

Quarterly Report and Commentary

October 2011

“What a Difference a Day Made
Twenty-four little hours
Brought the sun and the flowers
Where there used to be rain.

Dinah Washington won a Grammy in 1959 for her version of “What a Difference a Day Makes” lyrics by Stanley Adams.

I’ve been humming this song since September when we have witnessed many hundred plus point up days and hundred plus point down days. The stock market has acted like a drunk on steroids. We come to the office in the mornings and hear that the (choose a word) banks- Europe,-Greece,-Spain, are (choose a word) in-not in, big trouble.

A week ago the market was 1,000 points lower. This past Monday we had a 300 point rally. Sixteen days ago we had a 525 point drop. The Chicago Sun Times reports that if you total the Dow Jones Index closing changes each day this year, that “the market has traveled 20,301.98 points.”

Yet, in spite of the real and imagined problems in the world, a diversified portfolio of domestic, international, large and small cap stocks, and forty percent various term fixed income is down less than 3.5% for the year. That is, it is down that amount on this day, this one single moment snapshot in portfolio time.

Last quarter, July-September, was the second or third worst quarter for the Dow Jones 30 Industrials of the past fifteen years. The previous nasty quarters did not signal a bottom in that market, but they were close. Are we near a bottom this time? We don’t know. We do know that following our game plan for you, based on your financial plan, should allow for relatively stress free long-term management of your assets.

We live day to day with renewed market volatility. Volatility is an expression of uncertainty. Each week investors and the markets await the latest jobs report. Prices can soar or plummet on these figures. When the media says, “Investors are dumping stocks”, someone is buying them, usually long-term investors. While patience is desirable I find it one of the most difficult of all virtues.

As you review your personal performance reports, keep in mind what a difference a day makes in determining your portfolio’s percentage return. For example, in the chart below we show S&P 500 returns for the second quarter of 2011. If we calculate the quarterly return using a traditional market cutoff date of June 30, the return for the quarter was -0.88%. Notice how different the returns are if you had calculated the percentage on one of the five days preceding or following that typical, end of quarter

cutoff day. The returns ranged from a high of 1.56% to a low of -4.8%! That's why we never base large investment decisions on just one day's results or on just one period of time. Instead, we focus on the long term return of your portfolio and how that matches the assumptions we make in your individual financial plan. Our decisions are based on careful consideration of many factors, including returns over various periods of time. We believe this is one of the best ways to avoid emotional reactions to today's market volatility.

Short-term Volatility of S&P 500 Returns

What a difference a day makes....

		Return
8-Jul-11	1,343.80	0.85%
7-Jul-11	1,353.22	1.56%
6-Jul-11	1,339.22	0.51%
5-Jul-11	1,337.88	0.41%
1-Jul-11	1,339.67	0.54%
30-Jun-11	1,320.64	-0.88%
29-Jun-11	1,307.41	-1.88%
28-Jun-11	1,296.67	-2.68%
27-Jun-11	1,280.10	-3.93%
24-Jun-11	1,268.45	-4.80%
23-Jun-11	1,283.50	-3.67%
1-Apr-11	1332.41	

CONFERENCES

We attend a fair number of conferences each year. We mingle with our contemporaries from across the country and get a feel for what is happening elsewhere. We are required, just as CPAs and Attorneys, to keep up our continuing education, and that means 40-50 hours of CE each year. We are updated on such topics as: Behavioral Finance, Fixed Income Risk, Global Fixed Income, college planning, retirement planning, asset allocation, and coming changes in taxes. This leads to the following topic.

TAXES

Next year marks the final year of the "Bush tax cuts". Beginning in 2013, higher tax rates become effective. The current lowest bracket of 10% is eliminated and replaced with a new lowest bracket of 15%. In addition, all brackets will increase about 3%, and the top bracket increases from 35.0% to 39.6%. The 15% capital gains rate will jump to 20% and the ultra-long term rate (assets held for more than 5 years) will be 10%.

In other tax revisions, the AMT (alternate minimum tax) exemption reverts back to the prior amount of \$45K from \$72K for married couples. This means if you are currently subject to the AMT you could have an \$8,000 tax increase in 2012. But wait! The employee portion of the FICA tax was reduced by 2% for 2011 only, and goes back up in 2012. Some of the biggest news is that, in 2013, couples with earned income of \$250K or more will incur an additional Medicare Tax of 0.9%. The additional Medicare Unearned Income tax could add another 3.8% to the tax burden of individuals in this income bracket.

These changes keep us on our toes. We need to consider shifting your taxable/nontaxable investments and be certain that we time capital gains and available income to minimize your growing tax burden. We may find it to your advantage to accelerate or defer income and/or capital gains or losses. We have much to consider and, working with your CPA and tax advisor, we target a goal of minimizing your tax liability.

