July 12th, 2013

Here is our newsletter for the 3rd Quarter of 2013.

Markets-The Short View
Two developments dominated the markets and our portfolios in the 2nd quarter: the spike in interest rates (and subsequent decline in bond prices) and the sharp decline in emerging markets stocks and bonds. Both of these events hurt our portfolios and resulted in losses for the quarter in the 1 to 2.5% range. U.S. stocks were the only major asset class with gains for the quarter at 2.9% for the S&P 500 index. Developed markets lost 0.8 and emerging markets got hit hard with an 8.3% loss. All types of fixed income lost value with the total bond Market Index losing 1.6%. Emerging market local currency bonds lost over 8%.

U.S. stocks have performed better than the foreign markets since late 2010 and our portfolios benefited from our underweight to foreign equities thru December of last year. We increased our allocation to foreign equities in December of last year and this February and this has hurt our portfolios in the short run.

Why do we have almost half of our equities (and also some of our fixed income) in foreign markets, including emerging markets? First, the emerging market economies are growing much faster than the advanced economies of the U.S., Western Europe and Japan. In 2000 the share of world gross domestic product (GDP) was 80 % for the advanced and 20% for the emerging economies. Today the share is 60-40 and it is estimated the share will be 50-50 in 2023. Second, the advanced economies have a much higher debt overhang than the emerging world, both private and public. The average gross government debt as a % of GDP in the developed world is over 100%. Germany is in the best shape at 80%. In the emerging economies this figure ranges from a high of 60% for India to 20% for China and 10% for Russia. The advanced economies have to reduce their debts which will mean austerity, tax increases and will continue to be a drag on economic growth for many years.

We believe we are in a good place going forward to participate in the global growth story and to have a more diversified portfolio not dominated by one market. Imagine a Japanese investor with most of his investments in the Japanese market in 1990. The Nikkei index has gone from 38,300 to 14,472 today, a drop of over 50% over the past 23 years. I'm not suggesting the U.S. in another Japan. I'm simply saying it does not pay over the long haul to concentrate your investments in one country, including your own country.

Markets-The Long View
Our newsletter would not be complete without a couple of charts. Doug Short who runs a website for advisors called Advisor Perspectives put the chart together below which shows

monthly returns for large cap U.S. stocks over the last 142 years. These returns are real, meaning they are after inflation has been subtracted. Most interesting is the regression of the data, a fancy way of determining the average return and comparing how returns have deviated from the long-term average. The red lines show 4 periods when stock returns were negative for long periods of time with the average duration being about 17 years. In 2000 returns hit an all-time high of 153% above the trend-line. Since then returns have gotten closer to the trend line but are still 57% above. Note how in previous cycles there were several intermediate bull rallies followed by subsequent bear markets that took the stock market lower. Nothing about the future is certain but we believe the odds favor us continuing in the current long-term secular bear market we have been in since 2000 for another few years. This is one reason why we have emphasized downside protection for over 5 years now. Another reason is illustrated in the second chart.

The second chart is from Advisors Intelligence, a research firm we use in our practice. It shows their projections of returns over the next 5 years based upon their scenario analysis. Their most probably scenario, a sub-par recovery which has been the case the last 4 years, is illustrated by the solid black lines across the blue bars. The prospects for investment-grade bonds under any scenario are poor and this is why we are currently underweight this asset class. The prospects for alternatives and emerging market bonds looks good on a risk-adjusted basis and this is why we overweight these asset classes and use them to replace some of our investment-grade bond and equity allocations. On the equity side also note the better prospects for foreign over U.S. stocks.

What Happens in Vegas

The National Association of Personal Financial Advisors (NAPFA) annual conference was held in Las Vegas in May. Membership in this group of fee-only financial advisors helps me to keep abreast of changes in the profession and to network with other advisors. They require 60 hours of continuing education credits every two years, the most in the industry. Here is a sampling of some of information presented you may find interesting.

Rick Mayes from the University of Richmond detailed the State of the U.S. Health Care System. The big push in health care is to reduce the cost for everyone with many provisions of Obama Care attempting to drive costs down. Here is one factoid: half the US population accounts for 97% of all health care spending. The top 1% spends almost $52,000 annually. Medicare and Medicaid spending is by far the biggest budget problem. Medicare will eventually tell the health care providers “Here is how much money you will get per Medicare beneficiary, and you’re not allowed to charge any more (no balance billing)”.

There were a couple of sessions on disability and life insurance. There is a 27% chance for a 35 year old man to incur a long-term disability during the course of his career. The chance goes up to 31% for a woman. You’re also around twice as likely to become disabled vs. dying if you are less than 45 years old. What’s the leading cause of disability? Back, shoulder or knee problems, not cancer or accidents as most think. So don’t think you are immune from a disability just because you have an office job.

Paula Muschler with Alssup Medicare Advisor described how they help seniors select the best Medicare, Medicare Advantage and prescription drug plans. They do a personal needs assessment and budget, research available plans in your area, make recommendations and help with enrollment if needed. They are unbiased and receive no compensation from the insurance providers and charge a very reasonable fee based upon the level of service you require. Let me know if you or someone you know could benefit from this service.

