July 11th, 2011

Here is our newsletter for the 3rd quarter of 2011.

The Markets
Despite a fair amount of volatility throughout the quarter the equity market net returns were pretty flat. For the quarter U.S. large-cap stocks were flat while small cap stocks lost 1.6%. International stocks gained 1.1% while emerging markets stocks lost 1.0%. High grade U.S. bonds did better with a gain of 2.4%. High yield bonds were flat and emerging market bonds gained 3.4%. Commodities took it on the chin with a loss of 9.8%.

For the quarter our equity-tilted composite gained 0.5% compared to 0.7% for the benchmark and our balanced composite gained 1.4% vs. 1.1% for the benchmark. Our overweight to emerging markets stocks and our commodity allocation detracted from our performance while our overweight to bonds, especially emerging market bonds improved our performance. With our continued downside protection designed into our portfolios, we should expect a low level of volatility in our portfolios in either up or down markets.

Combating Low Cash Yields
Back in October of 2007 I wrote a piece on cash management in my newsletter which deserves an update. By cash we mean totally liquid funds in checking and savings accounts, money market funds and certificates of deposits (CDs) of no longer than 1 year maturity. You can find the 2007 newsletter on my website at www.CompFinancial.com. Go to the "What You Need to Know" page and click on 3rd Quarter under 2007.

How times have changed! In October of 2007 one year CD yields averaged 4.65% and even most Money Market accounts had yields over 4.0%. After the financial crisis yields on most of these accounts have plummeted and are now less than 1%. Forget about T-bills as they yield essentially zero. Eventually these rates will go back up and savers will benefit. However, if you believe the Federal Reserve they will hold these rates down "for an extended period of time".

An article in Kiplinger's magazine brought up a good idea that may be an appropriate alternative for some. "I" Savings Bonds offered by the U.S. treasury have yields set and paid every 6 months. The yield consists of a fixed rate (currently zero) and a rate tied to the Consumer Price Index, which most recently paid 2.3%. This inflation-adjusted yield is equivalent to a 4.6% annual yield. The downside is this rate could go to zero this November (but never negative if we have deflation). Another downside is you have to hold for at least one year and if you redeem before five years you lose the last 3 months of interest. However, compared to rates of 0.8% for the average one year CD, buying an I Bond by August 1st will earn you more interest in the next 3 months than you will in one year in your one year CD. For those that have some cash that can be locked up for at least a year, this looks to be a good alternative. You can buy up to $5,000 per year per person. They are exempt from state and local taxes and can be used federally tax free if used for qualified educational expenses. You can buy these directly from the U.S. Treasury at www.treasurydirect.gov.

