

## Quarterly Commentary | July 2008

### Market Analysis

As Thomas Paine said at the beginning of the Revolutionary War – “*These are the times that try men’s souls*” and certainly, no one can challenge the appropriateness of such a comment after living through the past quarter...unfortunately, the “pain continues” with the continuing rise in the price of oil and food and weekly barrage of headlines regaling the extraordinary measures being taken to shore up the US banking and mortgage industry. Oil continues to drive the commodity markets up and negatively affect the overall global equity market. Although there is a lot of political debate about the cause, two primary factors driving this price appear to be global demand and the weak dollar. China and India account for 12% of world consumption, but other countries with rapidly growing economies including Brazil and Russia are adding to the demand. The Fed, on the other hand, is caught between the need to keep the economy growing and controlling inflation, but with lower rates comes a weaker dollar. Recent signals that they will pause from lowering rates any further suggest their concerns for inflation have now moved to the top of their list.

With all major equity indices down for the year to date and the past year, it’s easy to become overwhelmed with all of this bad news.

<u>Index</u>	<u>2Q</u>	<u>YTD</u>	<u>1 yr</u>	<u>5 yr</u>	<u>10 yr</u>
S&P 500	-2.72	-11.91	-13.12	7.58	2.88
Russell 2000	.58	-9.37	-16.19	10.29	5.52
MSCI EAFE	-2.25	-10.96	-10.61	16.67	5.83
MSCI Emerging Markets	-86	-11.76	4.63	29.75	N/A
Lehman Aggregate Bond Index	-1.02	1.13	7.12	3.86	5.68
Consumer’s Price Index (CPI)	2.48	4.18	5.02	3.56	2.99
AIG-Commodities	16.08	27.22	41.56	18.60	13.01

## Important Trends

A closer look at these indices, however, reveals some important trends:

- Longer term equity returns for the higher risk asset classes have historically produced higher returns – although there have been periods where these returns are lower than fixed income (10 year Lehman Aggregate Bond vs. S&P 500).
- Global diversification is alive and well...albeit, in the short term, slightly masked.
- Fixed Income (Lehman Aggregate Bond) tends to produce positive returns in most extended periods (i.e. > 12 months).
- Changes in the consumer price index (measure of inflation) are significantly higher in past quarter, year to date (YTD) and 1 year than in the past 5 year and 10 year periods.
- The excess return from fixed income (FI – CPI) is less than 3% and would not support even a 3% withdrawal rate if not combined with other asset classes.
- Commodities continue to move in the opposite direction of other asset classes in the short term, thereby offering an additional opportunity for diversification.

For clients utilizing your portfolio for supplemental income, we have factored these trends into your investment strategies by including the following features:

- Generally no more than 60% of your portfolio's total value has been invested in equities. This leaves over 40% of your nest egg available to support your income needs without having to sell off your equities while in a loss position.
- A significant portion of your fixed income assets is held in cash and cash equivalents in which return of principal is essentially guaranteed.
- Fixed income securities typically share the following characteristics - high credit quality, short term, laddered across a 5 year maturity period, or part of a short term bond fund and/or inflation protected government bond fund.
- Inflation-adjusted withdrawal rates have been tested using state of the art Monte Carlo and other stress tests to consider the probability and effect of extended down markets. Actual withdrawal rates are monitored on an annual basis and discussed during at least one of your quarterly meetings each year.

For clients who are still accumulating wealth, down markets are an excellent opportunity to take advantage of dollar cost averaging – simply put, you get more (shares) for your money! In addition, your portfolios typically reflect a higher tolerance for risk based on your longer time horizon and the ability to ride out down markets without making any withdrawals.

## Possible Strategy Shifts? Not Likely

Despite these features, understandably, we are frequently being asked if there is some fundamental shift in investment strategy which should be made to react to the current market conditions. As long as there is no fundamental change in client objectives, our response is consistently “NO”. In fact, it is the potential for negative return periods like this year to date, that create the return premiums we seek when investing in higher risk, higher return asset classes. If there were no risk, all returns would be the same. By including a basket of different asset classes with varying degrees of risk, we capitalize on this relationship, as well as take advantage of the different timing of up and down price movements (“correlation”) for each asset class. Inclusion of the equities which are causing

most of the recent pain are a critical element of this strategy whether you are pre-retirement in *accumulation* mode or post-retirement in *utilization* mode. For the former, equities offer historically higher returns over the long term. For the latter, equities offer an excellent hedge against inflation. According to Vanguard's chief economist, Joe Davis, PhD, at the end of World War II, if you had put one dollar into an inflation index such as the Consumer Price Index, it would have risen nearly 10X, up to the present day. However, if you had put it in the S&P 500 Index, a broad stock market index, it would be well over 100X.

Beyond diversification and the inclusion of an adequate safety margin of fixed income in our portfolio design, there are two other factors which we consider from the outset and continuously monitor for additional opportunities: Taxes and Operating Expenses. In the coming quarter, we will release a briefing on how these two important concepts are also incorporated into your overall portfolio strategy.

### **Flood Insurance**

Our lives can be affected by many disasters such as fires, hurricanes, tornadoes and floods. Due to the extreme weather in the Midwest, we have had an increase in questions about flood insurance and what water damage is covered in basic homeowner policies. In this brief summary we will try to summarize what flood coverage is provided in a homeowner's policy and how flood insurance works. We are also in the process of preparing a summary outlining the basic elements for a family disaster recovery program and will be sending it out to our clients and contacts through email in the next few months, and then posting on our website. Please look for this tool as we think it will be very helpful in preparing for and recovering from the unexpected. Call us if you don't have computer access and we'll be glad to send you a written copy.

