

Often people do not plan because they see only what is, and they do not have a vision of what can be. Something is always possible. We believe that, with vision, the possibilities are almost unlimited.

The Year in Review

As Sir Isaac Newton himself observed – after losing a bundle in one of history’s stock bubbles – “I can calculate the movement of the stars but not the madness of men.” Centuries later, that’s still true. -- from Future Babble by Dan Gardner, March 2011

As I write this on December 30th, I can say that it has been a year of surprises. But why should we be surprised given that we know the future is not highly predictable, making most actual events of “the coming year” surprises? The failure of most predictions to be accurate is not a new thing.

In January, 2011 bankrate.com published its 2011 Interest Rate Forecast with the following quote “The Mortgage Banker’s Association recently hiked its prediction, and now believe 30-year fixed-rate mortgages will reach 5.5% by the end of 2011...” As of December 30th bankrate.com shows many such loans available at 3.5%.

In an October 27, 2010 article on cnnmoney.com Colin Barr wrote: “Gross, manager of the world’s biggest bond fund, writes in his monthly investment outlook newsletter released Wednesday that the 30-year-long bull market in bond prices will end next Wednesday. That’s when the Federal Reserve is expected to announce it will start another round of asset purchases known as quantitative easing.” At the time the 30-year Treasury was at 4.06%.

On May 19, 2011 reuters.com published the results of a survey that asked analysts what they thought would be the result of the Federal

Reserve ending its purchase of Treasury securities (known as QE2) that was designed to keep interest rates low to help the ailing economy. “The survey showed investors overwhelmingly thought government bonds would suffer from the Fed’s exit, with 40 of 64 respondents saying the end of quantitative easing would drive up yields on U.S. 10-year Treasury bonds.”

That same day the 10-year treasury yielded 3.17%, and on June 30th it was virtually unchanged at 3.18%. But, “surprising” the experts, on December 29th the yield had *fallen* by **39.9%** to yield just 1.91%. (source: treasury.gov).

The results for 2011 show just how surprising actual results can be. “The biggest star was the 30-year Treasury bond, with a 35% return, far outpacing even gold, another favorite safe-haven asset. The benchmark 10-year note has posted a return of 17% through Thursday.” (source: wsj.com 12/30/11). Gross was grossly inaccurate. There was no single, simple reason for the divergence between predictions and reality. It just happens that way.

This past year has been a year with incredible, event-driven changes in most asset classes. Early in the year we had the “Arab Spring” with decades-long repressive governments falling across the Arab world. Tunisia, Egypt, Morocco, and Yemen all faced internal uprisings that upended their authoritarian governments. Libyan leader Khadaffi aggressively resisted change, only

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to lose his country and his life to a NATO-backed popular resistance. These events created periodic whipsaws in global stock markets.

But the big stories of the year that drove markets up, down, and up again were the rising sovereign debt levels across the western world, with dire predictions creating significant volatility here and abroad. The lead story in the US was the inability of the Congress to agree on a heretofore non-controversial increase in the debt ceiling. The anticipation of a deadlock that would result in the first-ever default by the United States drove the S&P500 Index down over 17% from July 7th to August 8th. But, by the end of the year the index had recovered 12.6% (with a series of significant up and downs in between).

As is typical of organizations that feel obligated to predict the future, on October 24th abcnews.com reported, "The credit rating agencies have strongly suggested that further rating cuts are likely if Congress does not come up with a credible long-run plan" to cut the deficit, Merrill's North American economist, Ethan Harris, wrote in the Friday report. "**Hence, we expect at least one credit downgrade in late November or early December when the super committee crashes.**" [emphasis added]. The time has passed and the predictions, like so many others, has failed to come true. Since that prediction the S&P 500 index is up slightly and the 10-year Treasury yield is down. So much for fear of the future.

Over the coming weeks many financial periodicals will share with readers the advice of their *experts* telling us what to buy or sell, from stocks to bonds, oil to gold, and from China and Brazil to the US and Japan. Many people will follow the advice of these pundits because they appear on TV, or in print. Jim Cramer, one of the

better known financial celebrities, continues to have a successful (and entertaining) TV show, despite the fact that he has so often been wrong. On December 18, **2008** on his CNBC program he told his viewers that the Fed had done what was needed to solve the housing crisis and to go out and buy real estate and financial stocks. He recommended Bank of America, which at the time was trading at \$13.96, and at the end of 2011 was 60% below that price. But Cramer still has many rabid fans.

