The View From the Fiscal Cliff: Economic Update and Thoughts on 2013 and Beyond

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Important Information

The views and opinions expressed are those of the speaker and are subject to change based on factors such as market and economic conditions. These views and opinions are not an offer to buy a particular security and should not be relied upon as investment advice. Past performance cannot guarantee comparable future results.
Important Information

Performance quoted is past performance and cannot guarantee comparable future results; current performance may be higher or lower.

Results shown assume the reinvestment of dividends.

An investment cannot be made directly in an index.

Investments with higher return potential carry greater risk for loss.

Investing in small companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity.

Foreign securities have additional risks, including exchange rate changes, political and economic upheaval, the relative lack of information about these companies, relatively low market liquidity and the potential lack of strict financial and accounting controls and standards.

Investing in emerging markets involves greater risk than investing in more established markets such as risks relating to the relatively smaller size and lesser liquidity of these markets, high inflation rates, adverse political developments and lack of timely information.

Fluctuations in the price of gold and precious metals often dramatically affect the profitability of the companies in the gold and precious metals sector. Changes in political or economic climate for the two largest gold producers, South Africa and the former Soviet Union, may have a direct effect on the price of gold worldwide.
Total federal taxes would jump +20%. That would kill economic expansion.

This just-released study from the influential think-tank in Washington is bound to alarm congressional legislators on both sides of the aisle. In my opinion, it’s likely that they will enact legislation in their lame duck session to postpone the cliff until mid-2013.
Economic Data

Simpson-Bowles – the guts of a grand compromise

Preamble

Throughout our nation’s history, Americans have found the courage to do right by our children’s future. Deep down, every American knows we face a moment of truth once again. We cannot play games or put off hard choices any longer. Without regard to party, we have a patriotic duty to keep the promise of America to give our children and grandchildren a better life.

Our challenge is clear and inescapable: America cannot be great if we go broke. Our businesses will not be able to grow and create jobs, and our workers will not be able to compete successfully for the jobs of the future without a plan to get this crushing debt burden off our backs.

We propose a six-part plan to put our nation back on a path to fiscal health, promote economic growth, and protect the most vulnerable among us. Taken as a whole, the plan will:

- Achieve nearly $4 trillion in deficit reduction through 2020, more than any effort in the nation’s history.
- Reduce the deficit to 2.3% of GDP by 2015 (2.4% excluding Social Security reform), exceeding President’s goal of primary balance (about 3% of GDP).
- Sharply reduce tax rates, abolish the AMT, and cut backdoor spending in the tax code.
- Cap revenue at 21% of GDP and get spending below 22% and eventually to 21%.
- Ensure lasting Social Security solvency, prevent the projected 22% cuts to come in 2037, reduce elderly poverty, and distribute the burden fairly.
- Stabilize debt by 2014 and reduce debt to 60% of GDP by 2023 and 40% by 2035.

Economic Data

Simpson-Bowles –the guts of a grand compromise

The plan has six major components:

1) **Discretionary Spending Cuts:** Enact **tough discretionary spending caps** to force budget discipline in Congress. Include enforcement mechanisms to give the limits real teeth. Make significant cuts in both security and non-security spending by cutting low-priority programs and streamlining government operations. Offer over $50 billion in immediate cuts to lead by example, and provide $200 billion in illustrative 2015 savings.

2) **Comprehensive Tax Reform:** Sharply reduce rates, broaden the base, simplify the tax code, and reduce the deficit by reducing the many “tax expenditures”—another name for spending through the tax code. Reform corporate taxes to make America more competitive, and cap revenue to avoid excessive taxation.

3) **Health Care Cost Containment:** Replace the phantom savings from scheduled Medicare reimbursement cuts that will never materialize and from a new long-term care program that is unsustainable with real, common-sense reforms to physician payments, cost-sharing, malpractice law, prescription drug costs, government-subsidized medical education, and other sources. Institute additional long-term measures to bring down spending growth.

4) **Mandatory Savings:** Cut agriculture subsidies and modernize military and civil service retirement systems, while reforming student loan programs and putting the Pension Benefit Guarantee Corporation on a sustainable path.

