NEW ENGLAND GUILD
Wealth Management & Investment Advisors

WEALTH MANAGEMENT COMMENTARY

PROTECTING AND BUILDING YOUR FINANCIAL FUTURE

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Market Spotlight

Index	Returns Qtr	Annual		
	3 Qtr	1 YR	3 YR	10YR
Equities				
S&P 500	-13.9%	1.1%	1.2%	2.8%
Russell 2000	-21.9%	-3.5%	0.4%	6.1%
MSCI AC World exUS	-19.9%	-10.8%	0.5%	6.8%
REITs	-15.3%	-0.3%	-1.7%	8.2%
Bonds & Cash				
Barcap Agg. Bond	3.8%	5.3%	8.0%	5.7%
90 Day T-Bills	0.0%	0.1%	0.2%	2.0%

With the experience of 2007-2009 still distastefully fresh in investor minds, the events of the past quarter have subjected investors to wild market swings and evoked renewed fear and frustration. Fear is renewed because the reality is now beginning to set in that Europe's deepening debt crisis and the budget and job creation problems of the U.S. are substantial and intractable. Frustration exists because of the inability of politicians and policy-makers to address the problem. As a result, investors have turned away from stocks and riskier assets into gold, Treasury bonds, cash and other perceived safe havens.

As PIMCO's Bill Gross points out, "We are into the 'bumpy journey phase' of New Normal where fear, lack of policy and loss of control can dominate." We might use another analogy: One of the members of The Guild family recently contracted an illness called Guillain Barre Syndrome (GBS), a disorder that affects the peripheral nervous system. Typically the prognosis is for complete recovery, but the recovery period is unpredictable and the process of healing is highly uneven beset with physical and emotional setbacks. Unfortunately, we think the economies of the developed world face a similar journey. Deficit management and job creation require painfully difficult choices that sometimes conflict. Recovery takes time often with fundamental (recession, inflation) and emotional setbacks. Even if our policy-makers were to suddenly decide on a solution which everyone agrees could bring about a full recovery, the process of healing would be slow, painful and frustrating, much like GBS. Perhaps the solution could be as simple as adopting the Bowles-Simpson Commission Report, although there isn't apparent agreement among politicians on this.

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Investment Commentary

ASSETS – LIABILITIES = NET WORTH

One of the issues we think is not well understood, both with the investment and financial professions as well as with the general public, is the difference between ***asset management*** and ***wealth management***. Obviously there is considerable overlap between the two classifications of organizations, but there are also important distinctions. And with absolutely no disrespect for investment advisors (or the synonymous term, asset managers), the distinction is this: ***asset managers seek to maximize the return on assets*** for an acceptable level of risk, while ***wealth managers focus on net worth***, seeking to achieve the highest gain of net worth for an acceptable level of risk.

This difference is important. Because of their focus on only one element (i.e., assets), asset managers tend to see a client's investment objectives as a static input that serves as a basis to guide investment decision-making and performance measurement. The task of the asset manager is predominantly about 'beating a benchmark'.

At The New England Guild, we are wealth managers. Managing wealth (net worth) requires asset management skills as well, but with a critically important added dimension – *it must coordinate asset management with liabilities and cash flows*. What is happening to the liabilities may modify what should be happening with the assets: if a client is going through a divorce, or his/her job is endangered by a down economy, or health issues present new and substantial financial uncertainties, or a child is about to enter college, or a large inheritance looms – these are matters of high importance to the management of assets. It is much more akin to the asset/liability management of insurance companies wherein the values and cash flows of the assets must be viewed in terms of their ability to meet present and future liability commitments. We are fond of saying that 'every asset exists to satisfy a future need for cash'.

It follows therefore that just as a change in the timing and magnitude of needs for cash should influence how the assets are managed, a change in the value of assets may suggest a need to modify liabilities and/or cash flows. In periods of market adversity, clients who have the capacity to reduce the draw on their investment assets, or to delay their retirement in order to extend their income flow, have a better chance of fulfilling their long-term plans. Conversely, those clients who have high fixed dollar needs from their portfolio are typically less able to tolerate investment risk since volatile markets can be devastating to portfolios from which withdrawals are taken on a regular basis.

In this context, while the focus of asset risk management is on volatility of assets, the focus of risk for wealth management is on net worth and cash flows. Said more simply, "Risk is not having the cash you need when you need it." This introduces two additional considerations in the management of risk; consequence and correlation. Consequence speaks to the impact on net worth of an adverse event, either on the asset or the liability side of the equation. Correlation relates to the degree that a single risk (inflation, change in interest rates, business cycle) impacts both assets and the liabilities adversely, thus even more severely impacting net worth.

The implications of wealth management go well beyond this, however. They also incorporate considerations of taxation, estate planning, insurance needs, charitable giving, scenario modeling and the like. Managing net worth must focus on strategies to minimize tax consequences of asset management actions (realizing capital gains or losses) with cash flow actions (years of unusual levels of income or deductible expenses). It must coordinate estate planning and/or charitable giving intent with asset account structures and/or segmented portfolio objectives.