Several sessions dealt with all the changes to income, capital gain and estate taxation. Most of the changes affect those making more than $200,000 per year. The top income tax bracket has gone up from 35% to 39.6%. The big news on the estate tax front is the exemption has gone up to $5 million per individual and a couple can get a $10 million exemption by a simple election on their tax return for the first to pass (the so called portability provision). The AMT tax has at least been settled in that the exemption has been set and will be indexed for inflation going forward.

Several sessions discussed various investing topics. One factoid stood out among all the hundreds of charts and graphs for me: 85% of all trading on the stock exchanges are high frequency trading where large investment banks are buying and selling using computers in time frames measured in the milliseconds, trying to gain an advantage over others by locating their computer servers adjacent to the stock exchanges. For those with portfolios dominated by equities and planning to get out before the market takes a big hit, good luck with that.

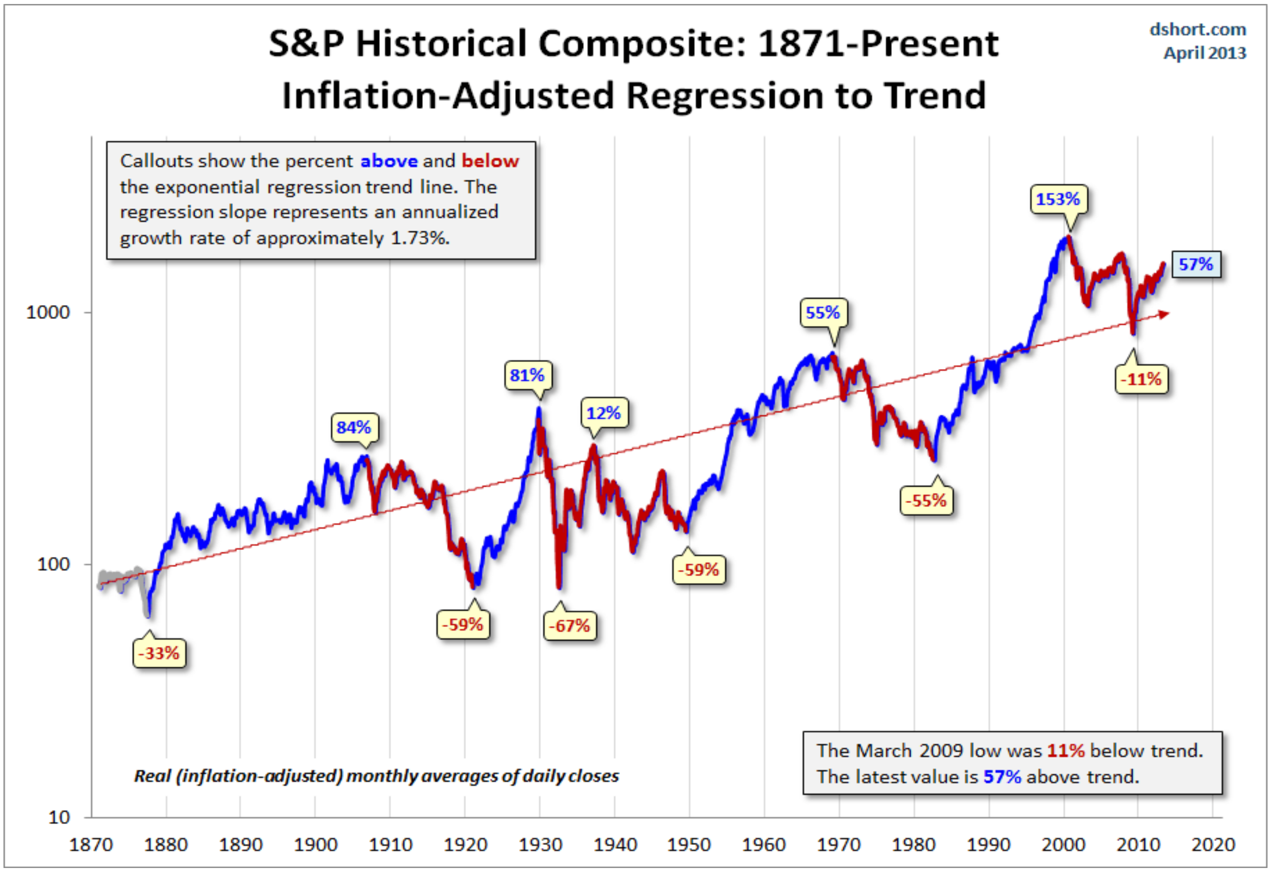
Laura Carstensen is an actuary and director of the Stanford Center on Longevity and had an interesting story (given the source) to tell about a lady, Jeanne Louise Calment who lived in France. When she was around 90 years old her neighbor offered to buy her home. She liked living in her home and turned him down. Her neighbor, who was 45 at the time then offered to pay her $500 per month for the rest of her live if she would pass title to the house to him upon her death. Jeanne had nobody to pass the home on to so this was a deal she could not pass up. Her neighbor, being only 45 at the time would most likely get her home at a real bargain. In 1997 Jeanne passed on at the ripe age of 122. Her neighbor predeceased her by 7 years, but not before paying Jeanne for about 25 years. There’s more than one lesson here for all of us.

