2nd Quarter 2010 Market and Economic Commentary

I got a jump on my summer reading and just finished "The Big Short", Michael Lewis' stunning account of what actually happened in the sub-prime mortgage crisis that ultimately led to the complete meltdown of Wall Street in 2008. You remember 2008…that terribly uncomfortable year when burying your money in the backyard became America's favorite pastime. Lewis, author of "The Blind Side", "Liar's Poker", and other notable true life stories provides a tragically accurate post-mortem of the financial crisis and lays the blame squarely where it belongs – at the feet of the ratings agencies, the investment banks, and government regulators. He does a decent job of crucifying the Wall Street cronies, the industry media (none of whom actually predicted the collapse in advance, but merely fanned the flames once the fire started), and the ineffective and astonishingly ignorant regulators and ratings agencies who still haven't explained how investments they rated as bulletproof on Tuesday became worthless by Wednesday. A remarkable story to read, for sure.

As Lewis notes in his book, the world has certainly changed. The massive spending by governments around the globe has led to an unsustainable level of debt in many developed countries, not the least of which is the United States. While our deficit woes are not as great or as imminent as some of our European counterparts, the headwinds the Euro Zone currently faces will surely be ours if our elected officials do not reverse their current path of unrestricted spending. (The good news? The Euro has fallen, making it cheaper to vacation there. The bad news? No one can afford to go.) One thing is for sure - both economic growth and dramatically reduced government spending are absolute requirements to right the ship of state. Our elected officials must first agree on these critical issues, and then execute policies to accomplish them. Like most of you, I become more cynical each day that our current elected representatives – on both sides of the aisle – can put aside their partisan agendas and get down to business. This is the single most critical challenge facing the next two generations of Americans. Make your voice heard at the mid-term elections. Hold your representatives accountable. And take a friend along to the polls. Responsible fiscal policy in Washington is our most pressing challenge.

Despite this rather large hurdle, the US economy continues to exhibit broad-based signs of mild growth and recovery. As I've said many times, the economy heals itself when politicians get out of its way. Corporate earnings continue to accelerate, jobs growth – while sluggish – is improving, and productivity and manufacturing gains build on each other every month. Even select real estate markets are showing signs of stabilizing and (dare I say it) growing mildly. While our debt problem is likely to overhang and stifle the rate of overall economic growth, things are in fact improving.

It comes as no surprise that opinions on the future direction of the stock and bond markets vary widely. I'm sure you're shocked. As I write this, the markets are hovering around the 10,000 level, which is largely attributed to the problems in the Euro Zone. Given the remarkable performance/recovery of 2009, this comes as no surprise to most. Unfortunately, the media coverage of daily events forces unguided investors to abandon their investment philosophy and adopt a market outlook. Nothing could be more damaging. What's the difference, you ask? An investment philosophy is rooted in facts and history. A market outlook is rooted in emotion and opinion. Back to Lewis' book to make my point here.

The one group notably absent from Lewis' dissection of greed and ignorance is the individual investor. For years, the conventional wisdom has held that, when it comes to investing, the little guy ends up getting the short end of the stick. Allow me to disagree.

In 1988, an investor who purchased the S&P 500 Index and merely looked out the window for 20 years saw his portfolio grow by an average annual rate of 8.35% by the end of 2008.* You'll note that this time period – 1988-2008 – contained some very difficult challenges like 9/11, the savings and loan debacle, the tech bust, and the most recent financial meltdown…all of which were trumpeted as the end of the world, but instead just turned out to be the apocalypse du jour.

And yet, through all of these world ending nightmares visited upon investors by Wall Street robber barons, self-interested politicians, and uncontrollable market forces, the patient and disciplined investor calmly watched his initial investment *almost quintuple* over this twenty year period.

Tragically, during this same time, the average stock fund investor experienced an average annual rate of return of 1.87%. How, you may ask, can the first investor have fared so well while the second one did so poorly? Both invested in stocks. During the exact same time period. Through frightening times. But their results were vastly different. How can this be?

Two words: Bad Behavior.

For the first investor, his only defense was to diversify, own good stuff, and be patient. Faith in the future helped too. These are all good behaviors and hallmarks of an *investment philosophy*. The second investor chased yesterday's winners and tried to time the markets. He panicked and ran after the horse was already out of the barn. He piled back into the markets after all the bargains were gone. It should be obvious to you these are bad behaviors, fed by a *market outlook*.

Here's my point: Through all of these difficult and trying times of the past twenty years, some individual investors have profited handsomely. Others have failed miserably. What separates them is nothing more than their behavior. I have no crystal ball, but I imagine the next twenty years will produce similar results for both investors. Your behavior largely determines your results, not the market. Embrace an investment philosophy, not a market outlook.

Herewith are some straightforward pearls to help strengthen your resolve in the face of today's challenging environment:

- Most people don't have an investment philosophy…they have a market outlook. Investment philosophies breed good behavior; market outlooks breed bad behavior.
- It's not different this time; it's just a new costume on an ancient fear. The world is always ending, but it never ends.
- Our country's challenges are formidable. They always have been. But, we've always prevailed. History is on your side here. Betting against history rarely rewards.
- If you focus on journalism, you cannot help but be a pessimist. If you focus on history, you cannot help but be an optimist.

As always, we are thankful and appreciative for the confidence you've shown in us as your trusted advisor. Please don't hesitate to call me. We're here to serve you.

See you next quarter,

Jeff Helms, CFA

**Dalbar Quantitative Analysis of Investor Behavior, 2009*