5) **Social Security Reforms to Ensure Long-Term Solvency and Reduce Poverty:** Ensure sustainable solvency for the next 75 years while reducing poverty among seniors. Reform Social Security for its own sake, and not for deficit reduction.

6) **Process Changes:** Reform the budget process to ensure the debt remains on a stable path, spending stays under control, inflation is measured accurately, and taxpayer dollars go where they belong.

**Key Provisions:**

**Taxes:**
- Lower rates, broaden base, cut deductions, maintain or increase progressivity. (P. 28)

**Health Care:**
- Reduce or eliminate tax exclusion for employer-paid health insurance premiums. (P. 36)
- Pay providers based on quality, not quantity. (P. 36)
- Raise the annual deductible and patient co-pay to reduce over-utilization. Restrict first-dollar coverage in Medigap policies. (P. 38)
- Eliminate states’ gaming of Medicaid tax gimmick. (P. 39)
- Medical malpractice reform (P. 39)
- Establish a federal healthcare spending growth cap of GDP +1%. (P. 41)

**Social Security:**
- Gradual move to a more progressive benefit formula that slows future benefit growth. (P. 49)
- Gradual increase in retirement age, indexed to increases in life expectancy. (P. 50)

Stock Market
Barely-believed bull – S&P 500 TR index is up +18% YTD

Source: Standard & Poor's. Data through October 5, 2012.

1 Fed's September 13th meeting statement: the Committee decided to continue through the end of the year its program to extend the average maturity of its holdings; buy $40 billion per month of mortgage-backed bonds, open-ended commitment (QE 3).

Better (and better than expected) economic data has been piling up:

- ISM PMIs - strong
- Leading Economic Indicators (LEI) – up
- ECRI’s weekly LEI – five straight up weeks
- Citi’s economic surprise index - up
- ADP’s August new jobs > 200K
- Weekly unemployment claims – consecutive down weeks
- Housing starts – up
- Home prices – up
- Car sales - strong
- Consumer income and spending – up
- Retail sales - up
- Household net worth – up
- Bank lending – up
- S&P earnings estimates – holding up
- CPI – down
- Valuation – room for P/E multiple expansion
- IMF’s October global forecast shaved but holding up
- Copper rallied +12% from summer lows and stabilized

The stock market rally from the June bottom has not only been fueled by QE. The more significant catalyst, in my opinion, has been the accumulation of better – and better-than-expected – economic data.
Quantifying better-than-expected economic data:

The Citigroup Economic Surprise Indices are objective and quantitative measures of economic news. They are defined as weighted historical standard deviations of data surprises (actual releases vs Bloomberg survey median). A positive reading of the Economic Surprise Index suggests that economic releases have on balance beating consensus. The indices are calculated daily in a rolling three-month window. The weights of economic indicators are derived from relative high-frequency spot FX impacts of 1 standard deviation data surprises. The indices also employ a time decay function to replicate the limited memory of markets. -- Bloomberg

Source: Citigroup. Data through October 4, 2012
Stock Market
S&P 500 — earnings estimates holding up

2012 and 2013 estimates have held steady despite all of the recent talk of weaker earnings.

Sources: Yardeni Research, Inc. and Thomson Financial survey of consensus estimates.
Stock Market
S&P 500 — revenues estimates up

2012 and 2013 revenue estimates have turned up.

Sources: Yardeni Research, Inc. and Thomson Financial survey of consensus estimates.


See how grossly distorted valuations became in the bubble run from 1993 to 2000 – the gap between the S&P Index (black line) and earnings (red line).
Europe’s leading economic indicators

“In August, the LEI for the Euro Area rose for the first time in six months, fueled by good stock market performance and improved business confidence. However, it seems too early to interpret this as a sign of stabilization, let alone as a sign of a sustainable recovery. ... Production-related indicators remained in contraction territory and consumer confidence declined on rising unemployment fears. If European decision makers can maintain the momentum towards greater financial and fiscal stabilization, then these first signs of better business confidence may help to support somewhat stronger economic conditions later in the year or early 2013.”
Economic Data

China’s leading economic indicators

“The improvement in the China LEI in August raises expectations for a moderate rebound in growth, even as current economic conditions remain subdued. The LEI’s largest increase in seven months was primarily due to a rebound in real estate activity, with strong credit growth and an improvement in consumer expectations also adding to the uptick.”

