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Volatility and Fear Return

September 2011

After a relatively benign first half of the year, volatility has returned with a vengeance. What are we to make of this? A normal “correction?” An end to the recent “cyclical bull?” “Or, what?” Peter Lynch, one of the most successful fund managers once said, “A stock market decline is as routine as a January blizzard in Colorado.” He went on to add, however, “If you’re prepared, it can’t hurt you.”

Before I go into some rather dismal projections, the important thing that I want you all to know is that our core strategy is always to be prepared. We built risk reduction strategies into all of your accounts at inception. They are diversified in their core investments, most have active tactical allocation that is designed to dramatically lessen the portfolio’s volatility, and almost all have some insurance backed income guarantees.* Each of your accounts is specifically tailored to your unique goals, so feel free to call me for a review if you are concerned. (800-660-8727)

At this point in time, I have no way to determine whether this recent setback is a “normal” correction, or if it marks the possible end of the cyclical bull market that began in April 2009. In my last quarterly letter I explained how we have been in a “Secular Bear Market” since the year 2000: loosely defined as a period of five years or longer where there are no lasting gains in the stock market.

Fact: On January 3, 2000 the S&P 500 stood at 1,455. On August 19, 2011 it closed at 1,123. After 11 years and 7.6 months, an investment in the S&P 500 stocks would be down -22.8%!¹

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.

A recent publication by Rydex-SGI shows that there have been three prior Secular Bear Markets since the Dow Jones Average was created in 1896: the shortest was 17 years in length and the longest was 25 years.² This history is not predictive of how long the current Secular Bear might endure, but it does show that it is *possible* for it to last much longer.

Is This Time Different?

It is said that one of the most dangerous economic assertions is, “This time it’s different.” So let me lay out my thinking as to why I think that maybe this current recovery really *is* different. I

believe this economic recovery will take much longer than previous post World War II cyclical recoveries, and that we still have a number of years of economic turmoil ahead of us, maybe even including a second recession in the near future, before we will regain a robust economy.

Real Estate is Different

Most recessions in the post World War II era have been caused by the normal excesses of the business cycle, so past recessions ended after businesses contracted back to the level of demand, and a new growth cycle began. Our current "Great Recession," however, began with a massive collapse of a world-wide real estate bubble. This exposed our 30 years of excessive borrowing and, without massive government intervention, would have brought down our financial system. Much of the damage done to real estate and our banking system remains with us to this day. Residential real estate prices remain low, and are expected by most people to go even lower in the year ahead. Banks are still sitting on many troubled properties, many of which may go to foreclosure this year and the next. Fannie Mae reports that 23% of all mortgage holders have negative equity.³ At best, having negative equity means one cannot refinance to take advantage of lower rates, nor sell one's house easily to move to where work is available. At worst, a negative equity puts owners under financial stress that leads to foreclosure.

On the plus side, a bottom seems to be forming in real estate. Prices have dropped to where young families (if they have jobs) can now afford to buy a home. A friend of mine who is a long-time investor in real estate is happily buying distressed properties at prices that allow him to rent them out for positive cash flow profits, a situation we have not seen for years. In my judgment, the real estate fortunes of 10 years from now will be created by today's astute buyers. Refinancing rates are now hitting new all-time lows below 4.5%. If your rates are higher than this, call me for a discussion about whether it might be wise for you to refinance (again).

Unemployment is Different

Unemployment remains high and will probably be high for several years because it is not just cyclical, but also structural. "Cyclical" means that you are laid off because business is slow, but you go back to work when business picks up again. "Structural" means that you are laid off because your job has gone away or moved overseas: like manufacturing jobs to China, insurance home office workers to Ireland, or computer and software technical support to India. Demographics are also adding to high youth unemployment as elder workers stay on their jobs longer, rather than retiring, because their 401k's have lost so much money over the past few years.⁴ In addition, next year will probably see an increase in unemployed government workers at the State, County and City levels as Federal stimulus money to State governments dries up.

Although this sounds pretty bleak for the next year or two, I have confidence that our ingenuity will create new industries along with new jobs. For example, in 1900 we had 41% of the workforce employed in agriculture, whereas by 2000 only 1.9% of the workforce was employed in agriculture.⁵ Nobody now laments that loss of those agricultural jobs because new industries and jobs took their place. We'll do that again. But it will probably take longer than past cyclical recoveries.

The Mountain of Debt

A key question remaining is how the United States and the European Union will deal with their respective mountains of debt. I was appalled that the Tea Party faction of the Republican Party was willing to “play Chicken” with the debt ceiling extension. Even though we didn’t drive over the cliff, the “Full faith and Credit” of the United States came into doubt for the first time in my investing life. Our budget deficits are constrained at both ends: from past profligate spending like the Bush tax cuts and two wars financed by off-balance-sheet borrowing, and from future unfunded liabilities like Medicare entitlements without reasonable limitations. It remains to be seen if we can find the political will to make the painful choices that can bring us back into balance.

The problems in Europe may also affect us in the near future. According to Michael Lewis, Greece may have to do a partial default on some of their debt in the near future.⁶ When they do, it may create a contagion of fear that affects the credit of other countries in Europe like Ireland, Italy, Spain and Portugal. This could have spillover effects on our credit markets as well. We continue to monitor these events and may make changes to your portfolios as needed.

Investment Strategies

It is important to remember that investments do not move in a straight line: there are volatile times to be defensive (and patient), and other times when it seems easy to make money. As I am writing this it is a time for defense and patience. During a Secular Bear market there can be opportunities in assets classes other than stocks, which we have taken advantage of over the past several years with over-allocations to high yield bonds. In our high yield bond strategy, we are now in a defensive posture. In accounts where I am limited to a relatively few diversified portfolios, we are making no changes for the moment. Please feel free to call me if you would like a review of your specific allocations.

Michael Coleman, Ph.D.

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 www.finance.yahoo.com

² Rydex-SCI: DJCSI-15-0111-1211 #2157

³ www.ABC12.com, Fannie Mae, August 15, 211.

⁴ *NPR*, Talk of the Nation, June 21, 2011

⁵ *USDA Publications*: The 20th Century Transformation of U.S. Agriculture and Farm Policy

⁶ *Vanity Fair*, October 1, 2010, “Beware of Greeks Bearing Bonds” by Michael Lewis