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A Time For Patience

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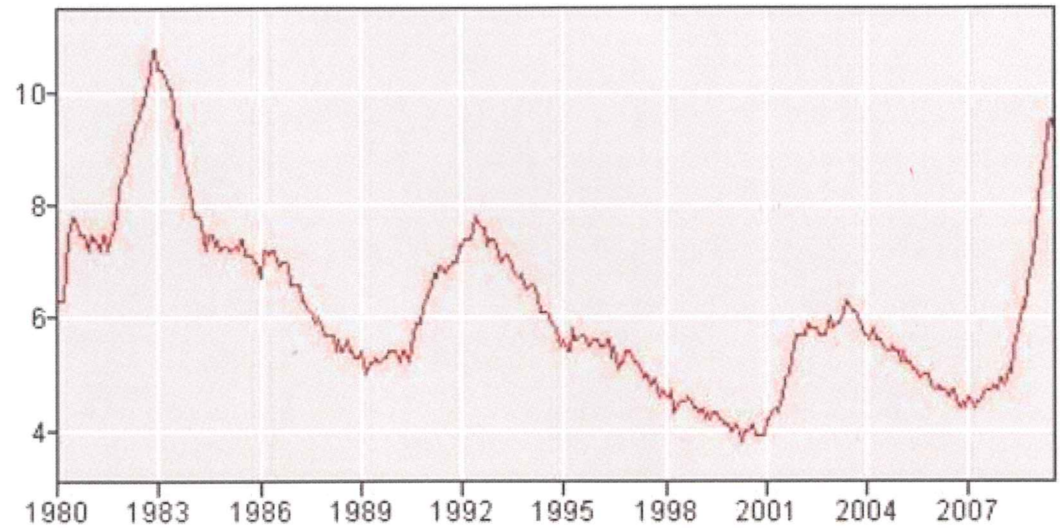
During these economically "interesting times," if one looked only at the stock market or the high yield bond market over the past six months and had no other frame of reference, it would seem that our economy is booming. On the other hand, if one looked instead at the unemployment rate, bank balance sheets, state and Federal deficits, and impending foreclosures in both residential and commercial real estate, it would seem that we are in deep economic trouble and will be for years to come. What are we to make of this? How do we successfully invest in such a "schizophrenic" environment?

First of all, let's remember that I put safety strategies into all of your accounts more than 10 years ago, long before this current crisis began. Beyond the standard systems of asset allocation, we have used guaranteed* fixed annuities, insurance backed income guarantees, and tactical asset allocation. This year I restructured our system to permit me to reallocate many of your accounts even more swiftly. I intend to use this authority to protect you in potential down markets, and also to take advantage of occasional opportunities when they present themselves. We are using one of those opportunities right now. All of your accounts that have a high yield bond option will find that we are currently strongly allocated to that asset class. All of our systems are in place, they are doing well, and we have "stop-losses" in place for when the markets turn against us. I will be using these strategies to make adjustments in your accounts as needed.

Long-time readers of this letter have heard me assert many times that "market cycles are longer than most investors' attention spans." What this means operationally is that most investors (and many financial advisors) don't study economic history and are thereby doomed to repeat it.[1] Let's take a long view at both unemployment and stock market returns to support our current strategies.

Unemployment Data

As of September 30, 2009, the unemployment rate officially stands at 9.8% and is predicted to rise for some time. This rate approaches the official high we last saw at the end of the double-dip 1982 recession. In the chart below, notice that unemployment rose from 1980 into 1983 as the economy experienced two recessions within three years. Also notice the rapid drop in unemployment following the end of the 1980-1982 recessions, as opposed to the recessions of 1991-92 and 2001-02, which had more gradual recoveries. In other words, immediate past history teaches us that it is possible to have two recessions back to back, and it is possible to have either swift increases or minor increases in employment following a recession. What will it be this time? We need to be invested to weather all of these possibilities. (All this information is available on the Bureau of Labor (BLS) statistics website.)[2]



The headline unemployment number shown on this chart (9.8%) is what we typically read in the paper and see reported on the news. However, this doesn't fully measure the "real" number of unemployed. For instance, if the BLS (Bureau of Labor Statistics) has no record of you actively seeking a job in the last four weeks, even if you would like one, you are not counted as unemployed. You are called a "marginally attached" or "discouraged" worker. There may be good reasons for no longer counting you as among the unemployed. You could be sick, dealing with a family emergency, or going back to school, etc. So the BLS has several other measures of unemployment.

The BLS estimates that one-third of "marginally attached" workers actively want jobs but have not bothered to look because they believe there are no jobs in their area, at least not for them. So the BLS has another measure called "U-4 unemployment" which includes this extra third of unemployed workers, and that percentage today is 10.2%. The BLS also has a number that includes all "marginally attached" workers called U-5 unemployment. That number is 11.1%

When the BLS adds those who are employed part-time for economic reasons (i.e., they can't get full-time jobs) the unemployment number rises to 17%. This is called U-6 unemployment.

What do I draw from all of this? A couple of points are worth noting:

1. Any way you want to measure it, unemployment has grown at a steeper pace than any time in the past 30 years.

2. In an economy which depends on the consumer for 70% of GDP, this level of unemployment does not bode well for a quick and steady economic recovery.

3. The current recovery in the stock market may be simply "cyclical" and not "secular." I will define these below and explain their significance for our investment strategies.

A 20-Year Look back at the Stock Market

As financial planners we warn you that investments in the stock market are not appropriate for short term goals because of the unpredictable volatility. However, we have often claimed that stock market investments typically do very well over ten-year periods of time. In the "new normal" times we are in, this can no longer be assumed. A single chart can show you what I am talking about.

Below is a 20-year chart of the S&P 500 index, from October 1, 1988 through September 30, 2009.[3] What you can see at a glance are two very different 10-year periods of investment performance. From 1989 to 2000 you can see what we call a "secular bull market", namely a multi-year period of a higher trending market. From 2000 through September 30, 2009 you can see several up and down "cyclical markets." The question is: what will the next 10 years look like? How do we adapt our investment strategies to protect us in case the next 10 years are "cyclical" rather than "secular"?

The hypothetical illustration above does not reflect any real investment results.
The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. Investors cannot directly invest in an index.

Just from this chart, I think we can safely draw a few tentative conclusions:

1. "Buy and hold" (or should we call it "buy and hope?") is no longer an investment strategy that we can count on to achieve our financial goals.

2. Tactical asset allocation, which I have used since 2007, and which Ocean Park has used since 1987, may protect us better than "buy and hold" strategies during cyclical markets.

3. Insurance income guarantees for our retirement accounts may be absolutely necessary to protect our future income streams.

I thank all of you for trusting me with your financial assets for these many years, some of you for as many as 25 years! Your trust has been a great blessing to me, and I hope that my management of your accounts in both good times and bad helps you to live the life of your dreams. Call me with any of your financial questions or concerns. Thanks for referring your friends and family to us. We still have room for a few more clients.

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[1] With apologies to George Santayana.
[2] www.BLS.gov
[3] www.Fasttrack.net