Financial Reform and Your Advisor

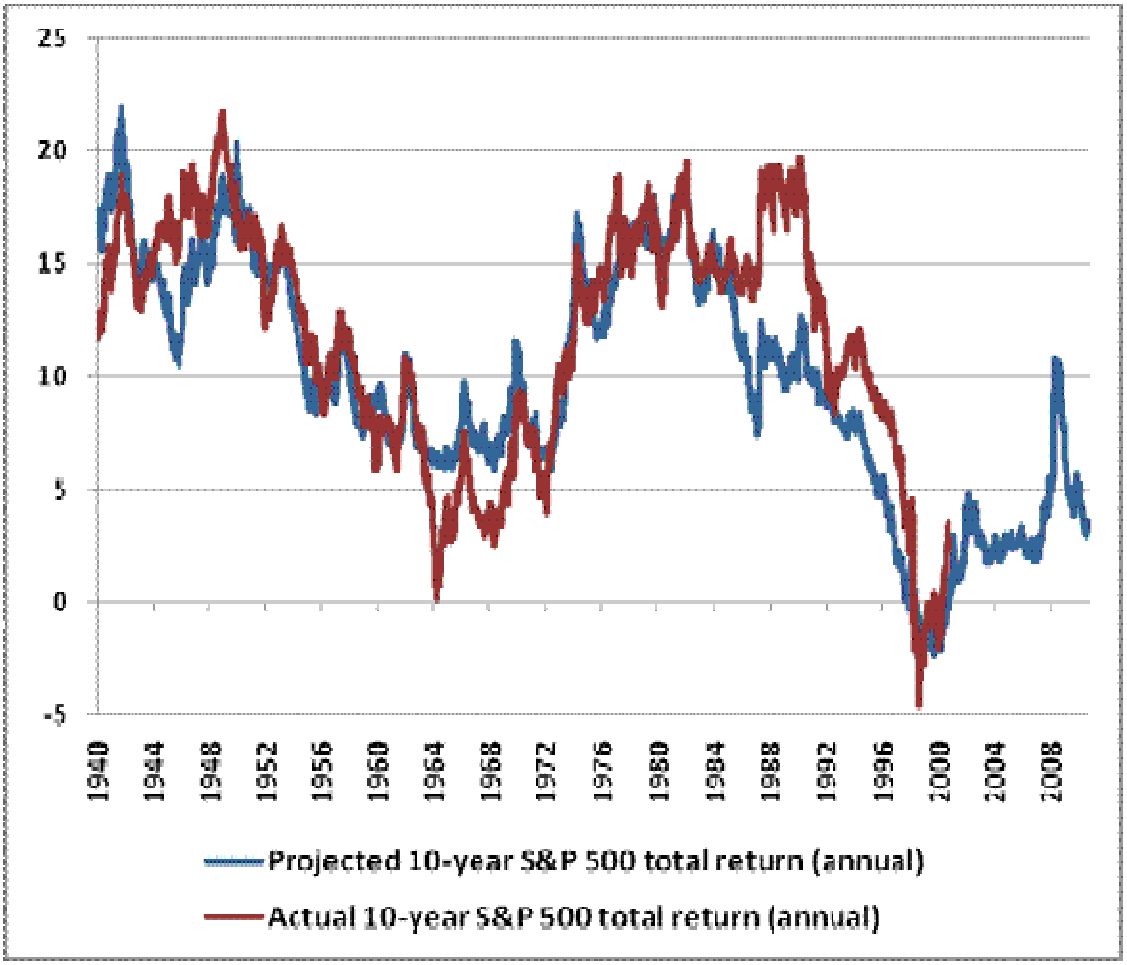
One of the few good things that came out of the financial crisis is the Frank-Dodd Wall Street Reform and Consumer Protection Act passed last year. One of the provisions of the so called Financial Reform Act was to require all Registered Investment Advisors to present information about their business, background and conflicts of interest in an easy to read written format. Advisors have had the option to do this in the past and I chose to do so in 2003 when I started my business. I had to revise it per the new requirements and post it on the SEC website. Read it and let me know if you have any questions. http://www.adviserinfo.sec.gov/(S(vnfycgju5vebnci3mb3w0ha2))/IAPD/Content/ViewForm/ADV/Sections/iapd_Adv2Brochures.aspx.

Another provision of the act gives the SEC the authority to impose a fiduciary duty on brokers who give investment advice --the advice must be in the best interest of their customers. Most consumers are not aware that brokers are not required to work in the best interest of their customers. In fact they are required to act in the best interest of the company they work for according to federal law. Although the Act seems clear the devil is in the details as the lobbying efforts of the brokerage industry are at work to dilute any positive impacts by weakening the standards or simply cutting funding to the regulators for enforcement. The fee-only financial planning association I belong to (NAPFA) and other financial planning groups have formed a coalition to make sure a tough and uniform fiduciary standard is applied to brokers and advisors alike. You can find out more and sign the petition at www.financialplanningcoalition.com.

Projected Equity Returns

Several analysts we respect analyze equity valuations and projected market returns. One we have mentioned in previous newsletters is the Shiller P/E ratio which suggests the U.S. stock market is about 25% overvalued. Another analysis by John Hussman uses similar methods in that average previous 10 year earnings are used, but also uses other factors such as dividend yields and profit margins. The chart below presents his analysis in the form of projected future 10 year annual returns in the U.S. stock market and comes from his May 16 2011 weekly commentary. The blue line is the projected return and the red line is the actual return. Looking back over a 70 year period the projected annual returns are usually within a few percent of the actual returns.

The current projected annual return for the market over the next 10 years is about 3.5%. That is a total 10 year return of 41%. A big note of caution; this analysis is not going to tell us what will happen over the next 2 or 3 years. Even over 10 year periods there have been times when the projected was 7-8% above or below the actual. For example from the late 80s to the late 90s actual returns were much better than projected over the next 10 years. In the mid-60s projected returns dipped to around 6% but actual dropped below 5% and hit a low of zero in 1964. Most recently the analysis correctly predicted 10 year returns dropping to an all-time low of almost -5% in 1999.



So what does all of this tell us? A portfolio predominately holding U.S. (and other developed market) stocks at current prices may not provide returns that even keep up with inflation over the 10 years. This is one of the reasons why our portfolios are underweight equities in favor of alternative asset classes that offer higher risk-adjusted returns.

Sincerely,

Stan Johnson, CFP(R)
Comprehensive Financial, Inc.
Registered Investment Advisor