful "recreational" poker player in Las Vegas. Becoming a successful investor requires a commitment of 40-60 hours/week devoted to research, tens of thousands of dollars spent annually on market data, years of practice and the self-knowledge to recognize that, of the thousands of investment decisions you make over a life time, 40% will not work out as you intended.

Those individuals who remained invested through the crisis in 2008 have been rewarded. Given how their accounts have rallied in the last year, we expect those clients to start making new highs (relative to October 2007) over the next two years. Key word is "expect" not "guarantee." The "real" economy, as opposed to the "financial" economy is recovering fastest in emerging markets such as China, Brazil and India, and also in developed economies such as Australia and Canada. The economies of the United States and Western Europe, with the most sophisticated financial systems, took the worst hits. It's pretty aggravating that bankers in the United States and Europe felt taking record bonuses this year was appropriate, even though about \$10 trillion in wealth was destroyed in 2008-09. So far, it looks like the world's real economy is recovering even with a crippled financial sector, and that growth would justify reasonable, but unexciting, gains in global stock prices, barring further any new crisis.

Are you honest with yourself about what's reasonable from an investment portfolio? Our analysis indicates that a properly diversified portfolio of bonds, stocks and alternative investments may return less than 7% per year over the next decade. For years, we have told our clients who draw upon their portfolios for retirement income that 4% (of the total value of a portfolio) is the conservative annual draw rate and 6% is an aggressive draw rate. A portfolio that gains a net 8% per year doubles every 9 years. A portfolio that gains 20% for 4 years and loses 50% in the fifth year leaves you right where you started. It is improbable for us to build a portfolio that will outperform the S&P 500 in a bull market and deliver money market returns in a bear market, on a consistent basis.

Now is a great opportunity to discuss goals and objectives while the markets are calm and it does not appear like the end of the world is upon us.

The Lost Decade, Part Deux?

As we all know, the 2000s were a lost decade for stocks, with the S&P 500 losing 9.1% for the decade, *without* adjusting for the effects of inflation. However, does this mean that everyone lost money for the decade? No, of course not. Some of our long-term equity managers averaged double-digit returns for the decade, allowing many of those clients who have been with us since the beginning of the millennium to satisfy their withdrawals while staying ahead of inflation.

In the financial press, you typically hear of the success stories in investing, but rarely the failures. Take for instance, hedge fund manager John Paulson, whose hedge fund returned over 500% in a little over a year, betting on a collapse in housing. However, this incredible performance obscures the fact that Mr. Paulson had been considered only an average manager in the hedge fund world up to that point. Now, his every move is watched and analyzed. If you were with us in 1999, you recall that Bruce and I (Kevin) were very skeptical of the dot com craze and what it was doing to stock valuations. In the summer of 1999, we analyzed the market and came to the conclusion that the S&P 500 was being driven by a handful of stocks at nosebleed valuations and was due for a possibly severe correction, which would take the entire index down. So, in the fall of 1999, we recommended that clients take a 5-10% position in a fund that would do the opposite of the S&P 500. For example, if the S&P 500 were to decline by 10%, this fund would appreciate by 10%. We felt very confident in this decision and knew we would look like geniuses when the market turned down. However, the market continued on its upward trajectory for the next six months, causing great anguish for those clients. Ultimately, we were right about the direction of the market, and guided clients through the bear market of 2000-02 with minimal damage, owning things like real estate, value stocks and bonds. The battle is won over the long-term, not on a day-to-day basis, but it is difficult to remember that when you are constantly assailed by so many messages.

Looking Ahead

“Most importantly...by increasing the interest rate on reserves, the Federal Reserve will be able to put significant upward pressure on all short-term interest rates...reflected in turn in longer-term interest rates.” - Ben Bernanke, Federal Reserve Chairman

Investors are very concerned about interest rates. While the Federal Reserve may make a policy adjustment late in the year to increase short-term interest rates, this will not be a reaction to inflationary pressures. Rather, it will be a move away from the unnatural state of zero interest rates, which in itself can cause asset bubbles like we have just experienced in housing. However, history shows us that deflation follows deep recessions, regardless of fiscal or monetary policy. The economist Irving Fisher explained this theory back in 1933. According to Fisher, over-indebtedness causes a decline in asset values that results in distress selling, which is what occurred in 2008. The distressed selling is done to repay loans that, once repaid, cause the money supply to contract and the velocity of money to be reduced. When the velocity of money slows down (fewer dollars in circulation), prices fall. After a fall in prices, unemployment increases, accompanied by higher personal bankruptcies and pessimism. Van Hoisington, a successful bond manager, feels that inflation will head towards zero. He feels the U.S. economy has no employment growth, no income growth and no room for further fiscal or monetary stimulus. In other words, short-term rates can't go lower and government spending is constrained by the deficit. In that environment, Hoisington states, the long-term U.S. Treasury rate could go from 4% to 2%. This is why we are staying at target allocation in fixed income, but we will be paying very close attention to what happens to interest rates.

Closing Comments

In a recent industry publication, we read an article entitled, "Managing Your Firm from Afar". This article detailed how some advisors spend up to three months not at their primary business location, but at a summer cottage, a ski resort town, a sailboat, or even a foreign country. All the advisors interviewed for the article seemed to feel the arrangements worked out well for them and their clients. We scratched our heads a little over this. While we take vacations and will start closing our office on Fridays at 3:00 p.m. beginning the Friday of Memorial Day weekend and continuing until Labor Day weekend, we still come to the office on a daily basis. There is no thought of operating from the summer cottage (none of us has one of those) or from the sailboat (ditto), as we feel that our firm exists to serve our clients, not the other way around.



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