Why do we continually look for the person with "the answer?" I think people have been asking that question for millennia, primarily because we *want* to know. We believe there are answers, right? After all, you may ask "how can I trust an advisor who says he *doesn't know what will likely happen.*" Based on Gardner's research, perhaps the question should be "*how can I trust an advisor who maintains he knows what **will happen**, or is even very likely to happen?*"

I am not saying we should ignore the past, or the risks of various decisions. My personal opinion is that very broad diversification reduces the risk of being concentrated in any one investment. Such a portfolio will usually reduce overall volatility. It will keep both gains and losses in a tighter range, as it takes a lot to climb out of a deep hole. Even though the NASDAQ Composite is up 104% from March 13, 2009, it is *still* down 46% from its all-time high on March 10, 2000 (data as of 12/30/11). It will take another 100%+ rise from here, just to get even with 12 years ago! But over the same period, the Dow Jones Industrial Average is actually up about 19% (data as of 12/30/11), in part because it did not go down nearly as much in the 2000-2002 bear market. Owning some of each would have smoothed the results, as would having added some overseas investments, some bonds, etc.

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Greed drives people to try for home runs. Fear drives people to sit out the game. Reason says to try for singles and doubles, while really trying to avoid striking out. There is a common sense approach, but even it will have some surprises.

Losing Ground by Being "Safe"

Over the past year there has been a great deal of debate over the Federal Reserve's expansion of the money supply and its efforts to keep interest rates low by purchasing long term Treasury bonds. There are a significant number of pundits and analysts who have (for over two years) been predicting the decline of the dollar and significant increases in interest rates, along with *hyperinflation*. Well, as is often the case, that hasn't really gone as planned.

In an April 12, 2010 post on businessinsider.com, analyst Henry Blodget pointed out that Bill Gross, one of the most respected bond managers in the country was "frantically dumping treasuries." He continued:

Why is Gross dumping Treasuries?

Two primary concerns:

Inflation -- The massive tidal wave of money the US needs to raise in the coming years, which will increase the supply of Treasuries (driving prices down and rates up).

More broadly, Gross believes that, while interest rates have now generally been declining for more than 25 years, we're now moving to an era in which rates will rise, not fall.

According to the statistics available on treasury.gov, on that date the 10-year Treasury bond had a yield of 3.87%, and the 2-year note was at 1.07%. On December 20, 2011 they were

yielding 1.94% and 0.26% respectively. Inflation is nowhere near what could be called *hyperinflation*, regardless of the monetary policies of the Fed. This has created a real conundrum for those investors needing cash flow on which to live (especially retirees), as they want "safety." That generally means keeping a significant percentage of their money in FDIC-insured deposits and shorter-term treasury obligations.

On December 16, 2011 the Bureau of Labor Statistics reported that through November 30th "The Consumer Price Index over the last 12 months increased 3.4 percent before seasonal adjustment." During that period it pointed out that "food at home" went up 5.9% and gasoline was up 19.9%, while fuel oil (important to those living in the north) was up 25%. Obviously other components in the overall index were up far less, or even down, in order to have an overall inflation rate of 3.4%. In addition, based on numbers from google.com, over the past 12 months the dollar is virtually flat, within 2-3%, of the Euro, the Pound, the Swiss Franc, and the Canadian Dollar. So much for the opinions of the experts.

Based off of my calculations, to maintain a capital-preservation portfolio during a time of extremely low yields and even modest inflation creates a real problem. The inflation rate means that the purchasing power of the principal is down 3.4%. If taxes and living expenses required a withdrawal of 5%, the net *real* value of the portfolio, after the 0.26% income, would be down 8.15%! It may not be very volatile, but the continuation of negative real returns will create problems if it persists. Going out to ten-year bonds to increase current yields would be very risky, especially when interest rates rise.

There are investments that have higher yields and higher expected returns. The reality is that there are none that qualify as "capital preservation," the

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lowest risk category. Investing to attempt to get higher yields or high total returns necessitates taking on additional risks. What I want to stress is that especially with the record-low yields on treasury or bank deposits, it becomes a matter of deciding *which* risks to take, not whether or not to take any risk. It is our job as your advisor to assist you in working your way through the maze.

The Teeth of the Saw

Have you ever looked at the teeth of the saws used to cut down trees before loggers started using chain saws? They are long, sharp teeth that have pinpoint tops followed by deep, near-vertical drops, which repeat themselves over and over. So was the stock market of 2011.

Money managers call these frequent steep ups and downs “whipsaws” which often force tactical managers to lose money as they move in and out

of the markets following “technical” signaling. On a December 20th conference call, Shawn Hanlon, an experienced tactical money manager, said that the number of whipsaws of 2011 were the most in recent history. He pointed out that the S&P500 Index had 13 countercyclical (quickly turning the opposite direction) moves of 7% or more during 2011.

One such move, from July 22nd to August 8th (during the Great Debt Ceiling Debate) saw the index drop 16.8%, followed by an 8.8% rise by August 31st, only to drop 9.6% by the end of September. Those who bailed missed the recovery over the next four weeks as the index rose 16.8% by October 28th. After another sharp drop, and another sharp rise, the index stands (on December 20th) down just 1.3% for the year-to-date. (source: finance.google.com) The sharp moves have been enough to challenge the stability of even the strongest “trees in the forest.” But, like the stands of old redwood forests, patient investors remain upright.

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Unless otherwise noted, the market statistics and data used in this newsletter were obtained from finance.google.com, and interest rate information was derived from www.treasurydirect.gov.

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