And you thought everything stays in Vegas.

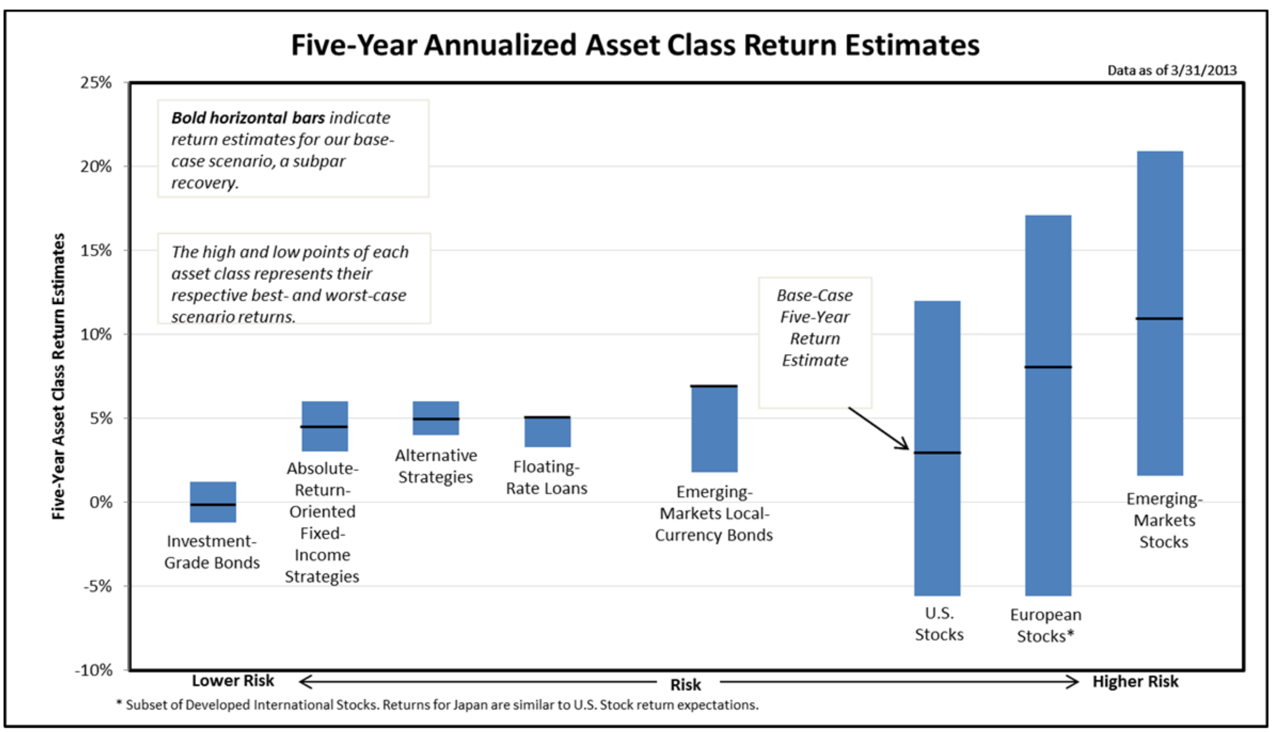
Thank you for your continued interest and let me know how I may be of service.

Sincerely,

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



S&P Historical Composite: 1871-Present
Inflation-Adjusted Regression to Trend
dshort.com
April 2013
Callouts show the percent above and below the exponential regression trend line. The regression slope represents an annualized growth rate of approximately 1.73%.
153%
57%
55%
-11%
81%
12%
84%
-55%
-59%
-59%
-67%
-33%
The March 2009 low was 11% below trend.
The latest value is 57% above trend.
Real (inflation-adjusted) monthly averages of daily closes
1000
100
10
1870
1880
1890
1900
1910
1920
1930
1940
1950
1960
1970
1980
1990
2000
2010
2020



Five-Year Annualized Asset Class Return Estimates
Data as of 3/31/2013
Bold horizontal bars indicate return estimates for our base-case scenario, a subpar recovery.
The high and low points of each asset class represents their respective best- and worst-case scenario returns.
Base-Case Five-Year Return Estimate
Five-Year Asset Class Return Estimates
25%
20%
15%
10%
5%
0%
-5%
-10%
Investment-Grade Bonds
Absolute-Return-Oriented Fixed-Income Strategies
Alternative Strategies
Floating-Rate Loans
Emerging-Markets Local-Currency Bonds
U.S. Stocks
European Stocks*
Emerging-Markets Stocks
Lower Risk
Risk
Higher Risk
* Subset of Developed International Stocks. Returns for Japan are similar to U.S. Stock return expectations.