

# BEACON INVESTMENT MANAGEMENT

## THE FRIDAY BRIEF

*Distributed to our clients and friends weekly*

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### Traps

How investor outlook has improved since those dark days of early March. The S&P 500 remains 32% above its March 9<sup>th</sup> low despite recent announcements that Chrysler and GM are closing 789 and 1,000 of their dealerships, respectively. All signs suggest this is a confidence rally. The huge liquidity pumped into the global economies is driving short-term interest rates to levels that no longer hold any appeal for investors. They are fleeing the relative safety of short government bonds in pursuit of higher returns of higher risk instruments. With real estate down for the count, stocks and commodities represent the only game in town at the moment. Still some argue that the current rally is a trap, a bear market rally that will eventually falter. Our opinion is that the rally is a bit overdone, but it is for real.

The global markets, particularly the emerging markets are acting as though global recovery is in full swing. The MSCI Emerging Market Index is up 50.3% from its October 27, 2008 low. The catalyst was the Chinese government's announcement of their huge infrastructure spending program last November. The large-cap global index MSCI EAFE is up 38% from its March lows.

Here at home, economic reports continue to suggest continued woes, but also that the rate of decline is slowing. Today the NY Fed reported that manufacturing in the region slowed at its slowest rate since August of last year. The six-month outlook improved for the third straight month.

Inflation at both industrial and consumer levels fell last month at the fastest rate in over 50 years, largely due to energy and food prices. Economists do not generally fear deflation because declines are mainly focused on food and energy and are not more broad-based. Too, oil has had a major rally in the last few weeks. In their last policy statement, the Fed said they expect inflation "will remain subdued" and that the Fed "sees some risk that inflation could persist for a time below rates that best foster economic growth and price stability in the longer term."

Earlier in the week, the government announced that the recession will likely shorten the life of Social Security by four years. The (legalized Ponzi scheme) government retirement program is now due to run out of assets by 2037. Medicare is in no better shape reaching its legal spending limit by 2014. Anyone doing the math realizes that there are not enough workers nor can taxes go high enough to sustain the Ponzi. Unfortunately as the ship sinks it appears the working strategy is to continue whipping a dwindling crew, forced to bail with ever larger buckets.

Unemployment remains under considerable pressure and is likely to get worse before improving. A reacceleration of losses is expected from auto manufacturing and dealership

closings. Dr. Ed Yardeni suggests the unemployment rate could easily jump to the 10.3% peak in the worst-case scenario of the government's stress test for the banks. He suggests that "this [rise in unemployment] may not cause any more stress for the banks than projected using the Fed's peak rate. How could this happen? Actually, quite easily, if the labor force participation rate rebounds as more Americans conclude that they can't afford to retire or to remain retired. Older workers who had saved and invested for retirement are coming back into the labor force looking for jobs. Many have seen their retirement assets depreciate significantly in value over the past couple of years."

### "The Performance Trap"

How can it be that so many retired Americans now find themselves lacking sufficient confidence to stay retired? The most likely culprit in our view is that they are caught in a 'performance trap.' Billions of marketing dollars encourage investors to unknowingly walk into a trap. They believe that finding the 'best' manager with the 'highest' returns is sufficient to reach their goals. The fallacy of this one-dimensional performance-driven planning is proven by this market collapse. Outsized performance carries outsized risk.

Let's take a real-life contemporary example. Thousands of investors bought into the Legg Mason Value Fund, attracted by manager Bill Miller's outstanding 15 years of outperforming the S&P 500. Fifteen years in almost anybody's book is a very long time, perhaps even a 'guarantee.' However, by March 6<sup>th</sup> of this year, the 'guarantee' disintegrated. The fund fell 73.4% from its peak of October 9, 2007. By comparison, the S&P 500 fell 56.3%. More damaging is the fact that the fund's significant drop puts its 10-year performance 3.27% below that of the S&P 500 on an annualized basis. Fifteen years of 'outperformance' evaporated in just a couple of years!

What about those unfortunate folks who invested in late 2007? They find themselves 17.5% below the S&P 500. In order to simply get even with the index's returns Mr. Miller will have to outperform them by more than 2.7% a year for the next ten years. His historical outperformance has averaged 1.8% if we toss out his last three years of underperformance and his one big up year in 2003 (to be fair). To catch the S&P 500 within 10 years Mr. Miller will have to outperform his own historical outperformance by 50%, and that's assuming he has no more hiccups. To bet your retirement on it is a trap.

Last year's outsized losses were not just limited to investors seeking growth. Even mutual funds designed to minimize risk for retirees, such as American Funds' Bond Fund of America and Income Fund of America declined 14.7% and 33.9%, respectively last year. Many of the nation's leading target-date funds of 2005-2010 were down more than 20%.

A sad truth is that many investors will continue to compound their woes in response to these losses. A 2003 study done by Dalbar, Inc. reveals that investors earned just 2.6% from 1984 through 2002. The S&P 500 returned 12.2% during the same period. They blame behavioral mistakes for the huge difference; getting in at tops and selling at bottoms.

If you invest to achieve lifetime financial goals, why risk underperforming markets? You can ensure market performance by owning indexes. But that isn't the greatest threat you face. It is the risk that market declines might occur when you need to spend from your investments, just like the retirees we discussed earlier. While we know that market risk will occur, we cannot know when. So we plan for it, testing your plan to determine what assets you will need for sufficient confidence to meet all of your goals and *stay retired*.