In short, standard homeowner's policies do NOT cover flood damage. The following is a definition of "flood" found in the National Flood Insurance Program policy: *A **general and temporary** condition of partial or complete inundation of two or more acres (general) or two or more properties (at least one of which is the policyholder's property) of normally dry land area (temporary) from the:*

- *Overflow of inland or tidal waters;*
- *Unusual and rapid accumulation or runoff of surface waters from any source; or*
- *Mudflow.*

Your homeowner's policy will not cover damage from an event meeting this definition. Damage created by other water events may be covered by your homeowner's policy, for example, if a water pipe bursts in your house. If you have a sewage backup you may be covered if your homeowner's policy has an endorsement for this damage.

Many homeowners feel they do not need flood insurance because they are not in a "flood zone". How does the government define a "flood zone"? A "flood zone" is a simplified name given to what the Federal Emergency Management Agency (FEMA) calls special flood hazard areas (SFHA's). A SFHA is defined as an area that has a 1 percent chance of being inundated by flood waters in any given year (thus the creation of the term "100-year flood plain"). Flood waters have an equal chance of submerging these areas every year for five

straight years, or not for 200 years; there is simply a 1 percent statistical possibility EVERY year. There are two broad classifications of SFHA: 1) "A" zones, and 2) "V" zones. Differentiating between "A" zones and "V" zones is simple; "V" zones are generally located near areas subject to hazardous tidal flows (waves) such as the ocean. "A" zones are those areas simply subject to inundation by overflow of rivers, low-lying areas subject to ponding, etc. "V" can be used to signify "velocity"; the water is flowing with the increased hazard and damage of wave action. "A" can mean "altitude"; the water goes up and goes back down, but it lacks the damaging wave action of a "V" zone. According to the National Flood Insurance Reform Act of 1994, any federally-regulated lender cannot make, increase, extend or renew any loan on any property located within a SFHA unless flood insurance is purchased by the borrower.

You must purchase flood insurance directly through your homeowner's insurance agent. However, the policy is actually provided by the Federal Flood Insurance Program. The annual premiums for national flood insurance are determined by your home's perceived risk and how much coverage you choose. You can determine your estimated flood risk and insurance premiums at <http://www.floodsmart.gov>. The federal flood insurance program provides only limited coverage up to \$250,000 of coverage to protect your home and up to \$100,000 to protect its contents. If you want additional coverage you need to buy excess flood insurance through specialized carriers and the cost varies significantly based on your individual circumstances.

Areas of moderate or minimal hazard are generally expected to flood only in times of severe storms or when drainage problems exist. However, it is estimated that 25 percent of all flood insurance claims are paid in these "less hazardous" areas; so we should not ignore flood insurance just because we are not in areas considered "hazardous". Before you run out and buy a flood insurance policy, there are some very important factors to consider. First is the definition of a basement. A basement is defined by flood insurance policies as any area of the building, including any sunken room or sunken portion of a room, having its floor below ground level on all sides. Why is this definition important? Because there is **no** coverage for any personal property located in a basement, **regardless of the flood zone**. For many homeowners, this is the room they are trying to protect. Some coverage is extended to property necessary for the operation of the structure and attached to a power source such as electrical equipment (outlets, switches, junction boxes and circuit breakers), HVAC and AC systems, water heaters, pumps, clothes washers and dryers and freezers (not walk-in). But any furniture, TVs or stereos are not covered. So much for that in-home theater! Even excess policies will not cover personal property in a basement. Another item to consider is that the Standard Flood Insurance Policy provides coverage for one building per policy. The only exception to this rule is 10% coverage for detached garages. A separate policy would be required for a pool house, guest houses and other building structures on the same property. Another issue is that pools and hot tubs are not covered at all.

Condo owners, even those on the third floor, are required to buy flood insurance if they are in a SFHA and have a mortgage. Owning a condo puts you in a unique position, because you have both common and individual insurance needs. Your condominium association has an insurance policy for common areas, like the building exterior and walkways. You're still responsible for insuring your personal property. Owners should understand what flood

insurance policies their association has and determine if there are any gaps you need to fill with an individual policy.

Flood insurance is a complicated and possibly a costly policy. We believe that floods are affecting a lot of people that thought they would never need flood insurance, so it is worthwhile to evaluate the need for this insurance. However, you have to make sure you are obtaining coverage for the risks that you are trying to protect your property from and that all of your property is going to be covered. We would like to note that we are not licensed property and casualty insurance agents but do have knowledge in this area and would be glad to talk with you and communicate with a qualified agent on your behalf regarding flood insurance.

### **Help for your friends may be urgently needed!**

While training to become “qualified” as an “Officer of the Deck” aboard the nuclear submarine, USS Thomas A. Edison SSBN 610, Ted Fischer’s commanding officer had one saying that would seem to be very appropriate for today - “Call me 10 minutes BEFORE you do anything DUMB!”.

For many of your friends who don’t have a trusted financial advisor, this is the kind of market that may spook them into doing something really “DUMB” – like getting scared and pulling all of their money “out of the market” into cash or fixed income – or even, “annuities”. If you know someone who you feel might be close to making such a move, please give them our card or our phone number or ask them if they’d like us to call them to review their thinking. We’d be glad to help, if we can.

Thanks – Please don’t hesitate to call us to discuss any concerns you have about your portfolio or any other financial questions you are struggling with.