RETIREMENT ACCOUNTS

If you have a retirement account outside of our management, please let us review your beneficiary designations. This is very important since, at death, distribution of IRA and qualified retirement plan assets is not directed by your will, but rather by your beneficiary designations. Even if you have executed an estate plan with wills, trusts etc., your assets are at risk of incorrect distribution if your beneficiary designations are incorrect. In reviewing your designations we will also determine whether you have named any minor children as beneficiaries. This may be problematic as, in order to inherit the assets, the court would require appointment of a guardian for the funds. Often times the court suggests the funds be held in cash, which can translate in to lost investment potential if the child is very young when inheriting the funds. There are ways to include minors in your plan, and we will coordinate with your attorney to establish a plan consistent with your wishes. Lastly, there are many court cases resulting from individuals forgetting to change their beneficiaries after a divorce. If a retirement account beneficiary form is never changed, the assets would be distributed to an ex-spouse in the event of the account holders' death. Please contact us if you have any outside retirement accounts so that we may assist you in avoiding these common mistakes.

SOVEREIGN DEBT RATINGS AND STOCK RETURNS

In early August, Standard & Poor's downgraded US government debt from a top-rated AAA to AA+. In the weeks preceding the event, some market observers expected a downgrade to result in higher interest rates and lower stock returns.

After the downgrade, yields on US government securities fell across the term spectrum as investors around the world fled to the safe haven of US bonds. US stocks experienced negative returns in the following weeks but logged positive performance from the day of the downgrade to month end.

These events raise questions about whether changes in sovereign debt ratings impact the financial markets. The short answer is that results are mixed, and many other factors affect a country’s cost of capital and stock market returns.

Regarding bond markets, history offers examples of major developed countries that experienced a credit downgrade without a significant rise in interest rates. Examples include Australia, Canada, and Japan, which lost their top ratings in 1986, 1992, and 1998, respectively.

Other research suggests that countries with high credit ratings may withstand a downgrade better than countries with lower ratings. One study looked at sovereign credit rating downgrades since 1990 and found that bond yields changed little among countries downgraded from the highest triple-A rating. However, countries with lower credit ratings (single A or below) experienced significant interest rate increases following their downgrade.

Stock market impact

Another question is whether the US downgrade has played a role in the US market downturn—and research does not provide convincing evidence.

Below is a chart that summarizes stock market performance of countries before and after a ratings change. It is based upon a study of ratings changes made by Moody’s from 1983 to 2009. During the twenty-seven year period, the ratings agency made seventy-one upgrades and twenty-five downgrades to governments in the developed and emerging markets tracked by MSCI.

The study identified the date of each change and logged each country’s market performance in the twelve months before and twelve months after the ratings change event. Each country’s market returns were compared to the respective market index and the excess return averaged for all events. (Excess return refers to performance above or below the respective market index, either MSCI EAFE or MSCI Emerging Markets, as appropriate.)

Figure 1. Equity market performance before and after Moody’s ratings changes

1983-2009	Cumulative Return in Excess of Market	
Sovereign Bond Rating Change	12 Months Before	12 Months After
Upgrade	13.83%	3.87%
Downgrade	-6.56%	3.73%

Analysis conducted by Dimensional Fund Advisors using sovereign bond rating data from Moody's Investors Services, "Sovereign Default and Recovery Rates, 1983–2009." Returns are in US dollars and represent performance in excess of MSCI EAFE Index for developed markets and MSCI Emerging Markets Index for emerging markets. A positive excess return indicates market outperformance; a negative excess return indicates underperformance. The table reports the return of an equal-weighted, event-time portfolio. Past performance is no guarantee of future results.

Results of this study show that, in aggregate, stock markets of upgraded countries outperformed their respective market index in the twelve months before the rating change – a 13.83% cumulative excess return. Stocks in downgraded countries aggregately underperformed the market index before the event. However, cumulative returns in the twelve months following a ratings change were almost the same for the upgraded and downgraded countries (3.87% vs. 3.73%).

The consistency in 12 month returns suggests that market prices reflect all available information and expectations about a country's economic prospects—including the possibility of a ratings change. By the time a country's debt rating is upgraded or downgraded, the market has already integrated the news into prices. Stock markets reflected positive economic developments prior to a ratings upgrade and negative developments before a ratings downgrade. After the event, markets did not appear to perform much differently, in aggregate.

Conclusion

This research underscores the importance of looking to market prices for signals about the fiscal health and prospects of a country or a company. Based on the foregoing analysis, markets appear to work faster and more accurately than ratings firms to assess a country's financial condition and evaluate the potential impact on its cost of capital and equity market.

