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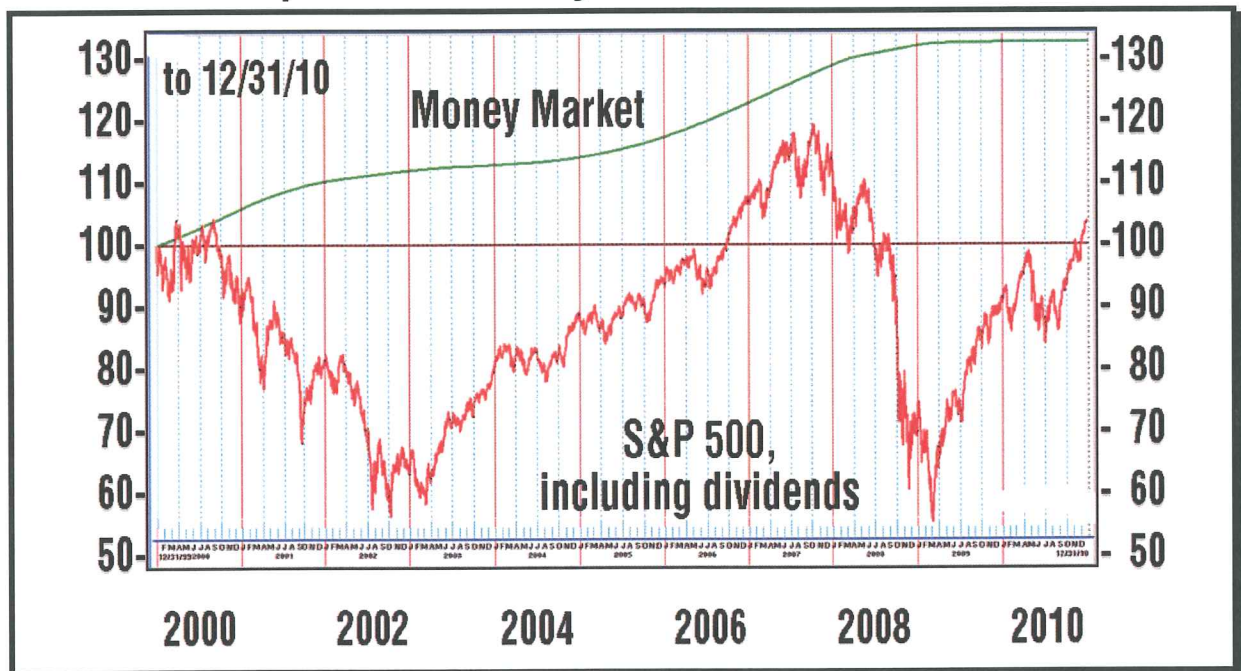
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Cautious Optimism

February 2011

The lead article in the December Issue¹ of the AARP (American Association of Retired Persons) magazine is entitled, "Farewell to a Dreadful Decade," which I think is a fair summary of our investment climate thus far in the new century. Below is a chart² of the S&P 500 since January 1, 2000, showing "exciting" ups, and "frightening" downs, with virtually no net gains for 11 years. Our state and our national government are running deficits and remain deeply in debt; unemployment seems stuck at extremely high levels; and real estate remains in the throes of the worst down market since the Great Depression. How, then, can I make a case that I am "cautiously optimistic" about the stock market going forward?

S&P 500 compared to Money Market Index from 2000 to 2010



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.

There are three major financial dislocations that we have been monitoring in our concern about the possibility of a "double dip." I would like to discuss each one to show what has changed so that it is now possible we are at the beginning of a healthy stock market.

Real Estate Difficulties May Continue For Years

Dickens once wrote, “It was the best of times, it was the worst of times... we had everything before us, we had nothing before us.”³ This could serve as a summary of our current real estate marketplace. If you need to sell your house to move, or you are among the 27% of mortgage holders⁴ whose debt is greater than the value of home, it is the worst of times. Prices are down and may be going even lower this year. However, if you are an investor with cash and good credit, this real estate marketplace may be the best real estate investment opportunity I have seen in my life. Not only are prices down, interest rates are near historic lows and many sellers are “distressed.” At today’s prices, rental income can give an investor a significantly positive cash flow after all expenses. In my opinion, the great real estate fortunes of 2020 will be made by investors who build real estate portfolios over the next several years.

The collapse of the real estate market helped to cause the crash in stock markets throughout the world in 2008. Why do I think that a poor real estate market over the next several years won’t negatively affect the stock market? There are two main reasons.

1. We have already had the crash. Prices today in many areas are below replacement cost. Contrarian investors have begun to buy. Even though prices may go somewhat lower due to foreclosure sales and a generally gloomy outlook, I believe it is highly unlikely that further losses will be dramatically lower.

2. Banks are being supported by the Fed. The crash in real estate was magnified by the fact that all the major banks held highly leveraged real estate assets. This meant that a small drop in real estate values was enough to create major drops in the balance sheets of the major banks, which in turn forced panic selling, which drove prices even lower in a vicious self-reinforcing cycle. Ben Bernanke, Chairman of the Fed, recently informed a congressional committee why the banks were bailed out. During a two week period in 2008, 12 of the 13 largest financial institutions were in danger of immediate collapse.⁵ That time of extreme duress and over-leverage has passed. Banks still have millions of properties to foreclose on and to sell, but I expect these sales to be spread over the next several years in a more or less orderly fashion. These sales will tend to keep inventories high and prices low, but they should not create panic selling.

