THE NEW ENGLAND GUILD, INC.

WEALTH MANAGEMENT COMMENTARY

PROTECTING AND BUILDING YOUR FINANCIAL FUTURE

SPRING 2009 **(860) 236-3301** **www.neguild.com**

Market Spotlight

Index	Returns			
	Qtly	Annual		
	1st Qtr	1 Yr	3 Yrs	10 Yrs
Equities				
S&P 500	-11.0%	-38.1%	-13.1%	-3.0%
Russell 2000	-14.9%	-37.5%	-16.8%	1.9%
MSCI EAFE (Int'l)	-13.9%	-46.5%	-14.5%	-0.8%
DJ Wilshire REIT	-33.9%	-60.7%	-27.0%	3.7%
Bonds & Cash				
Barcap Agg. Bond	0.1%	3.1%	5.8%	5.7%
90 Day T-Bills	0.1%	1.0%	3.4%	3.2%

Highlighted by the worst Inauguration Day showing ever in the markets, the S&P 500 posted a decline of 8.4% in January, resulting in the worst January on record. February proved to be worse. In March, however, stocks staged a major rally on news of the Federal Reserve's plan to buy $300 billion in long-term treasuries and the Treasury's intent to purchase toxic assets through a public-private investment program. As markets tried to climb a wall of worry, we witnessed wild swings with the S&P 500 declining 28% from Jan. 6th – Mar. 3rd and then rising by 23% from Mar. 9th – 26th. If a bull market is defined by a 20% rise in stock value and a bear market by a 20% fall, then we have just experienced the second quarter in a row containing both a full blown bull and bear market!

Historical returns now reflect the worst ten year period in the history of the stock market, and despite the S&P 500's strong close, the first quarter of 2009 marked the Index's sixth consecutive quarterly loss. All stocks were down: US and foreign, big and small, value and growth. Emerging markets were the exception, outperforming their developed market counterparts and ending the quarter in positive territory. REITs continued their decline, with Global REITs significantly outperforming those in the US. Bond investors continued to favor the "safe haven" of government bonds. Market

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Investment Commentary

JOHN BOGLE AND BLACK SWANS

John Bogle is one of the giants of the investment profession. In addition to being the founding father of The Vanguard Funds, which stand as the model of low cost, client driven mutual fund products, he is recognized as one of the clearest, most insightful observers of markets and investment practice.

This is no more apparent than in an article he authored in the March/April 2008 issue of the *Financial Analyst Journal* entitled, "Black Monday and Black Swans". Bogle makes reference to Nassam Taleb's book, *The Black Swan*, (discussed in our Fall 2008 Commentary) and notes Taleb's thesis "that our world is dominated by the extreme, the unknown and the very improbable," i.e., randomness. Bogle suggests this is particularly true for capital markets.

According to Bogle, the capital markets and the real economy of goods and services are intertwined. Returns on stock prices over time can be directly attributable to 1) the current dividend yield, 2) the growth in earnings, and 3) changes in the price/earnings ratio. The first two of these are 'economic' (or fundamental) in nature: dividend yield is observable at any point in time, while growth in earnings is highly correlated over time with growth in nominal GDP. The third component, change in p/e, is more 'emotional' or speculative in nature.

However, these relationships have become out of whack over the past few decades as new forces have come to influence markets. Bogle notes, for example, that the valuation of stocks relative to the value of goods and services has risen dramatically between 1975 and 2007 from 50% to 120%. While the GDP has grown by 8x over this period, stock market valuation has risen by nearly 20x. Bogle says, it is as though "the United States is now on its way to becoming a country where no business actually makes anything. We merely trade pieces of paper, swap stocks and bonds back and forth with one another, and pay the financial croupiers a veritable fortune."

The second force is financial innovation, the development of ever more complex financial derivatives that entail huge and unfathomable uncertainties and risks. More than their substantial impact on the costs of the intermediation, these instruments now overwhelm stock market valuation. Bogle notes that whereas futures and options did not exist in 1957, by 1982 the amount outstanding totaled $438 billion, about one-third the value of the S&P 500, and by 2006 the level had grown to $32 trillion, equivalent to the value of stock market capitalization and 250% of the value of GDP! On a world scale the aggregate nominal value of global financial derivatives is said to be $600 trillion, fully 10 times the value of net goods and services produced by the world!

Bogle makes reference to Hyman Minsky whose key concept was that the financial economy, focused on speculation, should not be considered separate and distinct from the productive economy. But his expectation and fear was that speculation would come to overwhelm the fundamental economy. But in Bogle's mind, at least, the value of speculation in the U.S. financial system has come to dominate the nation's productive economy.