The six components of The Conference Board Leading Economic Index® for China:

Source: ©The Conference Board, Data through August 2012.
Economic Data

World GDP growth forecasts

Economic Data
Private jobs rising, government jobs still contracting

With the fiscal crisis, net government job formation has been a damper on total new job formation.

Government sector job formation is unlikely to pick up much given budget constraints.

The recovery in private sector new job formation has been sluggish but not too atypical.

Economic Data

ADP jobs survey – private jobs recovery looks pretty normal

ADP private sector jobs reports showing higher lows, higher highs.

Note the last two summer slumps.

Non-manufacturing comprises the vast majority of the U.S. economy.

Economic Data

Vehicle sales recovering – pent-up demand

September’s 14.9 million annual run rate was above estimates and set a new recovery high water mark.

Economic Data

Housing starts recovering

Sources: U.S. Census Bureau, data through July 2012; Mortgage Bankers Association's housing starts forecast dated August 20, 2012.
Economic Data

Housing starts: the big picture – very positive

Basic housing arithmetic: the U.S. adds about 3 million bodies per year ... we need to build about 1.5 million new units per year. New home construction will substantially recover.

Historically these two categories have contributed >12% of GDP. Today, they are ~10%.

There is good reason to think both will continue to recover, providing a lift to GDP in the quarters ahead.

Sources: Bureau of Economic Analysis. Data through June 2012.
Economic Data

Household debt

The stock of household debt is high by historic comparison. This is often taken to mean that Americans are struggling under an unsupportable debt load.

Because DPI has steadily increased and interest rates are far lower than in previous decades, in fact, Americans are in the best shape with respect to servicing their household debt than they’ve been in a long time. See next slide.

Comparing consumers’ monthly flow of income to their fixed recurring monthly expenses, including debt service, gives a more accurate measure of consumers’ financial health.

Here’s the shocker: consumers’ ability to cover the monthly “nut” has seldom been better as incomes have recovered, household debt has been reduced and interest rates remain low.

The financial obligations ratio consists of estimated required payments on outstanding mortgage and consumer debt plus automobile lease payments, rental payments on tenant-occupied property, homeowners’ insurance and property tax payments divided by disposable personal income.
Economic Data

Retail sales – pause in powerful recovery from 2008-09 recession

The recovery in retail sales was at odds with the widely accepted new normal hypothesis that consumer spending would be substantially constrained.

2012 summer soft patch followed by reacceleration.

Source: U.S. Census Bureau; data through August 2012.
Economic Data

Personal income and spending by quintile

Because income and spending are skewed to the upper brackets, the recovery in spending growth is significantly a function of spending behavior in the higher brackets.

The top two income quintiles account for 62% of total spending; the bottom two account for 21%.

The Conference Board Leading Economic Index® (LEI) components: 1) average weekly hours worked, manufacturing; 2) average weekly initial unemployment claims; 3) manufacturers’ new orders – consumer goods and materials; 4) ISM index of new orders; 5) manufacturers’ new orders, nondefense capital goods; 6) building permits – new private housing units; 7) stock prices, S&P 500; 8) Leading Credit Index™; 9) interest rate spread; 10-year Treasury less fed funds; 10) index of consumer expectations.

“The economy continues to be buffeted by strong headwinds domestically and internationally. As a result, the pace of growth is unlikely to change much in the coming months.”

The Conference Board
September 20, 2012

The Conference Board Leading Economic Index® (LEI) components: 1) average weekly hours worked, manufacturing; 2) average weekly initial unemployment claims; 3) manufacturers’ new orders – consumer goods and materials; 4) ISM index of new orders; 5) manufacturers’ new orders, nondefense capital goods; 6) building permits – new private housing units; 7) stock prices, S&P 500; 8) Leading Credit Index™; 9) interest rate spread; 10-year Treasury less fed funds; 10) index of consumer expectations.