Unemployment Remains High

The most recent figures⁶ show unemployment dropping in January to “only” 9.0%, lower than the 9.9% rate in January 2010. When we include those who have quit looking for work and those who are underemployed the number is 16.1%. Most likely, a significant percentage of this unemployment is “structural” rather than simply “cyclical.” In other words, some of this unemployment is due to jobs that have disappeared from the economy, and will not return as the economy improves. Long-term unemployment is exceptionally hard on the unemployed individuals and their families, but some unemployment can be positive for corporate profits and stock market returns. Simply put, people will work for less right now.

If 16.1% of the working population is either working less or not working at all, then 83.9% of the working population still has jobs. Businesses are actively “right sizing” themselves through

rational contraction and are becoming profitable within this smaller customer pool. General Motors and Ford are both examples of this.

Even though some jobs are gone for good, innovation is always creating new jobs in new industries, some of which are being invented right now. So even though unemployment may remain high for longer than we would like, current businesses are adapting and new businesses will be invented that will increase employment over time.

Debt, Debt and More Debt

I won't spend a lot of time dwelling on the amount of debt that governments have taken on because it has been so widely reported. Suffice it to say that at every level of government, debt is a major problem: in the European Union, at our Federal level and in most state governments as well. The one significant positive feature to all of this debt is that we are no longer in denial about it, and that politicians are now taking it seriously. It remains to be seen if politicians, or if we the people, actually have the fortitude to take the necessary painful steps to deal with in a healthy way.

Stock Market Cautious Optimism

Over the past two years we have seen a dramatic improvement in the prices of stocks, albeit an improvement from an extremely low level caused by the greatest financial crisis we have seen since the Great Depression. We have been monitoring this improvement with a continuing concern that stock markets could collapse back into a second recession, a so-called "double dip." At the present, we are reassessing our fears with the following new data that may indicate the possibility of a favorable, potentially multi-year, healthy phase of growth in spite of the problems noted above. Here are some of our current observations.

1. Corporations are sitting on a lot of cash. Bloomberg estimates that S&P 500 companies collectively currently hold \$2 Trillion in cash.⁷ How can they have so much? This probably means that they have downsized and are profitable once again. What is the importance of "sitting on" lots of cash? Extra cash means companies have the ability to expand when necessary, by ramping up production, or by buying other companies, whenever they decide that the right time has come. In short, extra cash represents healthy future growth potential.
2. Price-Earning ratios (P/Es) for the S&P 500 companies stood at a healthy 15.5 at the end of 2010.⁸ Some economists price the S&P 500 at a moderate 14 times earnings for 2011 based on estimates of future earnings.⁹ To put this in context, since World War II the S&P 500 average P/E ratio has been about 17. During boom times it has been up in the 30s. In other words, based on earnings, stocks are priced very moderately, and any growth in earnings may directly support higher prices.
3. The typical small investor has been shunning stocks. For the past two years new investments by small investors have gone 96.7% into bonds, and only 3.3% going into stocks and other asset classes.¹⁰ If interest rates begin the climb, and if fears subside about the stock market, there is a

lot of money that could migrate from bonds into stocks, thereby supporting higher potential prices.

Going forward from here we are sticking with our core principles of conservative investing, using diversity, tactical asset allocation, and income guarantees* backed by healthy insurance companies to grow and protect your retirement assets. At this writing we are still maintaining our significant allocations to high yield bonds where we have that option, but we are maintaining the option to make proactive changes based on market conditions. Any changes that we make have three objectives in mind:

1. To deliver strong absolute returns;
2. To participate in stronger market periods while limiting losses in difficult ones, and;
3. To achieve your unique goals in the most conservative possible way.

We cannot guarantee that we can achieve these objectives as past performance is no indication of future results. Please call us if you have any changes in your financial situation, or if you have any questions about your accounts with us.

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The views expressed are those of the author as of the date noted, and are subject to change based on market & other various conditions. They may not reflect the views of United Planners Financial Services of America.

*Guarantees are based on the claims paying ability of the insurer.

Certain risks exist with any type of investment & should be considered carefully before making any investment decisions. Keep in mind that current & historical facts may not necessarily be indicative of future results.

¹ Aarp.org/bulletin. December 2010

² Chart courtesy of Ocean Park Asset Management

³ Charles Dickens, *A Tale of Two Cities*

⁴ www.Yahoo.com/Finance/TechTicker, February 10, 2011

⁵ *LA Times*, "Many are faulted in credit crisis." January 28, 2011

⁶ www.bls.gov. Table A-15.

⁷ www.Yahoo.com/Finance/TechTicker, February 14, 2011

⁸ Morningstar

⁹ *LA Times*, "The unhappiest bull market ever." February 2, 2011

¹⁰ *Bessemer Trust: Quarterly Investment Perspective*, January 2011, page 6