



2011 Quarterly Client Letter

How do you spell relief? It's not by recent market performance, that's for sure. We could laundry-list this past quarter's seemingly endless series of painful blows to investors, but the media has already done a fine job of it, play by excruciating play. With every fresh wave of bad news, you may be finding it increasingly difficult to maintain your investment resolve. Since our top priority is to provide advice based on your best financial interests, we must repeat the same advice we've offered all along:

Having prepared your portfolio in accordance with your personal goals and the expectation that risk happens, your best course of action is to stick to your plan.

To do otherwise would be like equipping your ship with a life preserver, and then jumping overboard without it when the seas threaten to overturn your vessel, forgetting the sensible emergency preparedness procedures you adopted during calmer days.

Still, society hasn't gotten where it has today by ignoring what may seem like important new information. And it's a fact that we're in particularly rough seas, with short-term market volatility at record highs. Under the circumstances, it's natural to wonder whether your circle of support is up for the job. Let's address potential concerns head on.

Regarding Economies

It would be difficult to make it through a day without hearing or seeing bad economic news, especially related to sovereign (government) debt in Europe and the U.S. But what should you do with the information? As CBS Moneywatch columnist Larry Swedroe observes, "When it comes to investing, there's a major difference between information and knowledge. Information is a fact, data, or an opinion held by someone. On the other hand, knowledge is information of value. Confusing the two is a major mistake."¹

So, before we assume we can know the effects that economic information will have on action-worthy investment knowledge, let's consider some facts. When Standard & Poor's downgraded own sovereign debt in August, you might have logically concluded that the investment would price itself cheaper to remain competitive as investors shied away from it. Instead, rates actually increased. Ironically, as people responded to general market uncertainty, they fled in droves to what was still perceived as the safest port in the storm – the recently downgraded U.S. debt.

Dimensional Fund Advisors, commenting on the phenomenon, cited a study looking at sovereign credit rating downgrades since 1990 and found that bond yields changed little among countries downgraded from the highest triple-A rating. They also observed that history offers numerous examples of major developed countries experiencing credit downgrades without a significant rise in interest rates (which would have implied a loss of investor confidence). Examples included Australia (in 1986), Canada (1992), and Japan (1998).

As additional evidence, Grubb & Ellis Chief Economist Robert Bach recently commented on the fate of Iceland, "an early casualty" in the ongoing crisis. In fall 1998, its three biggest banks collapsed and were nationalized, and the country defaulted on its foreign debt. Then, Bach described its turn-around: "Earlier this month, Iceland agreed to pay \$11.4 billion from the estate of failed Landsbanki to cover all foreign depositor losses. After two tough years of contraction, Iceland's economy is projected to grow 2.5 percent this year according to the IMF, outstripping the 1.6 percent forecast for the euro area."²

Basically, bad news today doesn't necessarily predict bad news moving forward. Even if it did, there's still that consideration of whether the economic information could be used as investment knowledge. Again, evidence is that there may be little to no connection between good/bad economic news and predictable, investable market reaction to the news. Even as the news is reported, rest assured you're not the only one out there who is aware of it, and many who are aware are doing their level best to fix whatever's broken. Sometimes they succeed and sometimes they don't, but the point is, as Yogi Berra quipped, "It's tough to make predictions,

¹ Larry Swedroe, "Do You Confuse Information With Knowledge?" CBS Marketwatch, April 16, 2010.

² Robert Bach, "The I's Have It," Grubb & Ellis: Good News Friday, September 23, 2011.

especially about the future.” And especially, we might add, in a global economy that has historically been as amazingly innovative and resilient as ours.

Regarding Your Investments

The future aside, have you been wondering whether you might have done better had you tried to time the market this year? Unlike some past periods when nobody saw the bad news coming, much of the news this summer came as no real surprise when it happened. What if you had tried to move in and out of the market or had sought alternative investments such as leveraged ETFs (where managers can “bet” for or against various outcomes so, in theory, they come out okay regardless)?

In terms of fleeing the stock market entirely, this is perhaps the most common reaction to market risk which, as we’ve touched on in past communications, typically results in selling low (when the risk appears and everyone is panicking) and buying high (when it seems “safe” and everyone is trying to jump back in), plus incurring needless transaction costs and tax ramifications along the way.

In terms of seeking inventive products that claim to deliver market returns *and* reduce risk, the best way we know to accomplish this feat is by using the same, sound global diversification you’ve already got built into your portfolio. Other products may add complexity and convulsion, but they’re not expected to add returns, especially after you adjust for the risks and expenses involved.

To understand why this is so, if you have five minutes, we encourage you to listen to a recent enlightening interview of Vanguard founder John “Jack” Bogle, found here:
<http://finance.yahoo.com/blogs/breakout/game-rigged-jack-bogle-122640921.html>³

Bogle reminds us of the essentials that drive our capital markets to thrive, and why it’s ill-advised to attempt to fly in the face of those essentials. He explains that, at their essence, U.S. market returns are based on employment of capital by corporate America. “It’s business, it’s earnings and dividends and capital and return on capital. If you own the stock market for a lifetime, you get those returns.” Beyond that, he cautions, “You shouldn’t be playing the game. You don’t need to play the game.”

We and an overwhelming bulk of academic studies fully agree with Bogle, whether the games are being played with the latest leveraged Exchange Traded Funds (ETFs) or other types of alternative investments.

A recent *Wall Street Journal* article reports that more than half of the alternative mutual funds, or “hedge funds for the masses,” have been launched within the past three years, and investors have flocked to them. Because these funds have wide latitude to get fancy with tactics such as using future options and selling short, in theory, they should shine brightest during periods of high volatility, when they get to show off their expert hedging skills. Morningstar analyst Nadia Papagiannis called the funds’ three- and five-year track records “disappointing.” And that’s before you consider their steep expense ratios in the range of 1.8%–2.1%. (In contrast, the expense ratio of the DFA funds we use are in the range of 0.2%–0.7%.) One of the alternative funds’ advisors defended its negative returns by explaining, “Like our entire industry, we were off on our assessments of risk.” So much for expert hedging skills.

Year-End Planning

Typically, our third quarter letters include planning strategies for your year-end and new-year tax strategies. Because this has been an unusual summer, we thought you might prefer to read these broader market reflections. Of course tax planning also remains a vital component in your wealth management. We will reach out to you soon to discuss strategies that make sense for you at this time. In the meantime, we hope you’ll be in touch with us with any questions or comments that may be top of mind for you or your loved ones.

We thank you as always for your turning to us as your wealth advisor.

Warmest Regards,



Robin and your Northstar Team

³ Matt Nesto, “The Game Is Rigged: Jack Bogle,” Yahoo Finance: Breakout, September 29, 2011.