



## Investment Commentary

by CENTER FOR FINANCIAL PLANNING, INC.

"Making a Difference in People's Lives for 25 years"

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### 2010 Second Quarter Investment Returns

Benchmark Performance Returns (% Total Return)		
Large-Cap Benchmark	12 Month	2nd Quarter
Idx: S&P 500 TR	14.43	-11.43
Idx: Dow Jones Industrial	18.94	-9.36
Mid-Cap Benchmark		
Idx: Russell Mid Cap	25.13	-9.88
Small-Cap Benchmark		
Idx: Russell 2000 TR	21.49	-9.92
Other Benchmarks		
Idx: Barcap Aggregate Bond TR	9.5	3.49
Idx: MSCI EAFE USD	3.13	-14.91
Idx: Goldman Sachs Commodity	-5.43	-10.41
Idx: Wilshire REIT	63.47	5.3

### Investment Commentary

After 2008's sharp decline and last year's recovery in stock markets, many had hoped that 2010 would see a return to relative normalcy and stability. Certainly, the year started on a positive note, as stocks turned in one of the strongest first quarter increases on record.

Then, in rapid succession came:

- The intensification of the budget crisis in Greece, and concerns about spillover into the rest of Europe
- Growing fears of a housing bubble in China

- The BP oil rig disaster in the Gulf of Mexico
- The May 6th "Flash Crash" in which US markets plummeted in a matter of minutes without explanation

Looking at these events, it's tempting to ask what catastrophe will be next. In fact, based on these last six months, history may view this as "the calamitous decade", even though it's only a few months in.

There is a tug of war between cyclically improving economic and strong company fundamentals and balance sheets on the one side, and structural concerns about debt-related stress points and the longer-term strength of the economic recovery on the other. The tension between these opposing forces has left investors uncertain and the stock markets stuck in a trading range. We think that unusually high uncertainty could be with us for years to come because the economic challenges we face are serious and will not be resolved quickly.

As long-term investors, our views tend to evolve gradually rather than change suddenly based on new information (the fall of 2008 being a notable exception). That's certainly been true in recent quarters with our assessment of the big picture unchanged.

## **Living With the Challenges We Face**

In talking to our clients about how portfolios should be positioned in light of this, we point to two guiding principles from Benjamin Graham, considered the father of value investing. Recently, financial journalist Jason Zweig unearthed a 1963 talk by Graham that he posted on his website. Titled *Securities in an Unsecured World*, Graham's talk reminds us of guiding principles that investors always need to bear in mind.

We focus on two of these principles today.

### **Principle One: Invest in stocks and bonds only so far as you can live with fluctuations in prices**

This principle is based on the idea that investors have to understand their own ability to live with volatility. Investors were reminded of this in 2008.

Our goal with every client is to tailor a portfolio that appropriately balances risks and rewards. To help you when you're retired (or when you plan to draw upon your portfolio for cash needs), we set aside sufficient cash for your near-term needs prior to making investments.

## **Principle Two: Long-term goals demand long-term thinking**

Graham's student Warren Buffett has said that it only takes two things to make money - having a sound plan and sticking to it. Of those two, it's the sticking to it part that most investors struggle with. Markets such as those we've seen of late create understandable stress and can lead to reactionary decisions; in fact, a whole academic field, behavioral finance, is devoted to the cost of such impulses on investor behavior.

Our experience bears out the view espoused by Graham and Buffett that the only way to invest successfully over time is to have adequate liquidity to meet short-term needs, and with the remainder of your assets to maintain discipline and a long-term focus - i.e., to have the right plan and then to stick to it.

The three charts below speak to this, showing returns among large cap US stocks from 1926 to 2009 after inflation is taken out. Since 1926, US stocks have had average gains of over 9% before inflation and more than 6% after inflation.

First, we see the returns over one-year periods - it truly is a roller coaster. If this was what investing over time always entailed, it would be very difficult to stomach.

The second chart shows returns over three years - showing less volatility but still more than many investors would be comfortable with.

Finally, the third chart shows returns over 10-year periods - the longer you own stocks, the more you avoid the extremes that most investors live with.

Hard as it can be at times (and with the acknowledgement that there are a few of you who disagree), we've found that the only approach to investing that works over time is to keep that long-term view, modifying portfolios as circumstances warrant but never losing sight of the fact that long-term goals demand long-term thinking.



Source: Ibbotson SBBI Large Company Stock index, Morningstar Encorr database Average = Red Line

The Ibbotson SBBI Large Company Stock Index measures the investment return of large capitalization stocks.

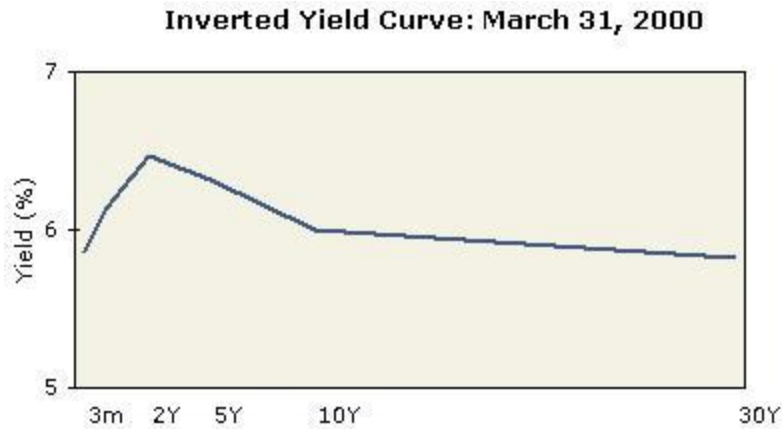
In closing, let us reiterate our appreciation for the continuing opportunity to work together. As always, we welcome your calls and questions and would be happy to discuss your particular situation and goals at any time.

