

THE JENTNER REPORT

Wealth Management Strategies from Jentner Financial Group

Fall 2009



DID THAT BEAR MARKET KILL THE DIVERSIFIED PORTFOLIO?

The bear market of 2008 has raised some serious questions. Do stocks really outperform bonds in the long-term? Is asset allocation dead?

The Standard & Poor's 500 Index fell 37% in 2008, and other groups, especially foreign stocks, fell even more. The 2008 bear market and another slump early in the decade pushed stock market returns well below average. The S&P 500 index, for instance, lost an average of 0.2% per year over the past 10 years.

Meanwhile, long-term government bonds gained 8% per year in the same period, well over their historic average of 5.5% per year going back to 1926. Bonds even beat stocks over the last 20 years, gaining 8.8% per year against stocks' gain of 8.0% per year.

Diversification dead?

Some investment experts now say asset allocation is dead, because it didn't protect diversified portfolio owners from loss in 2008, when nearly every asset class except for cash and short-term Treasury securities fell in value. Does this overturn the long-accepted wisdom that you should have a portfolio diversified among different asset classes: bonds, stocks, and cash?

Don't give up yet, because even last year a well diversified portfolio, while declining, dropped less than the stock market did.

The diversified portfolio did in

fact offer some protection. According to mutual fund company Dimensional Fund Advisors, a balanced portfolio of 60% stocks, spread among large and small stocks both foreign and domestic, and 40 % various short-term bonds, lost only 24% in 2008 compared to the market's 37% loss.

Longer term, the diversified portfolio did well. DFA's sample portfolio returned 6.5% annually in the ten years through September, compared to a loss of 0.2% on the S&P 500. That return beat cash and medium-term government bonds, and was more than twice the rate of consumer inflation. (Long-term government bonds still beat the diversified portfolio by about 1% per year. See "Use interest rates," p.3.)

Yield is all you get

Those who tout the higher long-term returns of bonds over the last 20 years may not see those returns repeat over the next 20. The old saying in the bond market is that you "earn your yield" – the yield on a new bond is about all you can expect to earn during its lifetime. Twenty years ago yields were much higher. Since then, interest rates have fallen, creating capital gains for older bonds and adding to their good returns.

Since no one can predict the next year or 10 years, it is wise to maintain a mix of stocks and bonds, benefiting from either asset when it rises.

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The President's Word

DON'T BECOME PARALYZED
BY REGRET

It is bad enough that investors lost money in 2008 during a frightening world financial crisis. The sudden and swift recovery that began in March may be even worse for panicked investors who had barely a day to catch their breath between swings in the market.

Many investors who suffered through the bear and still regret not selling out before the decline are now on the sidelines wondering whether it is safe to commit new money to stocks. Meanwhile, U.S. stocks, which fell by 57% from highs in 2007 (as shown by Standard & Poor's 500 Index), have rallied by 50% since March 9.

Idle cash

The shift in sentiment has kept a lot of investor money out of the stock market: nearly \$3.5 trillion sat in money-market mutual funds at the end of September. Some media financial "experts" claim the recent rally is

merely a "head fake" and that the bear market will reassert itself in coming months. Investors regret both the losses from last year *and* having missed some or all of the 2009 rally.

The best cure for these regrets and uncertainties? Take a long-term view, acknowledge that forecasting is very imperfect, and use a balanced investment approach. Market history going back 200 years is clear: large downturns like the 2008 bear have always been followed by extended recoveries. But history also shows those recoveries are uneven: there can be declines of weeks, months, even a year or more, within those upturns, obscuring the breadth of the upturn as it is happening and only allowing it to be seen in retrospect.

Forget forecasting

Those who think that accurate forecasting is possible should look at their own track records. Did they get out of stocks at the high of October 2007? Did they buy in at the low in March?

Investing is not an all-or-nothing game. At all times a rational investor should have a balanced portfolio with some cash, bond, and stock holdings. A balanced allocation will reduce the regret over suffering losses and missing gains, and give an investor confidence to keep investing new money regularly.

Bruce A. Jentner, President
Jentner Financial Group

TO RECOVER FROM 2008,
STICK WITH THE STOCK MARKET

The stock market plunge of 2008 has workers in their forties and older wondering about retirement incomes. Retirement accounts lost an average of 32% of their value last year, according to an Urban Institute study. But a more recent study had good news: retirement savers who keep adding to their accounts and maintain appropriate exposure to the stock market should come out even, or, at worst, with minor declines in retirement income.

The Institute looked at three scenarios: the stock market does not recover from the 2008 crash but resumes long-term historical average gains; it fully rebounds over 10 years and then continues to gain at average historic levels; and it rebounds halfway.

Buying and rebalancing

To recover, workers need to keep saving at current levels, an average 8% to 9% of salary, and maintain an allocation to equities. The Institute says those who have changed their future allocation and are not buying stocks at today's lower prices will not recover, no matter what the stock market does. With new savings put into stocks, future stock market performance will determine whether workers' potential retirement incomes recover from the 2008 crash.

Those born in 1951-1955, the study found, will see an average retirement-income decline of 9.9% if the stock market does not recover, a 3.8% decline if the market partially recovers. If the market delivers above-average returns over the next 10 years, fully recovers, and then delivers average returns, the average worker in this group will end up with 2.8% more income at age 67.

