



Back Up Through 10,000

October 26, 2009

Before we get to the glory that enveloped the investment landscape in the third quarter, let us first talk about an exciting change that is at hand. This quarter represents the first time we've been able to offer everyone the choice of receiving their reports in an electronic format. We're thrilled to be able to take advantage of technological advances, and to add our hat to the "going green" movement.

The majority of our clients have elected e-delivery, and some have not. In fact, if you find yourself reading these words off a piece of paper and feel motivated to make the change, please let us know and we will set you up for next quarter. If you still prefer a hard copy, that's no problem at all. We're happy to accommodate.

What happened in the third quarter was, by all accounts, shockingly good. In our last report we commented on the fact that the markets had experienced a nice bounce off the lows established in early March, but that many uncertainties remained from a global economic standpoint. Thus, it caught most every market professional by surprise when the sharp rebound continued through the middle of this month – carrying the Dow (once again) upward past the 10,000 mark.

At the heart of this continued rapid advance was optimism that the worst was behind us, and that the process of pulling out of the recession had begun in earnest. In our view, the surprisingly quick reversal of the market's fortunes also played a self-fulfilling hand in keeping things aloft. Each step of the way in the advance was met with a healthy dose of skepticism among Wall Street's money managers. Thus, as the market kept going higher, they were left on the sidelines still waiting for a better opportunity to get back in again. Feeling like they kept missing the boat, every time the market even hinted at a pullback those managers used that opportunity to jump in. Ultimately, such support kept propping up the market with each successive leg up.

By quarter's end, the results were nothing short of fantastic. Domestic, international, small, large, value, growth, emerging markets – all such equities generated returns from about 15-20% in that short period of time. The improving credit quality of bonds around the world, combined with continued, historically low interest rates, allowed the fixed income markets to participate strongly in the rally, as well. Bond positions gained anywhere from 3% (high quality intermediates) to 11% (high yield and emerging market debt).

We've been strong proponents of the high yield (junk) bond market for some time now, and we continue to feel it has a lot to offer going forward. If economic conditions gradually continue to improve, the underlying value of companies that have issued high yield debt will follow a similar trajectory. If, on the other hand, economic conditions

worsen again, you still have the healthy 8-10% yields that most of these securities offer as a nice cushion to rely upon. Yes, there is some risk, but an 8-10% yield is light years better than the 0% money markets continue to offer.

We would also like to expand on a topic we've touched on in the past. The topic is inflation, and its impact on interest rates. We all know about the flood of money poured into the worldwide economic engine over this past year. For better or worse, it did allow us to avert what otherwise would likely have been the outright collapse of our financial system. To spur growth, it has also been necessary to keep interest rates at rock bottom levels.

Well, that simply ain't gonna last forever. Inflation – which was the acceptable evil that accompanied all the money printing, will be here at some point. And when it arrives – look out. The Fed, and its fellow policymakers around the globe, will have no choice but to raise rates – hard and fast. Yes, that will help out long-suffering money market and CD investors, who will suddenly have income showing up on their statements each month that doesn't take a magnifying glass to locate. For bond investors, though, that will be a signal of difficulty ahead.

The problem, of course, is that we don't know when that time will occur. It could be upon us in as little as a few months, or it could take a year or more. While some will disagree, we do feel, however, that this will eventually occur, and when it does, we would like you to consider taking a protective stance. What follows are a few ideas on how one might go about doing just that:

1. **Shorting Interest Rates** – A newly created investment vehicle now enables you to place a direct “bet” on the belief that interest rates will rise, although it's no more like gambling than investing in any other stock. It represents a nice way to hedge an existing bond portfolio, particularly given the tremendous gains experienced by bonds of late. Rates have to go up at some point, and they can't go much lower.
2. **Real Estate** – When inflation kicks in, investors will typically flock towards hard assets, such as real estate. Those who stand to benefit greatly under such a scenario are ones who are able to snap up property at depressed values and combine that with a loan at a low interest rate. Less entrepreneurial types can participate via a sector-specific mutual fund or ETF.
3. **Gold** – Gold is another hard asset that has long been used as an inflation hedge. However, it's more than that. It's currently near record levels. Why? Because those who invest in gold tend to worry about everything. They're not only fearful of inflation, but they're concerned about the weakness in the dollar, about worldwide political and economic uncertainty, and about the stock market falling again – to name just a few.

Thus, as we rejoice in the sharp rebound of the stock market, it probably makes sense to recognize that a host of problems still exist, such as the debilitatingly high level of unemployment. So, despite its current lofty price, gold represents a way of protecting

some of those gains recently made. To make things simple, you needn't go out and buy actual pieces of gold. There are ETF's and mutual funds that facilitate your entry into this sector.

Almost exactly a year ago at this time, in our third quarter of 2008 letter, we wrote these words:

“As of today, most markets are off around 40% from their peaks of a year ago. In this heightened emotional time, it's completely natural to feel like pulling back altogether. If you've chosen to do that, or are strongly considering doing so, we certainly honor and respect that choice. It does come with a caution, though, that an even harder decision awaits you when trying to determine when to “get back in”. You can be certain that a bell will not go off! In fact, you will feel better about the market after it has already gone up (which, of course, is in and of itself the reason you'll feel better). Nevertheless, if temporarily getting out is truly the only way you can cope with these awful times, then that's fine.”

Well, no, the bell didn't go off on March 9th when the Dow finished just above 6,500. Now that the market is a full 50% higher since that date, we've clearly gone through a complete cycle of manic/depressive emotions. If nothing else, it should serve as a very potent reminder that there is nothing more difficult in the realm of investing than attempting to time the market. One has to be right so many more times than they are wrong in order to come out ahead in the long run. And if you are wrong, on the upside or down, the damage done to your portfolio could take many years to overcome.

Therefore, we urge you to take some time to reassess what your true long-term financial goals are, and to share with us any concerns you may have about your ability to reach those goals. Our efforts will always remain focused on helping you get where you need to be. More importantly, though, as we always like to do as we head towards the holiday season, we want to wish you and yours the very best of times, for the love of friends and family members is what truly makes the pursuit of financial gains worthwhile.

Warm regards,

Tony Reed, CPA, CFP
President