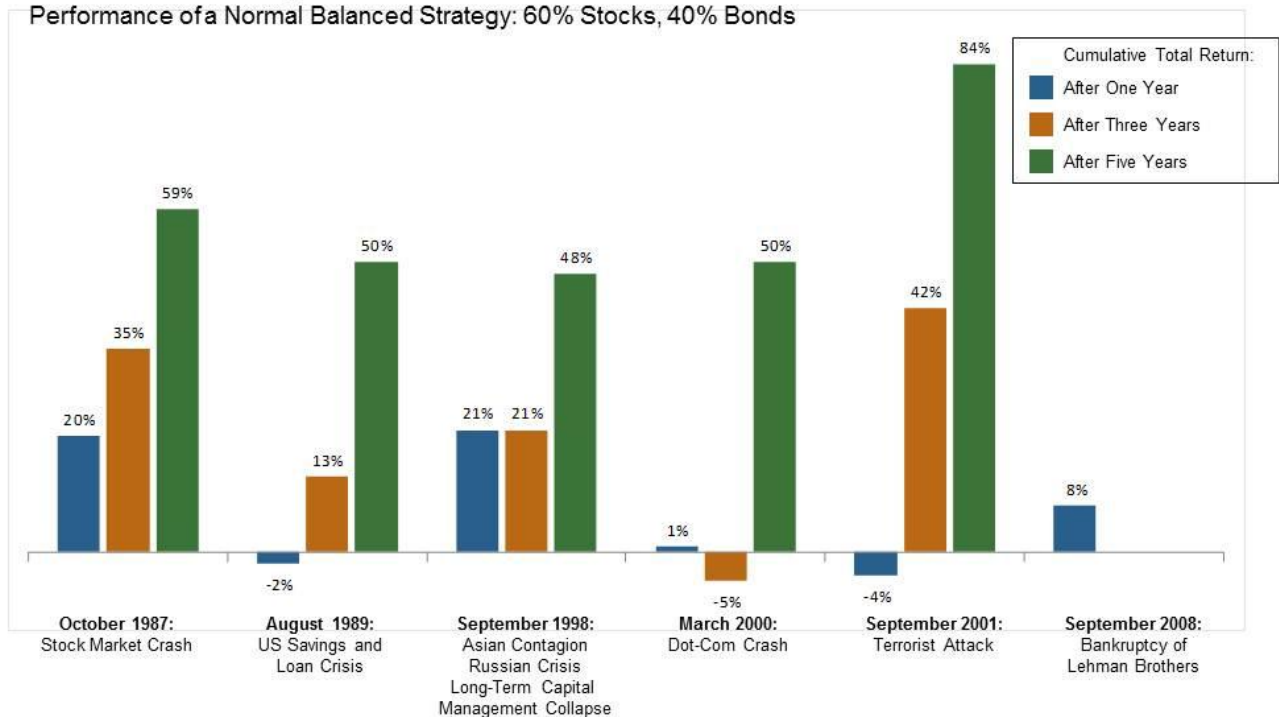
CORPORATE CHANGE FOR GOOD

The "for profit" corporation exists, under corporate law, to maximize shareholder value. The corporation is directed to maximum it's profit. If you invest in my corporation, we'll call it Yellow Banana Corp. (YBC), you have every right to expect YBC will work to make as much money as is legally possible. If YBC hires workers at wages significantly higher than comparable minimum wage or donates large gifts to charities, you may decide to sue the directors of YBC for failure to serve your best interests.

California is the sixth state to approve the "Benefit" class of corporation. This new class allows companies to pursue social and environmental issues or missions along with a profit motive. The Benefit Corporation must publish annually how it performed relative to its mandate. This should mean a high level of corporate transparency. The Yellow Banana Benefit Corp's directors may now direct the YBBC operate as a business for the good of the environment, employees, and society along with making a profit. I really like this idea and hope all states will quickly jump on the Benefit bandwagon.

The Market's Response to Crisis

Performance of a Normal Balanced Strategy: 60% Stocks, 40% Bonds



Balanced Strategy: 7.5% each S&P 500 Index, CRSP 6-10 Index, US Small Value Index, US Large Value Index; 15% each International Value Index, International Small Index; 40% BofA Merrill Lynch One-Year US Treasury Note Index. The S&P data are provided by Standard & Poor's Index Services Group. The Merrill Lynch Indices are used with permission; copyright 2010 Merrill Lynch, Pierce, Fenner & Smith Incorporated; all rights reserved. CRSP data provided by the Center for Research in Security Prices, University of Chicago. US Small Value Index and US Large Value Index provided by Fama/French. International Value Index provided by Fama/French. International Small Cap Index compiled by Dimensional from StyleResearch securities data; includes securities of MSCI EAFE countries in the bottom 10% of market capitalization, excluding the bottom 1%; market-cap weighted; each country capped at 50%; rebalanced semiannually. Indexes are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Not to be construed as investment advice. Returns of model portfolios are based on back-tested model allocation mixes designed with the benefit of hindsight and do not represent actual investment performance.

This graph provides further proof of what a difference a day makes when it comes to portfolio returns. The graph shows performance of a balanced investment strategy following a few historical crises. Each crisis is labeled with the month and year that it occurred or peaked. The subsequent one-, three-, and five-year annualized returns start from the first day of the month following each crisis. Although a global investment strategy would have suffered losses on the day of or days immediately following most events, the financial markets recovered in time, as indicated by the positive three- and five-year cumulative returns. Negative events such as these may tempt investors to flee the financial markets. However, diversification and a long-term perspective can help investors apply discipline to ride out storms caused by one-time significant events.

We look forward to this fourth quarter which, historically, has positive market returns. Have a wonderful fall.

John, Derek, Dawn, and Sue