Economists see higher growth in the quarters immediately ahead.
Oil and Gas Boom Lifts U.S. Economy

- The economic benefits of rising energy production are spreading far beyond the traditional oil patch ...
- Manufacturing plants are returning to the U.S. to take advantage of cheap natural gas, spurring major investments in petrochemical and steel production in the Gulf Coast and Midwest.
- “We think lower natural gas prices are creating a structural economic advantage for the U.S. ... it’s a new competitive strength for U.S. manufacturers ... Asian companies paying up to six times what their competitors are paying in Texas and Louisiana.”
- Consumers throughout the U.S. are paying lower bills for heating and electricity because of cheap natural gas.
- Augusta ME consumers to switch to low-cost gas from high-cost home heating oil, keep local paper mills going.
- The U.S. balance of payments is improving because of the new energy economy.
- For every new job working in the oil and gas sector, another four are supported by the energy supply chain and by workers spending more money on goods and services (one economist’s estimate).
- Consumer psychology: “People believe this is a game changer for the region”, resulting in more spending on dining out and entertainment.

“Labour costs are growing less and less important: a $499 first-generation iPad included only about $33 of manufacturing labour, of which the final assembly in China accounted for just $8. Offshore production is increasingly moving back to rich countries not because Chinese wages are rising, but because companies now want to be closer to their customers so that they can respond more quickly to changes in demand. And some products are so sophisticated that it helps to have the people who design them and the people who make them in the same place. The Boston Consulting Group reckons that in areas such as transport, computers, fabricated metals and machinery, 10-30% of the goods that America now imports from China could be made at home by 2020, boosting American output by $20 billion-55 billion a year.”
Economic Data
Manufacturing value added by country

The U.S. is still the world’s largest manufacturer.
Economic Data
Share of global manufacturing value added by country

The U.S. has done a remarkably good job of holding share of global manufacturing against China’s onslaught.
Benign Inflation Expected to Continue

“With crude oil prices expected to decline a bit from their current levels, the boost to retail food prices from the current drought in the Midwest anticipated to be only temporary and relatively small, longer-run inflation expectations remaining stable, and substantial resource slack persisting over the forecast period, the staff continued to project that inflation would be subdued through 2014.”

1 FOMC’s August 1, 2012 meeting minutes. 2 FOMC’s latest economic projections released with September 13, 2012 meeting minutes. Sources: Bureau of Labor Statistics; data through August 2012 (top chart). FRB St. Louis; data through March 2012 (bottom chart).
“You’re in luck, in a way. Now is the time to be sick — while Medicare still has some money.”
“Low interest rates disguise the federal debt bomb”

“... the federal debt has soared during the Obama years, yet net federal interest payments are lower than they were in 2007 and lower than they were in nominal dollars even in 1997 when public debt was a mere $3.8 trillion.

... CBO adds that every 100 basis-point rise in government borrowing costs over the next decade will trigger almost $1 trillion in new federal debt.”
Federal Debt Held by the Public

% of GDP

Source: Congressional Budget Office (CBO), The 2012 Long-Term Budget Outlook, June 5, 2012. ¹ CBO’s baseline revenue and spending projections reflect the assumption that current laws generally remain unchanged, implying substantial scheduled tax increases and spending cuts. The alternative fiscal scenario assumes that current policies are maintained, as opposed to current law, implying that lawmakers will extend most tax cuts and prevent the scheduled automatic spending cuts.
This slide shows the IMF's latest government debt-to-GDP ratios, actual and forecast. For now, the U.S. is better off than some. But, if we follow the AFS\(^1\) trajectory in the preceding chart the U.S. would become Portugal, then Italy.

Source: IMF, World Economic Outlook Database, April 2011. \(^1\) Alternative fiscal scenario.
Economic Data

Projected federal spending – entitlements to grow >5%/year

CBO's Baseline Federal Spending Projections
by category with compound annual growth rates in parentheses

- Defense (+0.4%)
- All other discretionary (+0.0%)
- Social Security (+5.8%)
- Medicare (+5.6%)
- Medicaid (+7.4%)
- All Other Mandatory (+2.1%)
- Interest (+9.6%)

Source: Congressional Budget Office (CBO), The Budget and Economic Outlook: Fiscal Years 2012 to 2022, January 2012. CBO’s baseline spending projections reflect the assumption that current law will not change. ¹ CBO projects compound annual growth in GDP of 4.65% over the same period.
Social Security – here’s the problem

Market Data

Bond yields: record lows

Market Data
Municipal Bonds

Municipals’ spread-to-Treasuries is attractive.

