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Market Update: *Volatility Returns*

By: David A. Jaffe, M.D.

A client recently asked whether I thought the spike in stock market volatility was here to stay, and whether this should be a concern. The exponential rise in trading volume of the last few years as well as events such as the recent “Flash Crash” certainly leave one believing that HAL from *2001: A Space Odyssey* is now running Wall Street. There seems little doubt that advances in technology have enabled those inclined to gamble on short term price swings to take a larger role in day-to-day trading, and the fall in transaction costs have made such endeavors more attractive.

The schizoid behavior of stocks in the third quarter of 2011 would lead anyone to question the market’s sanity. Logging the worst declines since the collapse of Lehman Brothers in 2008, the Dow Jones Industrial Average swung 200 points or more fully 18 times in the quarter, including four consecutive 400 point swings in the month of August. A measure of market volatility, the previously obscure VIX (volatility index) rose 160% for the quarter.

It is easy to understand how this behavior would lead observers to question the safety of their investments and the sanity of other market participants. And so this seems a good time to remind ourselves of what it really means to be an investor.

In our view, betting on short-term price swings, or day trading, really is nothing more than gambling. The average day trader has little interest in the underlying businesses of the stocks he owns for a minute, or an hour, or a day. His focus is trying to predict whether the next trade will be an uptick, or a downtick ... and capitalizing on that move. Contrast this to the *investor*, who studies companies looking for healthy businesses, superior growth prospects, capable management, sound finances, and a reasonable stock price.

In times when confidence is shaken by market volatility, not to mention dour predictions by Wall Street Bears, it is critical to remember that owning stock means owning a part of a business. Short term stock price fluctuations are driven by a multitude of factors, but long term if you own

an interest in a healthy, growing company, ultimately the value of your investment will climb. Whether this takes weeks, or months, or even a few years, no one can know with certainty. It is however reassuring to see that many strong businesses are also paying cash dividends in the range of 3% - 4%, attractive compensation while waiting for the stock price to appreciate, especially in today's low interest rate environment.

In unsettled markets, I sometimes hear clients say "I can't afford to lose all my money", as if the value of their stock portfolio could simply evaporate. If you own a diversified portfolio of companies like PepsiCo, Proctor & Gamble, Waste Management, Exxon-Mobil, and Intel, solid companies that have been around for decades, you own an interest in some of the best businesses on earth, and over time the value of those businesses will grow and their stock will appreciate in value.

In our view, the greatest risk to the investor who owns a quality, diversified portfolio is pulling money out of stocks at an inopportune time. This may be driven by emotion, fear of experiencing further declines in stock prices, or poor planning. The emotion of investing is very powerful, and we do our best to help insulate our clients from this phenomenon by education, counseling, and account structure seeking to minimize volatility. The problem of poor planning is most often characterized by the investor who chooses to commit money to stocks that must be redeemed at a specific time, regardless of market conditions. We do our best to lessen this risk by discussing goals with our clients, balancing stock holdings with very stable bond investments, and maintaining a moderate cash cushion for retired clients taking a monthly distribution for living expenses.

So what was going on in the third quarter of 2011? Corporate earnings have been surprisingly strong in the face of high unemployment and economic weakness in the U.S. and Europe. Multinational corporations have benefited from strong markets in South America and the Far East, including China, productivity gains from adoption of new technology, utilization of temporary workers, and low interest expenses. Paralysis in Washington D.C. and the near "default" of the U.S. government unnerved investors, casting doubt that meaningful budgetary reform was feasible, and leading Standard and Poor's to a largely symbolic demotion of U.S. creditworthiness below triple-A for the first time ever. Worries about the risk of a "double-dip" recession grew with disappointing reports on employment and domestic economic growth. Confidence in U.S. and European banks faltered as the European Union grappled with the seemingly insolvable problem of the economic crisis in Greece and worries about contagion to other southern European countries (the so called "PIIGS"). Further, the specter of inflation and slowing growth in China, heralded as the world's economic savior, cast a pall over one of the few remaining areas of apparent strength.

While the financial markets gyrated like two kids on a see-saw, the trend was decidedly negative. The Dow ended the quarter with a decline of 12%, while the S&P 500 lost 13.87% for the quarter (with reinvested dividends), posting a year-to-date decline of 8.68%. Against this backdrop, the PASI composite portfolio declined 11.59% for the quarter, resting at a 6.16% YTD loss for 2011. Despite worries about debt and credit, investors sought out the safety of fixed income, with bonds posting gains just shy of 3% for the year. In this unsettled market environment, the value of our conservative account structure has again been validated, with the

“average” PASI account (a mix of 60% stock and 40% bonds) ending the third quarter with a modest year-to-date decline in the neighborhood of 2.5%. Focus on preservation of capital will be rewarded when the market recovers, as we were all reminded through the 2008 decline and 2009 recovery.