New stock gains

In the latter scenario, gains on stocks bought after the crash make up for the 2008 loss in market value. However, that requires holding onto current stocks and buying more. A worker who sells his stocks before the market recovers will end up with lower income in retirement, no matter what the market does, the study found.

Workers born in 1961-1965 will experience smaller retirement income losses, even if the market does not regain ground – since they had less wealth to lose in 2008 and more years to make up losses by buying new stocks. Eighty percent of these late Boomers will see a decline of less than 2% in retirement incomes, the Institute predicted.

Stocks' potential for next decade is encouraging

Returns on U.S. stocks over the last 10 years have been next to zero. This has only happened twice before in modern market history: the 10-year period ending in 1935, and the 10 years ending in 1974. It's a traumatic change for investors who were used to the 20% plus returns of the late 1990s!

However, abnormally low decades of poor returns in the 1930s and 1970s were followed by long stretches of steadily rising returns as the stock market recovered. Each year after those decades ended, 10-year average returns on U.S. stocks steadily climbed, peaking in the 20% range about 20 years later.

Lesson: Don't give up on stocks.

The best time to invest is after a big recession

The easy money in the stock market comes in the first two to three years after a recession. During the 10 previous recessions, the U.S. stock market was up 33% (on average) one year after the economy bottomed. Within three years, the market was up an average of 59%.

Those figures were compiled by mutual fund manager Tweedy, Browne Co., based on data from the National Bureau of Economic Research and Standard & Poor's. After the recession that ended Dec. 31, 1970, the market gained 44% in the first 12 months, and 60% in two years. The biggest gains come after the biggest recessions. After the dismal recession of 1981-82, the market was up by 58% 12 months later and 83% three years later. A year after the 1973-74 recession, rivaling today's recession and recent bear market, stocks gained 38%, up 67% in two years.

Many economists speculate that today's recession has already ended, though the National Bureau of Economic Research has yet to determine the date. The S&P 500 Index in late October was up 58% from its low point on March 9.

Tweedy, Browne's managers warn that investors can't wait until the official end of a recession. "There is no starting gun signaling the beginning of the next bull market," they wrote. "It has been our experience that the low hanging fruit gets picked early and fast."

Use interest rates as
an investment guide

Like many Americans who lost faith in the stock market last year, you might be considering keeping everything in a fixed-income investment.

Good luck. Interest rates are pitiful, due to a decision by the world's central banks to keep short-term rates low in order to help the economy recover. The U.S. Federal Reserve has kept short-term rates at nearly zero for months, saying it expects to do so for the foreseeable future. The futures markets expect the influential Federal Funds rate to stay near zero until at least spring (at which time you can expect a paltry increase to 0.25%).

Banks are offering an average of 1.2% on money market accounts, 1.8% on one-year CDs and 2.2% on five-year CDs. The U.S. Treasury is paying 2.7% on its five-year securities. At a 2% interest rate, it will take you almost 20 years to recover your pre-2008 account balance. That number doesn't take inflation into account: if inflation returns to its long-term average of 3%, recovery in real dollars (assuming interest rates rise with inflation) will take even longer.

There is another option: stick with the stock market. Over the last 10 years, fixed-income investments beat stocks. When that has happened in the past, stocks ended up returning 12.6% to 13.7% over the next 25 years. At a 13.7% rate you would recover your losses of last year in about three years, and would then go on to beat inflation in subsequent years.

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STOCK MARKET NEWSLETTERS MISSED SIGNS OF THE BEAR

“We’ve long felt that the only value of stock forecasters is to make fortune tellers look good,” billionaire investor Warren Buffet has written. That largely described how stock-market newsletters fared in the fall of 2008.

The Hulbert Financial Digest, a newsletter tracking the performance of the investment newsletter industry, looked back at what newsletters were saying in September 2008, finding they did a poor job of warning readers of the looming disaster that came in October.

Editor Mark Hulbert said many of the major newsletters seemed “strangely complacent” on the eve of one of the worst-ever months for stocks.

Bullish forecasters

Hulbert notes that Jeffrey Hirsch, editor of *Almanac Investor*, said at the time that he was “ready to be a bull again.” Bob Brinker of *Brinker’s Marketimer* predicted the Standard & Poor’s 500 Index would top its previous record of 1565 in 2009 (it is now at about 1100). Mark Skousen of *Forecasts and Strategies* predicted a “Santa Claus rally” at the end of the year, while Stephen Leeb of *The Complete Investor* said the credit crisis had neared an end and the downside risk in stock prices had been reduced.

Best of the bunch

A handful of writers seemed to get it right, but their forecasts were deceiving, Hulbert said.

The Elliott Wave Financial Forecast said the market was building toward its “strongest decline of the bear market to date.” The problem with that forecast was that the newsletter had been overwhelmingly bearish for 20 years, and investors who followed its recommendations would have missed out on the big gains of the 1990s and mid 2000s.

Hulbert found two other newsletters pointing to stock declines, yet the model portfolios they published stayed heavily in stocks.

As Buffett concluded: “I continue to believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children.”



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“Financial life planning provides better wealth management by asking smarter questions, listening more carefully and applying sound financial and investment strategies to help you achieve personal and objective goals. It is not something different or new; it’s simply planning the right way.”

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