Bogle concludes his article with the following paragraph: "Whatever the case, some surprising event out there, far beyond our expectations, will surely come to pass, an event that will carry an extreme impact, and one for which, once it happens, we'll quickly concoct an explanation as to why it was so predictable after all. That event, if – perhaps I should say when – it comes, will be just one more black swan."

The Bogle article would have been timely and relevant had it appeared at any time over the past 10 years. It is, nonetheless, an amazing coincidence that it is based on a speech he gave on October 11, 2007, just two days after the U.S. stock market peaked and began its 50% slide!

MARKET SPOTLIGHT

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expectations of future inflation increased, resulting in a 5.9% gain in the Barclays US TIPS Index.

Despite the gloomy economic landscape, a run of better-than-expected data provided some relief to investors. Reports indicated that consumer spending rose marginally, helped by a drop in energy prices. An uptick in orders for big ticket items (ex-autos) raised hopes for a pick up in manufacturing. The housing market showed signs of stabilizing as homes became more affordable, sales of existing and new homes started to rise, and mortgage applications to purchase or refinance increased 32%. Although credit markets remain in stress, bank lending began to improve. Money on the sidelines ballooned to 49% of the market capitalization of stocks, pointing to the potential for a major flow of money back into the markets once investor sentiment improves.

Financial crises force us all to think harder about what's important. First off, fighting fear in a bear market is as critical as avoiding greed in a bull market: avoid impulsive actions; think long term; follow a plan, reviewing it as necessary. Secondly, future market performance is beyond anyone's control. Therefore, stay focused on what you can control: manage costs, spending and savings; diversify risks; reevaluate retirement options. Thirdly, to take advantage of a market recovery which usually precedes a rebound in the economy, portfolios for the long run should include long term assets (i.e. US and international stocks). Such a recovery can happen when the world seems darkest and as David Kelly of JP Morgan reminds, "is as certain in its occurrence as it is uncertain in its timing!"

Chasing Returns

We live in a world of disclaimers. This is particularly evident in the investment industry, where caveats continually remind investors about the returns and risks of investing. But, what is interesting about an investment performance disclaimer is how often investors rely on past results to buy an investment that has recently outperformed or to sell an investment following periods of underperformance.

Which reminds us of a story Charlie Ellis tells when he was a board member of a New York foundation with an impressive performance record. According to Charlie, the Board made it a practice to take invested money from the best performing managers to give to the worst performing managers, so long as those managers continued to adhere to the philosophies, processes and disciplines that were the basis for hiring them in the first place.

Reinforcing the merits of this strategy was an interesting study conducted by two Emory University researchers. Analyzing the outcome of investment decisions made by 3,700 institutions over ten years, their study shows that managers fired after one, two or three years of underperformance typically outperformed over subsequent periods, while managers hired after years of impressive relative performance subsequently failed to sustain their good results.

This is not to say that investors should ignore past performance, rather they should avoid making decisions based solely on recent results. Further, it is to say that doing nothing about the funds one holds in a portfolio may be the ultimate measure of success. If you select good managers based on people, philosophy, process, culture and integrity, performance should take care of itself over time.

IRA Reminder

Just a reminder that the IRS does not require a minimum distribution in 2009 from IRA or Inherited IRA accounts.

Nevertheless, it may still be advisable to take a distribution if one has deductible expenses (health costs, taxes, interest, charitable contributions) and needs additional income to make the deductions useful. Also, one may still make charitable contributions of up to $100,000 from their IRA in 2009 without having to pay taxes on the distribution.

A Silver Lining of Market Declines

Many have found that their tax bills this year are surprisingly reduced from previous years, simply because realized gains are sharply lower or negative. It is small solace, but the decline in market values provides opportunities for tax savings. For example, many equity mutual funds now carry significant unrealized losses in their holdings.

As a result, an investor is able to sell one fund to realize a capital loss and then reinvest proceeds in another equivalent fund which offers tax shelter to the extent of its unrealized losses.

EXCURSION

Most every town in Connecticut has a diner or some small, mom & pop luncheonette where townsfolk gather during the week for coffee, sometimes bacon & eggs, or a muffin now and then. But basically people gather because it feels like home – old friends, local news, opinions galore. The *Whistle Stop* in Windsor or *Town and County* in Bloomfield are such places, but they exist everywhere. It is a touch of Americana at its best. Invite a friend to breakfast someday and enjoy the experience.

QUOTE

"The evidence on investment managers' success with market timing is impressive – and overwhelmingly negative."

- Charlie Ellis (from *Winning the Loser's Game*)

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

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