### Economic Commentary

As we come out of a very challenging quarter for the markets and the economy, many are wondering about the risk of a double dip recession. Double dip recessions are actually quite rare; the only such occurrence was in the 1980's, when Paul Volcker, the chairman of the US Federal Reserve at that time, was

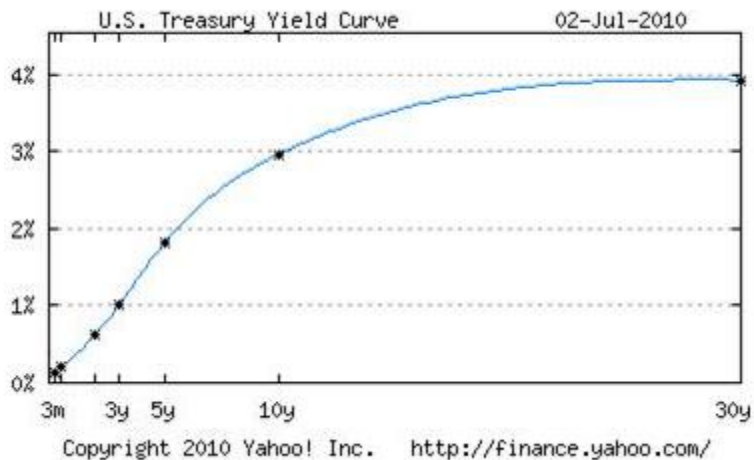
putting the brakes on the economy because inflation was so high.

The yield curve has an impressive record as a leading indicator of economic conditions, alerting investors to an imminent recession or signaling an economic upturn. Quite often an inverted yield curve signals a coming recession within the next year or two. It suggests that investors expect interest rates to decline in the future, usually in conjunction with a slowing economy and lower inflation.



Source: [http://www.pimco.com/LeftNav/Bond+Basics/2006/Yield\\_Curve\\_Basics.htm](http://www.pimco.com/LeftNav/Bond+Basics/2006/Yield_Curve_Basics.htm)

However, right now the yield curve in the chart below looks quite normal, with the exception that short term rates are near zero.



This would suggest that we are in for a period of economic growth. However, we are not coming out of a normal business-cycle recession. We went through a debt crisis and continue to be in a balance-sheet, deleveraging cycle. The bubble wasn't just in housing, it was a bubble in debt as well. Now consumers and businesses are reducing that debt while our government and governments around the world are increasing theirs. So is it different this time, could we be heading into recession despite a bullish yield curve? While we try to be careful in thinking

"it is different this time" we don't want to be lulled into a possible false sense of security that a double dip recession is not going to happen.

Leading indicators are also another measurement of economic activity that we pay attention to. The Index of Leading Economic Indicators has turned down of late. This index tracks ten leading indicators, including the S&P 500 and Money Supply (M2). We had one slightly negative reading after the end of May which included the "flash crash." The most recent reading was a slight positive. This could indicate that the economy is leveling off or could be the transition to more negative readings in the future. Persistent negative readings often signal an economic downturn although there have been many head fakes. We will also continue to monitor this closely in the coming weeks and months.

### Melissa's Note from Chicago

While we often devote this quarterly missive to a discussion of our big-picture outlook (and rightly so), we also want to keep you informed about our individual fund selection process. As investors in actively managed funds, we consider "knowing the manager" to be a critical part of our investment process.

Over the years we've refined this mission. We've accumulated a small group of trusted third party research sources, gotten to know the way to speak with investment managers (and the questions that are two and three levels down that don't come out in a general annual report or conference call), developed our own customized due diligence questionnaire, created a proprietary investment database to store the information we have gathered over the years, and most importantly, we've listened to and talked directly to managers - both investments in our portfolio and some that are not - whenever possible.

Experience tells us that for many financial planning and wealth management firms, investment research is of secondary importance. Investment decisions are often guided by models at a parent company or based on the whims of recent sales visits. We have always considered our independence to be an advantage. We seek to work with investment managers who will discuss their strategies with us through phone conferences, public speaking engagements, conference calls, completion of the aforementioned due diligence questionnaires, and face-to-face interviews.

This brings me then to the Morningstar Conference, one of my favorite times of year, which occurs each summer in Chicago. I am attending three days of investment manager interviews and sessions, as well as having many opportunities to speak one-on-one with managers. The stuff that dreams are made of for an "investment geek" like me! It is a great opportunity to connect with managers whose funds we aren't currently using. I'm also pleased to note that more than ten managers from our current investment recommended list were at the conference, so I could get their most recent thoughts on markets and investing in general. Finally, the ability to network and discuss investments with other

colleagues who consider investment research critical is invaluable.

Our presence at this conference is just one example of our commitment to research and independent thinking. In the second quarter, members of our Investment Department team had one-on-one discussion via phone or in person with more than 20 investment managers. We attended three investment conferences and received approximately 20 due diligence questionnaires from investments we plan to consider. While we cast a wide net, very few investments make the cut. We work to keep an open mind so that when an appropriate opportunity presents itself - or a trusted investment is no longer making the cut - we are prepared to act.

All the best from Chicago,

Melissa Joy  
Financial Associate  
Department Head of Investments

Center for Financial Planning, Inc.  
Investment Committee

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