Market Data
Stocks vs. Bonds

Stocks vs. Bonds, 30 Years at a Time
Annualized returns of the Standard & Poor's 500-stock index (blue) and long Treasury bonds (green) over overlapping periods from 1927-1956 through 1982-2011

“Today, a wry comment that Wall Streeter Shelby Cullom Davis made long ago seems apt: ‘Bonds promoted as offering risk-free returns are now priced to deliver return-free risk.’”

Warren Buffett: “The bond outlook is extraordinarily bad,” says Jeremy Siegel, a Wharton School finance professor and author of the best-selling “Stocks for the Long Run.” Bonds are in vogue and overvalued, much as stocks were at the end of the 1990s, he says. After 30 favorable years of declining yields and rising prices, the best case for bonds over the next couple of decades is a return of “zero” after inflation—and more likely a negative outcome, Mr. Siegel predicts.

Bill Gross: Stocks Are Dead and Operate Like a ‘Ponzi Scheme’

By Steven Russolillo

The bond king says stocks are dead.

Bill Gross, co-founder and co-chief investment officer of Pacific Investment Management Co., says stock investors should rethink the age-old investing mantra of buying and holding stocks for the long run. He says consistent, annual returns from stocks are a thing of the past.

“The cult of equity is dying,” Mr. Gross wrote on Tuesday in his investing outlook column, a monthly note that has become a forum for his colorful, and occasionally inflammatory, market musings. “Like a once-bright-green aspen turning to subtle shades of yellow then red in the Colorado fall, investors’ impressions of stocks for the long run or any run have mellowed as well.”

Stocks, he says, operate much like a Ponzi scheme, showing returns that have no real bearing on reality.

That may not seem like such a surprise from the man who made his name, and his fortune, in the bond market—and currently runs the largest bond fund in the world.

But Pimco, a unit of Allianz SE, has recently made a big push into stocks. The firm made a splash in December 2000 with the hiring of Neil Kashkari, then a top Treasury Department official, to start its equity business. Of the $1.3 trillion Pimco has under management, only about $6 billion is in active equity assets under management.

Mr. Gross points out stocks have averaged a 6.6% annual gain on an inflation-adjusted basis since 1902. But he labels that rate of return as a “historical freak” that isn’t likely to be duplicated soon, due to slowing economic growth around the globe.

He says that return has “healed a common-sensical flaw much like that of a chain letter or yes—a Ponzi scheme.”

His point: Economic growth run at about 3.5% over that time, meaning stockholders were “skimming 3% off the top each and every year.”

“If an economy’s GDP could only provide 3.5% more goods and services per year, then how could one segment (stockholders) so consistently profit at the expense of the others (lenders, laborers and government)?” he asks.

Mr. Gross says he wonders how stocks can keep appreciating at a 6.6% annual rate with such low growth.

He says it can’t “absent a productivity miracle that resembles Apple’s wizardry.”

Reached after Mr. Gross’s missive, Mr. Kashkari said the firm is still committed to stocks. “We believe that investment returns across asset classes are going to be lower in the future than in the past, but we think equities still have a very important role to play in clients’ portfolios,” he said.

Note how Bill Gross’ last big splash market call of 2002 turned out.

Stock Market Arithmetic
Total Return = 7% earnings-driven price + 3% dividends reinvested

If the cult of equity is dying among average investors, it’s probably because stocks have seemingly gone nowhere since 2000. That happened because market valuation got so overheated during the preceding bubble run from 1993 to 2000.

Market valuations having now spent over a decade coming back into line with underlying fundamentals, it seems to me that now is precisely not the time to declare the death of equities.

Source: Standard and Poor’s. Data through June 2012.
What drives stock prices? Corporate profits.
Nominal GDP and profits growth have followed a 7% long-term growth path.

Higher inflation that peaked in 1980 drove higher nominal GDP growth.

