THE NEW ENGLAND GUILD, INC.

WEALTH MANAGEMENT COMMENTARY

PROTECTING AND BUILDING YOUR FINANCIAL FUTURE

FALL 2009 (860) 236-3301 www.neguild.com

Market Spotlight

Index	Returns Qtly 3rd Qtr	Annual 1 Yr	3 Yrs	10 Yrs
Equities				
S&P 500	15.6%	-6.9%	-5.4%	-0.2%
Russell 2000	19.3%	-9.6%	-4.6%	4.9%
MSCI EAFE (Int'l)	19.5%	3.2%	-3.6%	2.5%
FTSE REIT	31.5%	-25.3%	-12.7%	9.1%
Bonds & Cash				
Barcap Agg. Bond	3.7%	10.6%	6.4%	6.3%
90 Day T-Bills	0.0%	0.2%	2.6%	3.0%

The current market performance offers an excellent opportunity to show how one might slant the news. Compare, for example, a statement that "The US stock market has now gained 58% since its lows in March; riskier assets (high yield bonds, emerging market stocks, small-cap stocks, REITs) have had even more dramatic returns" with the statement, "The US stock market is now only off 29% from its highs of October 2007 while riskier assets have fallen even more dramatically." Both statements are true; what do they tell us about the future?

Thoughtful, respected observers argue persuasively for either a V-shaped recovery or a W-shaped double dip recession. The former cites the traditional contributors to recovery (inventory rebuilding, auto sales, housing sales – all reflecting pent-up demand) plus the protracted stimulus of government spending, an improved environment for lending and foreign demand for exports. The stock market, as a lead indicator, lends support to this view. But the double-dip view notes that unemployment is still rising with little evidence of new job creation, deleveraging by financial institutions and individuals continues to the curtailment of both lending and consumption, and the economy in general remains fragile in the face of potential oil shocks, geopolitical threats, institutional vulnerabilities and/or any number of other material threats. As always, the outcome will most likely fall somewhere in the middle.

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Investment Commentary

OUT OF THE ASHES

Several clients have sent us recent articles that question a number of the investment precepts which underlie our investment management processes and those of most other institutional money managers. In essence, the claim of these articles, based on the horrific experience of the past two years, is that diversification does not work to shelter returns, that probabilistic models of risk and return are flawed, that markets are not particularly efficient, and therefore that asset allocation as a primary basis for managing risk is ineffective.

These articles strike us as a bit naïve for three reasons. First off, *diversification has worked*. Over the past 30 years the S&P 500 has suffered declines of 10% or more over a 12-month period on four occasions, most recently over the 2001-2003 and 2008-2009 periods. In each of these periods the Barcap Aggregate Bond Index has had very favorable absolute and real returns. What is true is that US and non-US stocks are increasingly moving in tandem because of globalization. Therefore an investor no longer gains as much diversification within an equity portfolio.

But one must be careful. Correlations between asset classes have never been stable and are far more closely related to macroeconomic events and trends than to natural relationships between asset classes. While bonds may have diversified stocks in 2008-2009, they did not serve that role in the 1970's when inflation was rampant. Commodities, including gold, have at times been effective diversifiers to stocks, but not when the market declined sharply in 1998.

A second reason these articles seem naïve is that they suggest the data that support assumptions underlying investment theory are simply extrapolations of history. Historical patterns of risk, return and asset correlations can be a useful guide for modeling ("the past is prologue"), but these data have never been stable within any shorter-term time period. Modeling should use assumptions believed to be reasonable over a longer-term future time horizon. These assumptions will inevitably be wrong but they must represent thoughtful judgments about future relationships between asset classes based on sound financial theory. In our mind, these theories relate to the idea that return and uncertainty of return (risk) are positively correlated *over time* because rational investors seek compensation for taking risk. Additionally, asset class returns must be related to underlying fundamentals *over time* because it is impossible for financial markets to be independent of the real economy for any prolonged period of time.

Finally, in reality these articles offer nothing new. Modern Portfolio Theory has been criticized since its conception as inadequate for the reasons stated above and for the reasons that investors are not all alike. Investors differ in their tolerance for risk, investment time horizons, tax situations and many other factors. Therefore, there is no "optimal portfolio" that serves all investors. These criticisms are all valid. But no one has come up with a better way for constructing investment portfolios, nor for evaluating the types and magnitudes of risks inherent in a portfolio. So modern portfolio theory (MPT) is the best tool we have. It works reasonably well most of the time, but not all of the time. Investing will always be about exposures to unknown risks.