The bottom line is that asset and liability management is a dynamic interaction that requires a close partnership between advisor and client on financial matters. It is a process that is incredibly complex and highly subjective. And when it works well, it is wonderfully fulfilling!

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What we don't know is the extent to which capital markets have discounted these problems. We know that US stocks are still 25% below their level of October 2007, but 71% higher than the level of March 2009. Current valuations are low by historical measures. We also know that volatility of markets can wreak havoc with a portfolio from which significant regular withdrawals are needed. So we believe that caution is still justified. Clients would be well served by maintaining adequate liquidity to fund anticipated needs. Then, once the portfolio has been constructed to meet liabilities, we would encourage clients to remain diversified and focused on the long-term. In a recent WSJ article, Vanguard's John Bogle said it best. When asked about the growing cadre of investors who believe that diversification is unnecessary, and buy-and-hold investing is foolish in an era of low returns, he replied, "Diversification is not only the first important thing investors should think about, but the second and the third, and probably the fourth and the fifth, too!... For the buy-and-hold philosophy to work, it must be applied not just to stocks, but across an entire portfolio, including bonds and other assets. That's because the stock market is, above all else, spasmodic!" He's got that right!

An Intellectual Excursion

Those interested in an experience of extraordinary entertainment and intellectual content should travel to a class in moral reasoning taught by Michael Sandel, professor of political philosophy at Harvard University. Drawing upon the classic philosophers, Prof. Sandel effectively uses the case method to engage students in stimulating discussions on such contemporary topics as affirmative action, same sex marriage, murder, torture, health care rationing, and military conscription among others. One can observe this in the comfort of one's own home, while enjoying a glass of wine, by going online to the ***youtube.com*** website and typing in ***'justice: what's the right thing to do?'***. There are 12 episodes in all. They are captivating!

Real Real Returns

Every year Thornburg Investment Management Company updates its study of '*Real* Real Returns' – returns calculated for several asset classes after adjustment for inflation, taxes and investment expenses. This year's report covers the period of 1980-2010 along with several sub-periods for US and non-US stocks, bonds, real estate, T-bills and commodities. The following is a brief summary of results for 1980-2010:

Factors of Return

- **S&P 500** 10.71% (nominal total return) less 0.55% (expenses) less 1.24% (taxes on dividends) less 0.36% (capital gain taxes) less 3.33% (inflation) = **5.23% *real* real return.**

Asset Class *Real* Real Returns

Asset Class	1980-2010	1990-2010	2000-2010
Large-cap US Stocks	5.23%	4.82%	-1.74%
Small-cap US Stocks	4.97	6.50	2.59
International Stocks	4.54	2.16	0.42
Municipal Bonds	3.89	2.95	1.93
Intermediate Term Gov't Bonds	1.71	1.51	1.32
Corporate Bonds	2.07	1.68	1.33
Real Estate	0.26	-0.36	-0.57
Treasury Bills	-0.77	-0.85	-1.42
Commodities	-3.01	-0.90	0.15
Inflation	3.33	2.50	2.34

Observations

- While the tendency exists to think of returns only in nominal terms, the factors of expenses, taxes and inflation have significant impact on the ***'spendable value'*** of investment returns. The management of investment assets must also consider how best to *capture* nominal returns in the context of individual circumstances.
- The 30 year pattern of returns is largely consistent with the thesis that over the long-term stocks do better than bonds and greater risk (volatility) corresponds with higher return over time. However, shorter-term periods of 10 and 20 years do not necessarily follow suit, proving, yet again, that diversification pays off.
- In taxable accounts of individuals with higher marginal tax brackets, the *real* real returns of municipal bonds capture the highest proportion of total returns because of their tax efficiency.

Donor-Advised Funds (DAF)

With year-end tax planning upon us, we once again suggest that clients consider whether donor-advised funds fill a need. You will recall that a DAF is an independent public charity endowed by contributions from many individuals and corporations. Donors make irrevocable contributions to the DAF which are considered charitable contributions for tax purposes. To the extent of the amount of funds within their individual account, donors are able to make grants to their favorite charities so long as the grant recipient is a recognized tax-exempt organization qualified under section 501(c)(3) of the U.S. Internal Revenue Code.

There are many advantages to a DAF, among them 1) low set up and annual expense costs, 2) ease of record-keeping and tax reporting, and 3) ease and flexibility in making grants. In addition, they provide a vehicle for charitable giving that can be a legacy fund in which children and/or other trusted persons can be involved. A DAF works like a private foundation in many ways, but with fewer costs and headaches. A number of organizations offer DAFs, of which Schwab, Fidelity and Vanguard are the largest. It is clearly an idea whose time has come.

QUOTE: *"Alexander Hamilton started the U.S. Treasury with nothing – and that was the closest our country has ever been to being even."* Will Rogers

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

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