1 Nominal GDP.
2 Corporate profits after tax with inventory valuation and capital consumption adjustments.
Conclusions

Economic data:
- Economists see continued economic expansion despite Europe.
- Slow but steady progress on new job formation.
- Consumers’ savings and liquidity have risen substantially.
- The “negative wealth effect” may be overestimated.
- Significant skew in income, spending is relevant to economic recovery. Retail sales have come roaring back.
- The U.S. economy is positioned to continue its +2½% to +3% long-term trend rate of growth.
- Positive changes in manufacturing.
- Inflation is subdued and will probably remain so for at least a few years. Commodity inflation is transitory.
- The CBO projects massive budget deficits.

Market data:
- ECB’s bank bailout proposals have been catalysts for stocks; but Europe’s challenge is to build a stronger fiscal union.
- Better, and better-than expected, U.S. economic news has been a catalyst for stocks.
- Stocks are still attractively valued on estimated earnings.
- Total return on bonds cannot continue recent years’ returns.
- Municipal bonds are attractive.

“It’s just a correction. The fundamentals are still good.”
“Winning is crucial to my retirement plans.”
Saving and Investing for Retirement

*Saving* is key – the powerful arithmetic of compounding

A simple concept, maybe, but your children and grandchildren need to understand and appreciate the power of compounding.

If a 25 year-old managed to put away $10,000 in each of his first five working years - $50,000 total - he’d have over $600,000 by age 65.

More than 10 times the original amount saved!
### Investment Strategy

**Wall Street’s Call for 2012 – Should you take heed?**

**Barron’s 2012 Forecast**
Survey of 10 stock market strategists’ sector picks and pans for 2012

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**1 Published Dec. 19, 2011.**

**2 Big money center financials.**

**3 Through August 13, 2012.**
### Investment Strategy

**Wall Street’s Call for 2011 – Heed Not the Talking Heads!**

**Barron’s 2011 Forecast**
Survey of 10 stock market strategists’ sector picks and pans for 2011

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**Actual 2011 Sector Returns**

<table>
<thead>
<tr>
<th>Sector</th>
<th>+4% (4)</th>
<th>+11% (2)</th>
<th>+3% (5)</th>
<th>-18% (10)</th>
<th>+10% (3)</th>
<th>-3% (8)</th>
<th>+1% (6)</th>
<th>-12% (9)</th>
<th>+1% (7)</th>
<th>+15% (1)</th>
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<tbody>
<tr>
<td>(Rank)</td>
<td>Miss</td>
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<td>Big Miss</td>
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<td>Big Mistake</td>
<td>Big Mistake</td>
<td>Big Mistake</td>
<td>Big Mistake</td>
<td>Big Miss</td>
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</tbody>
</table>

1. Published Dec. 20, 2010. 2 Oil services. 3 Railroads
4. These are S&P 500 sector returns for calendar 2011. Past performance is not a guarantee of future results. For Illustrative purposes only.
# Investment Strategy

## Wall Street’s Call for 2010 – two colossal mistakes

### Barron’s 2010 Forecast<sup>1</sup>

Survey of 12 stock market strategists’ sector picks and pans for 2010

<table>
<thead>
<tr>
<th></th>
<th>Consumer Discretionary</th>
<th>Consumer Staples</th>
<th>Energy</th>
<th>Financials</th>
<th>Health Care</th>
<th>Industrials</th>
<th>Information Technology</th>
<th>Materials</th>
<th>Telecommunication Services</th>
<th>Utilities</th>
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<td>Blackrock</td>
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<td>U.S. Trust</td>
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<td>+</td>
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<td>Morgan Stanley</td>
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<td>+</td>
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<td></td>
<td>+</td>
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<td>+</td>
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<td>Prudential</td>
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<td>Barclays</td>
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<td>+</td>
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<td>Goldman Sachs</td>
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<td>JPMorgan</td>
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<td>+</td>
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<td>+</td>
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<tr>
<td>Citigroup</td>
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<td>+</td>
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<td>-</td>
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<td>ISI Group</td>
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<td>-</td>
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<td>+</td>
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<tr>
<td>Net (+/-)</td>
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<td>-1</td>
<td>7</td>
<td>8</td>
<td>5</td>
<td>-2</td>
<td>-8</td>
</tr>
</tbody>
</table>

| Actual 2010 Sector Returns<sup>3</sup> (Rank) |  +26% (1) |  +11% (7) |  +18% (4) |  +11% (6) |  +1% (10) |  +24% (2) |  +9% (8) |  +20% (3) |  +12% (5) |  +1% (9) |
| Big miss       | Good call | Big mistake | Good call | Good call | Good call | Good call | Good call | Good call | Good call | Good call |

