

January 2010

Welcome to the second decade of the 21st century. From an investment standpoint, we are not sorry to see the first one end – it was the second worst decade for equities ever, topped only by the 1930s. Annual stock returns over the past 80 years have averaged 9%; however, they were -1% for the last decade while bonds averaged 6%. It is clear that investors are rewarded for taking risk over the long term but the short term can be a different story. Defining the line between short and long term has become more challenging.

The investment environment has felt like a roller coaster ride lately. From the high on October 9, 2007 to the low on March 9, 2009, the S & P 500 lost 57%. As of year-end 2009, the market has rallied 65% since the March lows but we are still down 29% from the peak in 2007. Over the past year and a half, we have witnessed the severe downturns of the market and the ensuing rallies that invariably follow big declines.

What did we learn from this experience? You may recall that I tell prospective clients that we do not like to take them on roller coaster rides. Rather we aim to provide returns in the middle range of potential outcomes, avoiding the extreme highs and lows. The way we accomplish this is to invest in a diversified portfolio of no-load mutual funds rather than individual securities or a concentrated group of funds or strategies. The goal is to diversify away as much risk as you can by adding asset classes that do not correlate perfectly with ones you already own. This recent experience has taught us that while diversification does work over time, there are short term periods during which correlations can increase significantly and almost all market sectors are affected by the downturn.

During the past year, I have spent a lot of time thinking about how best to position the portfolios in order to minimize future downside risk and be able to react quickly during difficult times like the ones we just experienced. As a result of this research, we will be adding two additional asset classes to our investment models – Diversifying Strategies and Real Assets. The Diversifying Strategies category will include funds that employ long/short trading strategies and absolute return strategies. These fund managers have the ability to go long or short based on market conditions rather than just long as traditional funds that buy and hold securities do. The Real Assets category includes commodities, metals and real estate funds. These asset classes will be funded from the equity allocation thereby reducing the volatility of that portion somewhat. If the equity market continues to go straight up from here, this new strategy will most likely underperform the current one; however, if the market goes down or sideways, this new approach is designed to add value. We will also be using additional fixed income funds such as foreign and real return to complement the corporate and government bond funds you already own. Finally, we will be moving the high yield bond funds back to the fixed income sector after tactically classifying them as large cap value funds last year when we added them to the portfolios.

I also want to encourage you to begin thinking about your assets in three distinct groups: the liquidity portion – money you need in the next three years; the mid-term portion – money you will need in years 4 through 9; and the growth portion – money you won't need for 10 years or more. This is another change in approach that I will be making to help you design an investment strategy that is appropriate to meet all of your short, mid and long-term goals while sleeping at night in the event of another downturn. If the assets you need in the short term are not at risk, then you should be able to weather a downturn better while allowing the growth assets time to recover.

Over the next quarter, I will be calling you to discuss how these new ideas will be incorporated into your specific portfolios. As always, please feel free to call me with any questions you may have.

Best wishes for a new year filled with peace, joy, health and laughter!

