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Are You a Tactical or a Strategic Investor?

We will get to the economic data shortly, but a good self-evaluation is appropriate every so often, particularly at the first of a new year. When you consider your investments do you make your most significant decisions according to a plan which looks well into the future, or do you tend to let the daily price, data, and tongue wiggles wag those decisions? Consider carefully, because the answer could well impact the quality of your lifestyle.

Capital market returns over a lifetime of saving are sufficient to meet investor needs if costs, taxes, and risk are carefully controlled. That's not to say that the markets do not involve risk; they do and the timing of that risk is unknowable. But if one minimizes his risk to only that of the capital markets, by eliminating the chance of material underperformance of active managers, then he can significantly improve his confidence of meeting all of his goals.

Despite the fact that the last decade has provided miserable stock returns, long term averages are still quite high. Take a look at the chart below. You can see that returns given various stock and bond allocations are very attractive.

Capital Market Returns since 1926

	<i>Potential Average Return</i>	<i>Odds of Losing Money in Any One Year</i>	<i>Worst Return</i>	<i>Percent in Stocks</i>
Portfolio A	11.5%	1 in 3.9	-40%	100%
Portfolio B	11.1%	1 in 4.1	-37%	90%
Portfolio C	10.6%	1 in 4.4	-33%	80%
Portfolio D	9.5%	1 in 5.2	-26%	60%
Portfolio E	8.6%	1 in 6.3	-20%	45%
Portfolio F	7.6%	1 in 7.9	-15%	30%

Source Financeware.com

You might also note that risk declines faster than returns do as one moves from Portfolio A (100% in stocks) toward Portfolio F (30% in stocks). It is allocation as well as other non-performance oriented variables such as savings, spending, timing of goals that are most important in the strategic investor's plan. The strategic investor understands that markets and goals are going to change, sometimes dramatically, over the course of a lifetime. By continually stress-testing his comprehensive plan in light of market changes, he can take advantage of *opportunities* to make adjustments that would otherwise be missed by someone focused on simply on returns.

If after honest and objective self-analysis you find that you are easily swayed by the winds and currents of the markets and economy, then you are likely to wind up where the winds and currents will take you. You will be all the more impacted by the storms along the way.

The Wall Street Journal named Ken Heebner's \$3.7 billion CGM Focus Fund the best-performing US diversified stock mutual fund. It rose more than 18% annually for the decade and outpaced its closest rival by more than three percentage points. Unfortunately investors weren't around to enjoy the gains. The typical CGM Focus shareholder lost 11% annually in the 10 years ending Nov. 30, according to investment research firm Morningstar Inc. as they weren't able to weather high variability of the fund. Dalbar, a market research firm focused on investor behavior, reveals that from 1984 through 2002, individuals earned just 2.6% while the S&P 500 rose 12.2% during the same period. Studies show that a majority of investors flock into markets near their peaks and jump ship just before they bottom.

This behavior is clearly irrational and emotional. When markets are calm and investors are relaxed everyone agrees that the time to buy is when prices are cheap and you sell when they are high. But what is missing for the emotional investor is a plan. If one has not planned for the certainty of future crises then they are much more apt to act irrationally and emotionally in a in the middle of one. The numbers prove it.

Just as sailing the ocean requires a chart and course corrections caused by unexpected winds and currents, investors need to plan, to visit their plan regularly, and to make adjustments when indicated to get back on course. Knowing how and when requires more than your gut.

The Economy This Week

The recovery appears to be gaining speed. Economists forecast that the economy will expand 2.7% this year, the best performance in four years. It probably grew by 5.5% in the fourth quarter, according to estimates, the fastest in more than five years. The Fed's Beige Book business survey released on Wednesday indicated the recovery is broadening, with 10 of the Fed's 12 district banks reporting improvement last month. Home sales increased toward the end of last year in most Fed districts, and manufacturing improved or held steady while the labor market and loan demand remained weak. While the recovery is underway, it is largely expected to be both sluggish and uneven.

Business inventories added to the positive news rising 0.4% in November, the same rate as in October. These two months mark the turn in the inventory correction. But inventories are still slipping relative to sales according to Bloomberg. Total sales jumped 2.0% in November following a 1.4% rise in October. The stock-to-sales ratio fell 2 tenths in November to a very lean 1.28. This is a good combination for an improving jobs outlook if sales continue to rise.

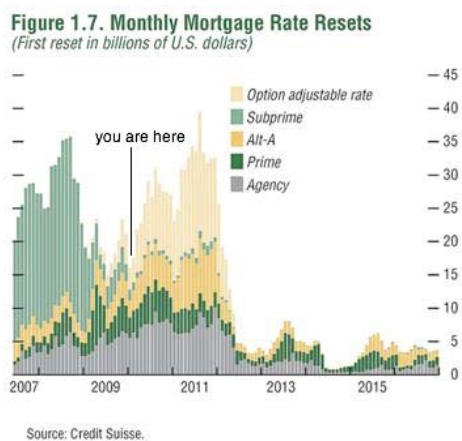
Production in the US rose in December for the sixth consecutive month, propelled by a jump in utilities use as temperatures turned unseasonably cold. Output at factories, mines and utilities climbed 0.6% for a second month, according to a government report today.

The international trade deficit rose sharply in November due to significantly higher petroleum imports. But US exports continued their uptrend keeping that part of the economic recovery intact. The overall US trade gap widened to \$36.4 billion from a revised \$33.2 billion shortfall in October. Exports gained another 0.9% while imports surged 2.6%, largely due to petroleum.

On the consumer side, the RBC Consumer Attitudes and Spending by Household index saw the largest single monthly gain in expectations for jobs since that index began eight years ago. After declining much of 2009, American consumer confidence improved sharply this month, returning to levels not seen since the financial crisis began in September 2008. The Reuters/University of Michigan preliminary index released today did not echo the strength of the CASH index as it rose only from 72.5 to 72.8 in December. Unemployment and housing still weigh heavily on sentiment. Neither is expected to improve soon and housing may just be in for another huge setback. Unfortunately, additional remedies may be scarce this time around as the Fed has few arrows left in its quiver.

During the housing bubble when banks were stumbling over each other to put anyone who could fog a mirror into a mortgage, one of their most frequently used tools was the Option Adjustable Rate mortgage. This instrument is characterized by a low 'teaser rate' (a rate that makes the house appear affordable on less income) for a limited period of time which entices the would-be buyer into an obligation he clearly could not meet at higher conventional rates. Unfortunately for the homeowners, their banks, and for we taxpayers (in this age of universal responsibility) the rates eventually reset to reflect reality (oftentimes at rates above conventional rates). Another reality check is upon us and may portend difficulties as great or greater as the past subprime debacle caused for banks, and us.

In the next few months as you can see in the chart on the right, the yellow bars represent the adjustable rate mortgages as a percentage of total mortgages. See how they compare to the subprime mortgages on the left in green? Are the banks and the Fed ready for this storm?



Stocks are down today on JPMorgan's earnings announcement which included a lower-than-expected revenue number. More importantly the bank boosted its loss reserves for consumer loans by \$1.9 billion, bringing the total to \$32.5 billion. Do the reserves adequately address the coming mortgage problems?

Even though recovery is taking hold, investors still face significant challenges this year. While 2010 will likely not bring the extremes of 2008 and early 2009, there will undoubtedly be 'opportunities' to test whether you are a tactical or a strategic investor. If you have had enough tactical investing and wish to become a strategic one who makes informed decisions calmly, objectively, and in advance of 'opportunities,' we would love to help.

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