<sup>1</sup> Published Dec. 21, 2009. 2 Media.
<sup>2</sup> These are S&P 500 sector returns for calendar 2010. Past performance is not a guarantee of future results. For Illustrative purposes only.
Investment Strategy
Wall Street’s trading mentality

David Swensen, PhD, Yale’s chief investment officer:

Y: I was hoping you’d mention Cramer. In the new edition of *Pioneering Portfolio Management*, you write: “Educated at Harvard College and Harvard Law School, Cramer squanders his extraordinary credentials and shamelessly promotes stunningly inappropriate investment advice to an all-too-gullible audience.”

S: Jim Cramer exemplifies everything that’s wrong with the advice—and I put advice in quotation marks—that is given to individual investors. Investing is a serious business. We’re talking about retirement security of American citizens, and he turns it into a game. It’s a game where his listeners lose. It’s ridiculous. These high-turnover, rapid trading strategies enrich the brokers. If you look at Jim Cramer’s approach on an after-fee, after-tax basis, the individual doesn’t have a chance. ... *Unconventional Success* is a book for the overwhelming number of individual and institutional investors who cannot manage a portfolio actively. Almost everybody belongs on the passive end of the continuum. A very few belong on the active end.

Y: Maybe we need new language, David. No one wants to be in the “passive” group.

S: No, they don’t. The basic problem is, it’s boring. The approach that I recommend is going to give you absolutely nothing to talk about at a cocktail party. You’re going to be in a corner by yourself, and no one will pay any attention to you. But you’ll end up with a better-funded retirement.

---

Investment Strategy
Investors’ bad behavior – Dalbar’s 2012 QAIB

Excerpt:¹

**Investor Irrationality on Display**
The following charts illustrate that investors continue to react to market movements and the news. One of the most startling and ongoing facts is that at no point in time have average investors remained invested for sufficiently long periods to derive the benefits of the investment markets. ... The result is that the alpha created by portfolio management is lost to the average investor, who generally abandons investments at inopportune times, often in response to bad news.

```
Longtime Laggards
Annualized returns on a rolling 20-year period

<table>
<thead>
<tr>
<th>Year</th>
<th>Average equity-fund investor</th>
<th>S&amp;P 500</th>
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</thead>
<tbody>
<tr>
<td>2003</td>
<td>5%</td>
<td>10%</td>
</tr>
<tr>
<td>2004</td>
<td>7%</td>
<td>12%</td>
</tr>
<tr>
<td>2005</td>
<td>9%</td>
<td>14%</td>
</tr>
<tr>
<td>2006</td>
<td>11%</td>
<td>16%</td>
</tr>
<tr>
<td>2007</td>
<td>13%</td>
<td>18%</td>
</tr>
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<td>2008</td>
<td>15%</td>
<td>20%</td>
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<tr>
<td>2009</td>
<td>17%</td>
<td>22%</td>
</tr>
<tr>
<td>2010</td>
<td>19%</td>
<td>24%</td>
</tr>
<tr>
<td>2011</td>
<td>21%</td>
<td>26%</td>
</tr>
</tbody>
</table>
```

¹©Quantitative Analysis of Investor Behavior prepared by Dalbar, Inc. April 2012 [www.dalbar.com](http://www.dalbar.com). Dalbar offers a $99 version of this study for financial advisors’ distribution to clients and/or posting on their password-protected websites.