So where does this leave us? First, it leaves us committed to building portfolios that we believe are well diversified and where we think the inherent risks are consistent with the risk tolerances of our clients. That being said, we also know that we need to better understand risk, not only the volatility that can be inherent in financial markets and the tails of probability distributions, but also the risk tolerance levels of our clients. We have seen new approaches to modeling risk as undertaken by Andrew Lo at MIT and Abdullah Sheikh and Hongtao Qiao at JPMorgan which offer potential

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MARKET SPOTLIGHT

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What does seem clear, however, is that a year ago the economy was wheeled into the Emergency Room in very critical condition. Circulation (financial liquidity, lending) was severely impaired, organs (banks, autos, housing) were failing, and vital signs (stock prices, credit spreads) were in states of erratic and precipitous tailspin. Doctors (Federal Reserve, Treasury) stepped in to perform major surgery. Some amputations and grafting were necessary (Lehman, Countrywide, Merrill Lynch, Wachovia, General Motors) as were major transfusions (AIG, Citigroup, Bank of America). The patient remained critical but at least blood flow and breathing were sustained.

The patient is better now, but remains in intensive care, perhaps in serious but not critical condition. Close vigilance remains a necessity, but time will likely be healing in and of itself. However, we won't know the side effects (inflation, regulation, deleveraging, globalization) of such a major intervention for years to come. While we breathe a sigh of relief that the patient is still alive, one would be foolish to believe that everything is back to normal. At the same time it is reasonable for us to hope that the patient will continue on the path to recovery. For this reason we remain committed to an investment plan based on long-term recovery, but one that also recognizes uncertainty and takes into consideration the individual needs of each of our clients.

INVESTMENT COMMENTARY

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enhancement of existing models.

We also hope academics and practitioners develop improved methods to assess the risk tolerance levels of individual investors who, unlike institutional investors, have much greater emotional involvement in their portfolio. Finally, we hope the experience of the past year will make us all better investors.

Effective Gifting Strategies - A Case Study

We recently helped a client solve some estate planning issues with a number of instructive ideas that may benefit others. Our client, a widower in his 80's, has an estate of significant size. He had established trusts for the benefit of his children, but was interested as well in gifting upon his death to family members (other than his children) and to charities. Our challenge was to identify the best way to implement his intentions so as to *maintain flexibility* (in case he wished to make future changes in his plans), to *maintain ownership* of assets (so that they would be able to support him, if needed), and finally to *minimize the costs of executing his plans* (legal fees, estate & income taxes, probate fees). To achieve his plans required using beneficiary designations in his IRA and Schwab One accounts (using "Transfer on Death" provisions).

We proposed that the gifting to family be done within a separate Schwab One account for which family members would be designated as beneficiaries to receive funds upon the client's death using a "Transfer on Death" provision. This would require establishing an additional account with funds transferred from his existing Schwab One account into the new "Family Gifting" Schwab One account.

With respect to gifting to charities, we suggested using IRA funds. IRA assets gifted to charities avoid both income taxes and estate taxes that might otherwise result in losing as much as 85% of the IRA to taxes. We proposed creating a second 'Charitable IRA' account with transfer of approximately half of the assets from his existing IRA account.

It is notable that each of these new accounts is *completely revocable*; i.e., the client can change beneficiaries, bequeathed amounts, or completely close these accounts at any time were his wishes to change without trigger either income or estate taxes or legal fees at the time of the change.

Finally, we suggested consideration of a Gifting Trust or Foundation account which could be funded either by some portion of the annual required minimum distributions (RMD) he takes from his IRA and/or upon his death by designating this Gift Trust account as a beneficiary of his Charitable IRA (instead of or in addition to other specific charities he had named). One benefit of this is that his children could serve as co-trustee on the account. This Gift Trust account, however, would not be revocable, that is, the client could not retrieve funds for his own use once they had been transferred into this account.

We believe these ideas are not generally understood and can serve a number of purposes in effective estate planning.

EXCURSION

While the growing season for capital markets is random, it's fairly predictable at Avon's *Pickin' Patch* farm, where you pick your produce directly from the fields or from the shelves at their retail shop. The season starts in June and July, when lettuce, peas and strawberries ripen, and continues into August and September with squash, peppers, tomatoes, raspberries and blueberries. And then there is October, when hayrides take eager visitors to thousands of pumpkins that dot the landscape under Talcott Mountain's palette of vibrant fall colors. Perhaps best is how the experience tends to grow into a family tradition; it certainly has for this farm's 11 generations of owners. The Pickin' Patch (677-9552) is located on Nod Road and is open seven days a week.

QUOTE

"Quality means doing it right when no one is looking."

- Henry Ford

Our firm continues to grow by referrals from our clients. Thank you for recommending us.

PRINCIPALS OF THE NEW ENGLAND GUILD, INC.

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