There is no denying the current challenges facing the world economy. However, it is sometimes valuable to reflect on historical events that may have seemed insurmountable at the time, and are now a distant memory. Remember the oil embargo and resultant recession of the 70's, or the stagflation and double-digit interest rates of the 80's? How about the stock market crash of 1987 or the bond market crash of 1994? And while we all scrambled to prepare for the Y2K cataclysm that never came, Russia defaulted on sovereign debt, sending emerging bond markets into a tailspin (1998). The bursting of the NASDAQ bubble in 2000 is still too fresh to have faded yet, but the point is that traveling backwards in an economic time machine, we are reminded that comparable obstacles have surfaced at least every ten years, and while it no doubt looked darkest before the dawn, dawn did finally come. Make no mistake, our current economic challenges are substantial, and there are no easy remedies. Still, our U.S. companies provide essentials to the world (food, drugs, technology, and yes, even financial services) and when we do finally see meaningful recovery in employment, the housing and credit markets, and the European economies, our U.S. companies will be there to serve and profit from their global businesses, efficiencies, and expertise.

What We Know that Isn't So

By: Nathan Polackwich, CFA

There is no question that human beings have accomplished incredible things – flight, the Internet, space travel, the internal combustion engine, antibiotics, Major League Baseball in October. The technology that surrounds us is so incomprehensible, so perfect and precise, that you would naturally assume this expertise must extend to all spheres of human activity. Yet it doesn't. My voice can magically travel thousands of miles over the air on a cell-phone, but the research concerning something seemingly as simple as whether saturated fat is bad for our health remains inconclusive. The consensus among the experts remains that it is. Yet they struggle to explain the far superior cardiovascular health of numerous indigenous populations – the Masai, Inuit, and Tokelau to name three – who consume three to four times as much saturated fat as the average American.

The global economy is rife with similar conundrums that confound experts. For instance, U.S. budget deficits are soaring and Standard & Poor's recently downgraded U.S. government debt, yet U.S. Treasury rates continue to plummet. The ten-year treasury yield is now below 2%, implying that buyers of government bonds aren't the least bit concerned about the Federal Government's ability to honor its financial obligations. In addition, despite record budget deficits and rock-bottom interest rates, inflation remains benign. High food and energy costs (which have more to do with surging demand from emerging markets and, arguably, financial speculation), have been largely offset by flat and even falling prices in much of the rest of the economy.

What's going on? Every day the talking heads on CNBC drone on about how the Federal Reserve is "printing" tons of money and the Federal Government is going "bankrupt." But Treasury rates and inflation measures are talking too, and they're saying something much different. They're saying the government has zero risk of bankruptcy. Moreover, they're saying quite emphatically that *deflation* due to weak demand, rather than inflation, is the greatest threat to the economy (something we've been adamant about since the debt bubble burst in 2008). Maybe, like with saturated fat, the conventional wisdom on how the economy works is all wrong. Here's where we think some confusion has arisen:

1. **The Federal Reserve doesn't print money.** All the Fed does is buy and sell Treasuries (the Fed's trades are called open market operations) so it can control interest rates and thus ostensibly the economy. Of course, when the Fed issues (sells) Treasuries it's not injecting money into the economy. It's actually taking cash out in exchange for bonds. Should it later choose to buy some of the Treasuries back, the Fed can use the same cash it received when it sold the bonds earlier. So really the Fed's actions merely change the composition of banks' balance sheets. Based on what the Fed does, banks will either have X dollars in Treasuries or X dollars in cash. But overall, total assets in the financial system stay exactly the same.

2. **The Federal Government can't go "bankrupt."** Most people think the Federal Government must tax or borrow in order to fund its spending. Not so. Remember, the U.S. government controls the dollar and thus creates money at will.¹ Before it buys a nuclear submarine the government doesn't ask, "Did Nathan Polackwich pay his taxes this year?," or "Did China buy our bonds?" Nope. The government just presses a button, credits a bank account, and voilà – new money is injected into the economy. The government doesn't need my dollars or China's dollars because it can make an infinite supply of its own.

Now, you may be wondering if the government owns the printing press, why does it even bother to borrow or tax? Concerning the former, as I alluded to above, the government issues Treasuries so the Federal Reserve can conduct open market operations and thereby control interest rates. Secondly, Treasury issuance helps "lubricate" the U.S. financial system by creating benchmark interest rates upon which all other financial assets are priced.

Taxation, on the other hand, has just one simple purpose – to keep the deficit and thus money creation/inflation under control. Of course, the government could just create and spend trillions of dollars year in and year out and not offset this prodigious money supply growth by collecting taxes. But that would be highly inflationary. Taxation, then, mitigates the growth in the money supply which naturally results from Federal spending.