“‘Over the years, there has been a huge gap between what [mutual-fund] investors could have done versus what they put in their pocket,’ says Louis Harvey, CEO of Boston-based investment research firm Dalbar. The reason is most investors fail to hold mutual-fund investments for long enough, and instead try to time their investments. But they tend to enter the market after it has risen, Mr. Harvey says. So they are likely buying at a higher price. They also are apt to leave the market after it has dropped, therefore selling at a lower price. The result: investments that will massively underperform against their benchmarks. The average equity-fund investor saw annual returns of only 3.49% in the 20 years through 2011, according to the latest analysis from Dalbar. Compare that with the average 7.81% annual return of the S&P 500.”
Investment Strategy

Investors’ classic capitulation – “Modern Portfolio Theory is dead”

Barron’s
“Modern Portfolio Theory Ages Badly – The death of buy-and-hold.” 2/16/09

Wall Street Journal
“Advisers Ditch ‘Buy and Hold’ For New Tactics” 4/29/09
Investment Strategy

Modern Portfolio Theory

Wall Street strategists’ dismal track record with their S&P 500 sector recommendations illustrates how extremely difficult it is to systematically add $\alpha$ with tactical asset allocation – ie. trying to guess which sectors, styles, markets (foreign vs. domestic) or asset classes (eg. stocks, bonds, commodities, gold, etc.) are going to outperform and which are going to lag. In my opinion, MPT is still the best investing mousetrap yet devised.

“Your mother called to remind you to diversify.”
Modern portfolio theory was introduced by Harry Markowitz with his paper “Portfolio Selection,” which appeared in the 1952 *Journal of Finance*.

Thirty-eight years later, he shared a Nobel Prize with Merton Miller and William Sharpe for what has become a broad theory for portfolio selection.

Asset allocation and diversification do not guarantee a profit or eliminate the risk of loss.
Source: Riskglossary.com
Investment Strategy
Asset Allocation — An Example
Let’s construct a global balanced portfolio using 7 asset classes …

Investment Strategy

Asset Allocation — An Example

Past performance is not a guarantee of future results. An investment cannot be made directly in the indexes used in this illustration.

Investment Strategy

Asset Allocation — MPT has delivered

Risk vs. Return by Asset Class
1970-2011

Compound Annual Return (%)

Standard Deviation of Annual Returns (%)
“Out of the 73 categories in our study, we recommend a bias to active management in 23 categories and a bias to passive management in 22 categories. Twenty-eight (28) categories were deemed neutral.”

73 Fund Categories Analyzed

Bank Loan, Bear Market
Commodities Broad Basket, Communications
Conservative Allocation
Consumer Discretionary, Consumer Staples
Convertible, Currency, Diversified Emerging Mkts
Diversified Pacific/Asia, Emerging Markets Bond
Equity Energy, Equity Precious Metals
Europe Stock, Financial
Foreign Large Blend, Foreign Large Growth
Foreign Large Value, Foreign Small/Mid Growth
Foreign Small/Mid Value, Global Real Estate
Health, High Yield Bond, High Yield Muni
Industrials, Inflation-Protected Bond
Intermediate Govt’ Bond
Intermediate-Term Bond, Japan Stock, Large Blend
Large Growth, Large Value, Latin America Stock
Long Government, Long-Short, Long-Term Bond
Mid-Cap Blend, Mid-Cap Growth, Mid-Cap Value
Miscellaneous Sector, Moderate Allocation Multi-sector Bond
Muni National Interim, Muni National Long
Muni National Short, Muni Single State Interm
Muni Single State Long, Muni Single State Short
Natural Resources, Pacific/Asia ex-Japan Stk, Real Estate
Retirement Income, Short Government Bond
Short-Term Bond, Small Blend, Small Growth
Small Value Target Date 2000-2010
Target Date 2011-2015; 2016-2020; 2021-2025
Target Date 2026-2030; 2031-2035; 2036-2040
Target Date 2041-2045; Target Date 2050+
Technology, Ultrashort Bond, Utilities, World Allocation, World Bond, World Stock

©FundQuest BNP Paribas Group study dated June 2010, Jane Li, author. “When Active Management Shines vs. Passive – Examining Real Alpha in 5 full market cycles over the past 30 years.”
And Don’t Believe Everything You Hear

A study by Media Research Center of a year’s worth of economic coverage on ABC, CBS and NBC found more than twice as many stories and briefs focused on negative aspects of the economy (62%) compared to good news (31%).


“We were wondering if now would be a good time to panic?”