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Navigating the Secular Bear

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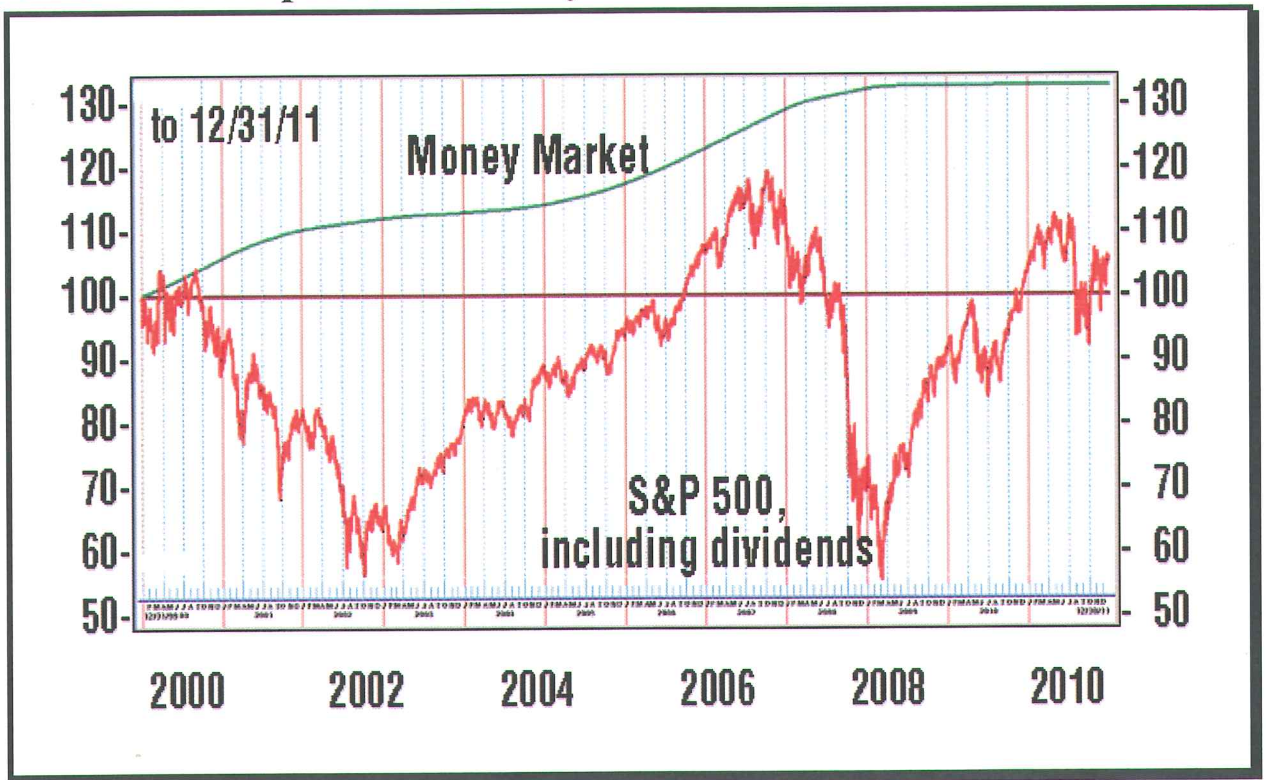
2011 has turned out to be another difficult year for investors. Each significant advance in the U.S. stock market was followed by an equal or greater decline. During 2011 the S&P 500 was up as much as +8%, down as much at -19%, but finished the year at precisely 0.0% gain. Markets outside the U.S. were not so lucky: European stock indexes were down -17.1%, Brazil -18.1% and China -20.0%.[1] My "cautious optimism" at the beginning of last year was "premature" as the chart below shows. For **12 YEARS** now we have had virtually no net gains in the stock market!

S&P 500 compared to Money Market Index from 2000 to 2011



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.

This reminds us once again – as if we needed such a reminder since 2008 – that successful investing requires both patience and courage. Now is the time for patience as we wait to see how various problems resolve themselves. There will be years, like this one, and maybe like 2012, when we need to be careful not to lose money. Then there will be years like 2009 and 2010 when we can make significant money. Because we can never know the difference in advance, we must constantly monitor and adapt our strategies.

Is 80 the new 65?

I am continually surprised by how few commentators mention that we have been in a Secular Bear Market for 12 years. They may notice the effects, but are unaware of our financial history. The main effect of the Secular Bear is the erosion of retirement assets for the Baby Boomer generation. Most Baby Boomers have been unable to grow their retirement assets for 12 years, and now current returns are not enough to support a lifestyle that potential retirees were hoping for.

We have all heard expressions like "60 is the new 40" referring to the improving physical health of our elders. Now there is a new phrase "80 is the new 65" referring to our deteriorating fiscal health, meaning that those who planned on retiring at age 65 now fear they must work until they are 80. In a recent survey by Wells Fargo 74% of the respondents expect to work to supplement their meager retirement income, and 25% fear they will not be able to retire before age 80 because of insufficient savings.[2]

- According to a recent Gallop Poll, the top financial concern for 66% of Americans is poverty in their retirement years.[3]
- New School of Social Research in New York recently projected that "most middle-class workers, not just low-income workers, will be living at or near the poverty level in their old age."[4]
- Baby boomers are the first generation since the 1930s that will be worse off in their older years than their parents.
- The first members of the Baby Boomer cohort are turning 65 this year, and many are postponing retirement or giving up on it altogether.[5]

Win by not Losing

I recently saw the movie "Money Ball" in which my college roommate and friend since 3rd Grade, John Cole, has a significant cameo role as a baseball scout. The movie tells the story about how General Manager Billy Beane transformed the Oakland Athletics into a winning team by statistical analysis to put the odds in his favor. On offense he created a strategy of just getting on base and avoiding strike outs. Don't go for home runs. A base on balls is as good as a base hit. On defense, he developed an excellent pitching staff which kept the opposition's scores low. The goal was to win by steadiness and consistency, to win by not losing.