But the big question is if deficit spending injects money into the economy, why isn't the current \$1.5 trillion budget deficit causing more inflation? This really cuts to the heart of why the U.S. (and most of the developed world) economy hasn't been able to pick itself up off the floor since the rupturing of the debt bubble in the fall of 2008.

¹ This is in stark contrast to members of the Eurozone like Greece who don't control their currency (the European Central Bank does) and thus don't print money.

3. The Federal Reserve doesn't print money, but it can stimulate banks' creation of "temporary" money by lowering interest rates to encourage private sector borrowing.

Consider what happens when a bank makes a loan – the bank goes from having an asset called cash to an asset called a loan. But the borrower also now has an asset he didn't have before – the cash he received from the loan. Of course, he also has a new liability in the same amount. Regardless, total assets in the financial system just effectively doubled (though *net* financial assets, or assets minus liabilities, remained the same). Note, however, that as the borrower pays off his loan, total assets in the financial system slowly decline. If he defaults on the loan, total financial assets immediately go back to where they were prior to the loan being originated. Thus, money created through private sector borrowing is only temporary.

As we saw in the housing market from 2003-2006, huge increases in temporary money created by reckless bank lending can create artificially heightened demand and consequently inflation. But then the music stopped. Scores of people started defaulting on their loans. Many more decided it was time to start saving more and borrowing less. The result has been the outright destruction of temporary money, as household borrowing levels declined. Less money means less demand and lower prices, particularly in areas like housing where the excessive borrowing was concentrated. This trend remains in place, and will likely continue for at least a few more years until households reduce their debt to a more sustainable level. The reason, then, that we're not experiencing greater inflation is that the Federal Government's money creation from deficit spending is being offset by the destruction of temporary money from declining debt levels in the private sector.

4. The Fed is out of ammo to help the economy. In fact, it's been out of ammo since it lowered short-term interest rates to near zero percent in late 2008. At this point there's really nothing more the Fed can do. In truth, pretty much everything the Fed has done subsequently – from "Quantitative Easing" last year to the more recent "Operation Twist" – has been a charade. The Fed simply can't induce more private sector borrowing because the U.S. economy's problem isn't that interest rates aren't low enough. The problem is that U.S. households are overloaded with debt and have little desire (or financial ability) to borrow *at any interest rate*.

5. The solution is time. The U.S. economy continues to stagnate for one basic reason – households still have too much debt. It's just going to take time for that debt to fall to a healthier level. Until it does the consumption of goods and services (70% of the economy) will remain anemic, as households save more and spend less. Weak consumer demand also means businesses have little incentive to invest or hire. Accordingly, we expect the economy to continue to struggle and remain vulnerable to exogenous shocks like sovereign defaults in the Eurozone or an implosion of the Chinese property bubble. The silver lining is that the world's best companies now change hands for just 11 or 12 times earnings. In fact, aside from the March 2009 market lows, stock prices haven't been this attractive in decades, which brings to mind the stock market aphorism that "the news is always worst at the bottom." Have we reached the bottom in the current market downturn? No one knows. Short-term stock market movements are a coin flip. History suggests, however, that at current valuations the odds of solid long-term returns from blue chip stocks are heavily stacked in investors' favor.

Important: *RMD Issue*

Most of our clients are aware that they must begin a **Required Minimum Distribution** from IRA accounts at age 70 ½. Your IRA custodian (usually State Street Bank) calculates the annual RMD and we at PASI monitor your distributions to be sure all RMDs have been satisfied by year-end. However, *if you have retirement money that is still held in a corporate plan* (profit sharing and/or 401(k)) the situation is a little more complicated. You are still subject to a required minimum distribution beginning at age 70 ½ (with one possible exception) but, because your dollars are pooled with the retirement assets of the other plan participants, you will *not* receive RMD notification by the custodian bank. In this instance, the RMD is usually calculated by the Third Party Administrator, the company that does the annual recordkeeping for the plan. So, if you have reached age 70 ½ and have retirement money in a profit sharing plan or 401(k), and you have *not* made arrangements to take the RMD distribution, please contact your TPA. If you have questions please don't hesitate to call our office for clarification.

The one exception to the rule: If you are still working, own less than 5% of the corporation sponsoring the plan, and if your plan document allows distributions to be deferred you may not be required to begin the RMD yet. If you think this applies to you please contact your TPA or call our office and we will be happy to help resolve this issue.

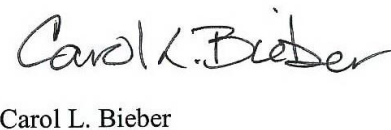
Be sure you take the required minimum by December 31st. The IRS penalty is 50% of the shortfall!



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