WINTER 2009

in Context

WEALTH STRATEGY FROM A DIFFERENT PERSPECTIVE

MAXWELL & LOCKE & RITTER

Riding the Storm Out

In December 2008, the National Bureau of Economic Research determined the United States was in a recession, one that began in December 2007. Since World War II, the two longest recessions have each lasted 16 months.

While economists may try to predict when this current downturn will conclude — with forecasts ranging from June 2009 to after January 2010 — research has found there are no economic forecasters who consistently lead the pack in forecasting accuracy.

We live in a world of uncertainty (the odds of events occurring cannot be measured), not a world of risk (the odds can be measured). Since we cannot calculate the odds of a bear market occurring like the one we experienced in 2008, investors require a large equity risk premium. That risk premium is why over the long term, stocks have outperformed riskless Treasury bills by a wide margin.

Investment returns are not earned smoothly. The result is most of the market's returns come from short but powerful bursts of bull and bear markets.

As for the current recession, investors and policymakers alike can look to the past for guides on how to (and how not to) address the current market situation. That is why there are significant differences between a time like the Great Depression and the current recession.

For example, dramatic steps have been taken by central banks all around the globe (with most at or heading toward a zero interest-rate policy and flooding markets with liquidity to unfreeze credit markets). Stock markets know that such programs take time to work their way through the system. Anticipating the ultimate effects, markets typically rally well before economies recover. In addition to the major fiscal and monetary stimulus programs, there are other major positives that can go unnoticed.

Energy prices have collapsed with the price of crude oil well below the highs of the past summer. That is the financial equivalent of a large fiscal stimulus program, acting like a massive tax cut.

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Shelf Life

"Small wonder that confidence languishes, for it thrives only on honesty, on honor, on the sacredness of obligations, on faithful protection, on unselfish performance; without them it cannot live.

Restoration calls, however, not for changes in ethics alone. This Nation asks for action, and action now."

— Franklin D. Roosevelt, Inaugural Address, March 4, 1933

Why the Banks?

As the credit crisis deepened in the second half of 2008, the government initiated massive programs in an attempt to minimize the effects of the worsening financial conditions on the broader economy.

While a few firms, most notably Lehman Brothers, were allowed to fail, the government "bailed out" a significant number of firms, including AIG, Citigroup, Fannie Mae, Freddie Mac and Wachovia.

Government bailouts raise legitimate questions. Classical economics is based on the belief that the invisible hand of the market will ensure the flow of resources to their most efficient uses, and that government intervention leads to suboptimal results. From this perspective, all bailouts are viewed with skepticism.

However, there are situations where government intervention is beneficial. For example, the free market does not account for effects on parties not directly involved in the economic activity. The most efficient way to produce energy may be to burn coal, but this does not consider the effects of pollution. In such cases, regulation is needed.

The government actions to prevent a complete meltdown of the financial system were equally justified. All economic agents need money to perform their functions, the same way that all residents of a town need water. The financial system is like the water pipe system — it allows money to flow from its providers to its users. Allowing the financial system to collapse would be similar to allowing the water pipes to freeze — clearly not the best way to run a town.

Business Cycles, Sector Rotation and a Better Outlook

By Dr. Mendel Fygenson

As if 2008 was not tough enough, here come the market timing crusaders. Appealing to the intuitive truism that asset prices are influenced by macroeconomic fluctuations, market timers assert that one can outperform the market by riding the various phases of a business cycle.

But an inspection of the last 10 complete business cycles (as defined by the National Bureau of Economic Research) provides a quick awakening.

The average cycle lasted 70 months with a standard deviation (SD) of 37 months. The shortest lasted 18 months (01/80–07/81), and the longest lasted 128 months (07/90–03/01). So much for regular and predictable cycles.

Could you and should you have run the sector-rotation strategy? In his 1996 book, *Sector Investing*, Sam Stovall lists the "right" sectors to rotate in and out of during the five phases of a business cycle. Phases I/II are the early/late stages of a recession; phases III/IV/V are the early/middle/late stages of an expansion.

However, this strategy is picked apart by Stangl et al. in the 2007 research paper "Sector Rotation over Business-Cycles." Even without transaction costs and with perfect hindsight identifying the start of each of the five phases of the last 10 business cycles, the strategy's returns (adjusted to risk) are marginal at best and do not consistently outperform the market.

Do the phases of the business cycle hold any value to investors? Yes! By any measure, phase II (of a recession) is the most profitable of all the phases. During the last 10 cycles, market returns (weighted returns of all NYSE, AMEX, and NASDAQ listed stocks) in excess of the 30 days Treasury bill averaged above 30 percent in phase II. Sure, they're volatile (with a SD greater than 18 percent), but the potential for great returns is there. Therefore, investors, passive or otherwise, can look back on 2008 for redemption, since in all likelihood it has left us at or near the beginning of another phase II.

Mendel Fygenson is a professor at the University of Southern California's Marshall School of Business.

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Falling interest rates are providing an opportunity for many homeowners to refinance and dramatically lower their payments (again, acting like a major tax cut). More potential homebuyers are now eligible. Eventually, the combination of lower interest rates, lower prices and pent-up demand should lead this sector of the economy to recover.

It is important to remember that we have been here many times before and very recently (2000–02). When it looks gloomiest, many investors panic and sell and then cannot recover as the losses become permanent. It is easy to sell, but difficult to know when to get back in, as there is no bell that rings to signal all clear.

What we do know: Investing in stocks is highly risky. Thus, the key to successful investing is to not take more risk than you can handle. If you do, it is very likely you will be forced to sell either because your stomach demands it or your economic situation requires it (because you cannot withstand further losses). You must be able to stay the course and rebalance to sell high in bull markets and buy low in bear markets (when future expected returns are highest).

What can you do to weather this or any future storm? Conduct a "lifeboat drill." Simulate in your mind the likelihood that another financial crisis will occur. Envision your emotional state and think about your willingness to rebalance just when equity values are plummeting. Adjust your current investment plan to incorporate no more risk than is needed to keep the lifeboat afloat.

While each crisis is different — including this one — nothing really is different. In other words, the only thing about investing you don't know is the investment history you don't know.

Making Plans

Five Things to Consider for Your 2008 Income Tax Return

Make sure charitable contributions are properly documented.
You need written documentation from the charity, including the value of any goods or services you received in exchange for your donation.

Be on the lookout for corrected 1099s that may arrive in the mail.
It is important that you send them to your tax preparer, even if the corrected 1099s arrive after you have sent in your income tax return.

Make sure you have the appropriate documents when donating real estate to your favorite charity.
A written appraisal is necessary when claiming a deduction.

Take advantage of the tax organizer packet you receive from your tax preparer.
Taking the time to complete these forms (and attach the necessary supporting documents) will save your tax preparer from sorting through all your documentation.

Be aware that the annual gift tax exclusion increases in 2009.
In 2008, the annual exclusion was $12,000. The annual exclusion for gift tax purposes increases to $13,000 in 2009. Consider making gifts early in the year to get appreciation from the gifted assets out of your estate.

Source: RubinBrown LLP

ML&R Wealth Management LLC
401 Congress Avenue, Suite 1100
Austin, TX 78701

phone 512.370.3200
fax 512.370.3250
web www.mlrwm.com

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