This is similar to our strategy for your success. Based on your goals and requirements we build portfolios that strive to stack the odds in your favor, to win by steadiness and consistency, to win by avoiding significant losses. What this means in practice is first of all to "protect the nest egg." Most of you will have a significant percentage of your retirement incomes protected by insurance income guarantees*, and for 2011 these guaranteed values grew more than your account values. Diversity protects your accounts from single company risk – we never risk a "strike out" by loading up on a single "hot stock" in hopes of a "home run." And, finally, we use tactical allocation to bring in our defensive "pitching staff" during times of high market volatility and risk. In practice, this means that we don't stay fully invested in stocks. Sometimes we retreat to money markets. Sometimes we reallocate to various bond asset classes. Sometimes we have used fixed annuities. Typically we wrap your stock investments with an income guarantee covered by an insurance company.*

Debt and Real Estate

Excessive debt continues to be the major problem in U.S. real estate, in the finances of the U.S. Federal government and most state governments, and in virtually all of the countries in Europe. As one insightful commentator put it: "Think of it this way: The prosperity of the 1990s and 2000s was in part stolen from the future. Borrowing allowed for immediate gratification. Now the bills are coming due."[6] We are now in that future we stole from and the resolution of these debts will probably take many more years.

There are only three ways to remove debt: 1. Pay it off. 2. Stay current on your payments until you can afford to begin paying it off. 3. Default in whole or in part. All of these actions on a macro level are deflationary and this is why we are not expanding in the same way that we did out of prior recessions. Typically in prior recessions, a pickup in real estate buying helped to expand employment and lead us into the next expansion. Although we are seeing some positive signs, like a reduction in unemployment claims and a slight lowering of the unemployment rate, real estate may stay in a bottoming area for a number of years. The Federal Reserve reports that since 2007 net home equity has declined from $12.9 trillion to $6.2 trillion. This means that $6.7 trillion has disappeared from our economy.[7] Currently 28.6% of all mortgages holders remain "underwater", i.e. owe more on their mortgages than their properties are worth.[8] CNBC predicts home prices will fall an additional -5% in 2012 and 3,000,000 distressed properties will move to the foreclosure stage.[9]

Why Does Europe Matter to Us?

Fears of a major financial crisis over European debt roiled the U.S. stock markets several times this past year. There are two main ways that problems in Europe could impact our investing strategies. Europe may tip into recession in 2012, and there remains a possibility that additional European countries, beside Greece, could default on their sovereign bonds. These are threats of different magnitudes. A recession in Europe could affect our economy since we sell a significant percentage of our exports there, but it may not be catastrophic to us. Japan, a major trading partner, went into recession for many years and our economy was able to remain healthy. However, if sovereign defaults in one or more of the major countries lead to a precipitous breakup of the Euro Zone, this could affect us significantly. Mohamed El-Erian, the CEO of PIMCO (the world's biggest bond firm) said a collapse of the Euro Zone could trigger a financial crisis akin to the one that devastated the global economy in 2008. He does go on, however, to predict that the most likely outcome is that European policy makers will "get their act together" and downsize to a smaller, more viable currency union.[10]

I have outlined some of the major concerns we continue to monitor, but there are also a number of positive, though slow and painful, changes taking place. Governor Jerry Brown in California is forcing us to face economic reality by cutting programs and aligning state income with state expenditures. The national saving rate, which was 1 percent six years ago, increased to 5 percent last year. Corporations have posted 9 quarters of increasing profits due mainly to downsizing rather than expansion. Unemployment fell from 9.0% in January to 8.6% by the end of November.[11]

We may be able to take advantage of a number of potential investment opportunities in 2012. Plenty of cash sitting on the sidelines could one day be used for more productivity, like financing new businesses: $8.6 trillion in U.S. bank savings accounts and money markets is earning virtually nothing.[12] With the Federal Reserve committed to keeping interest rates near zero until 2013, high yield bonds or high dividend paying stocks may give us some profitable opportunities in 2012.

We continue to live in "interesting times." Call me anytime for a discussion of the economy, a review of your accounts or with any other financial questions or concerns.

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[1] ***LA Times***, "U.S. Stocks withstand a volatile year", Dec. 31, 2011.
[2] ***InvestmentNews***, "Thanks to economy, '80 is the new 65'", Nov. 28, 2011
[3] www.chicagotribune.com/business, "U.S. on threshold of retirement crisis amid rising baby boomer population, growing threat of poverty," Nov. 23, 2011.
[4] ***Ibid.***
[5] ***Ibid.***
[6] ***LA Times***, Tom Petruno, "The debt, the future and other parting thoughts", Nov. 26, 2011.
[7] www.aarp.org/bulletin, "The people are leading the way", December 2011.
[8] www.news.businessweek.com, "U.S. 'Underwater' Homeowners Increase to 28.6%, Zillow Reports, Nov. 8, 2011.
[9] www.cnbc.com, "Predictions 2012, "Diana Olick: Real Estate", Dec. 1, 2011.
[10] www.bloomberg.com, "Pimco's El-Erian Sees Risk Europe May Spark a Lehman-Like Financial Crisis", Dec. 20, 2011
[11] www.bls.gov
[12] ***LA Times***, Petruno, **Op.Cit.**