

THE JENTNER REPORT

Wealth Management Strategies from Jentner Financial Group

Winter 2010



SUCCESSFUL INVESTORS AVOID STOCK-PICKING

One of the most dangerous temptations for investors is that next big hit stock, one that supposedly will grow at super-sonic speed and far beyond the overall market's growth. The hunt for the next Microsoft has probably led to more wealth destruction than has any other investment fallacy. Consider this:

- Although the U.S. stock market has survived periodic crises and thrived over time, the majority of its stocks vanish in any 10-year period, to be replaced by new stocks.
- Successful investing is a long-term game, but buying individual stocks shortens an investor's time horizon: forcing more decisions and increasing the risk of making a bad one.
- We intuitively seek growth stories, yet the market leaders year-to-year are often the counter-intuitive "losers," the so-called value stocks.

Irresponsible investing

Much evidence exists to show that individual stock investing loses out to diversified market investing. Investors who ignore that evidence should be considered irresponsible, gambling with their own money or with their legacies for loved ones.

In the short-term, investing in a broad basket of stocks that resembles the market or investing in individual stocks may have equal chances of success or failure. In fact, buying the

"right" stock in this scenario may give the individual investor a slight advantage of beating the market.

But studies have shown that over longer periods of time the diversified market investor has a much better chance of beating the individual stock investor. Since individual stocks can have larger declines than the overall market – or may cease to exist – a certain percentage of individual stock investors are guaranteed a much worse experience than the market's.

Consider the bear market of 2008, when a diversified market investor lost 37% or more in American stocks. Yet individual stock investors who had been enjoying years of outstanding returns in some financial stocks like insurer AIG, Washington Mutual Savings Bank, or mortgage company Fannie Mae saw their investments sink nearly to zero. Investors in Lehman Brothers saw their holdings vanish.

Diversified wins out

One study by Dimensional Fund Advisors simulated returns on a concentrated stock portfolio and a diversified market portfolio over 25 years. The majority of diversified returns far outpaced the concentrated stock returns. Even the worst 5% of diversified cases saw their market portfolio nearly double – while the worst concentrated stock portfolios resulted in a 91% loss.

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The President's Word

A STOCK MARKET HISTORY LESSON: GOOD TIMES FOLLOW LEAN TIMES



So far in the 2000s investors have had a disappointing decade. A two-year+ bear market began the decade and the worst stock market decline since the Great Depression closed it. U.S. stocks, as measured by the Standard & Poor's 500 Stocks Index, have produced a negative return to investors over the past 10 years.

However, a strong rally that began in March 2009 has lifted the market well above its lowest point of the decade. Can that continue? Jeremy Siegel, a finance professor and author of "Stocks for the Long Run," says that similar historical periods indicate the stock market could do well during the next decade.

There have been only three other 10-year declines in U.S. stocks before the current downtrend, he told *The Financial Times*. Stocks posted 10-year drops in the periods ended in 1920,

1974, and 1978, he said. However, stocks posted annualized returns of 8% to 13% in the 10-year periods that followed those losing decades.

Mutual fund managers Tweedy, Browne Co. noted in their recent semi-annual report that the latest bear market in 2008 was similar to the 1973-74 bear market when U.S. stocks lost about 44%. However, the next 10 years were a terrific period for investors.

"Over the next 10 years, the S&P 500 and the MSCI World Index compounded nominally at roughly 15% and 14%, respectively, per year despite a ravaging inflation during the Carter Administration that drove interest rates to as high as 21% in 1980," they wrote.

Investors should ignore the inevitable short-term reversals to come and instead focus on the potential for healthy long-term profits. A diversified investment portfolio with stock and bond index funds has historically produced competitive returns to investors over the long term.

Bruce A. Jentner, President
Jentner Financial Group

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Regulated mutual funds avoid blowups

If the financial tumult of the last few years has proved anything, it is that investors are better off sticking with highly regulated mutual funds. Hedge funds, private equity deals, residential real estate – all experienced major frauds, blowups, and insolvencies over the past two years.

Although many mutual funds declined in value as the stock market fell in 2008, none went out of business due to fraud, none restricted investors from getting their money out, and the average fund recovered nicely as markets went back up in 2009.

Madoff mania vs. protecting the ordinary investor

Investors who were duped by Bernard Madoff and other Ponzi schemers did not do so well. Nor did investors who put money into unregulated hedge funds that ended up with severe losses and restricted investors' ability to get their money back.

Less well known but just as bad was Stanford Financial, an Antigua bank run by American money manager Allen Stanford, who sold phony "certificates of deposit" worth \$8.5 billion to over 30,000 clients. And, still of concern is money placed with Akron-based Fair Finance Co., currently under an investigation.

Even investors in legitimate investment pools like hedge funds suffered severely during the financial crisis. By some estimates 117 hedge funds suffered major losses over the last three years. Or look at the failed investment bank Lehman Brothers, custodian to hundreds

MANAGEMENT, REGULATION OF MUTUAL FUNDS

of millions of dollars in hedge fund assets. Lehman used those assets to secure its own borrowing; some of the hedge funds lost their assets to Lehman's senior creditors.

Mutual funds, on the other hand, have been tightly regulated ever since Congress passed the Investment Company Act of 1940. Congress recognized that ordinary people would be the principal investors in mutual funds and took steps to protect their interests. Mutual funds must be registered with the Securities and Exchange Commission, must make extensive disclosures, submit financial statements audited by outside, independent accountants, and segregate client assets with regulated and qualified custodians.

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Look for funds with big manager stakes

Mutual fund investors may want to restrict their purchases to funds whose managers eat their own cooking, says a new report by Morningstar, Inc. Looking at levels of fund ownership by fund managers, the mutual fund analysis service found that those who put more than \$1 million of their own

money into their funds outperformed their peers.

"The best managers that we've followed and respect a lot tout the fact that they're investing alongside investors," Karen Dolan, director of fund analysis for Morningstar, recently told *Investment News*.

She found that managers with a million or more in their own funds ranked on average in the 42nd performance percentile over the five years ended in July, beating 58% of peer funds.

Yet slightly more than half of mutual fund managers invest nothing at all in their own mutual funds. Morningstar found that only 413 funds out of 4,383 had more than \$1 million in investments by their managers. Another 876 funds had manager stakes of between \$100,000 and \$999,999, the study found. Some funds have begun paying bonuses in fund shares to avoid bad publicity.

Morningstar is not yet sure whether or how ownership levels affect fund performance, but Dolan thinks further study will show there is a relationship. Although there are cases where managers have legitimate reasons for not investing in their own funds, in most cases there is no reason why they can't.

Younger managers who have not built up significant wealth may not have \$1 million to invest, but they should at least have something in the game, Dolan said. "How you define that could vary, but it's something more than zero," she said.

Did the last decade invalidate a buy and hold strategy?

Do two major bear markets in 10 years, and the recent whipsaw when stocks fell sharply in 2008 and rose sharply in 2009, mean that "buy and hold" investing is dead? Some pundits say so: investors who held stock portfolios over the last 10 years made very little money, they argue. Those who sold when things turned sour and bought back in on the recovery did better, protecting their capital while enjoying some nice gains.

Yet the answer is not so simple.

"I almost have to laugh when I get a question like that," said Larry Swedroe of BAM Advisor Services. "Whenever we get some kind of crisis, all those who believe in active management come out of the woodwork with this nonsense. All that shows is that they don't know the basics of investing."

Buy and hold also prevents investors from making errors when the going gets tough, says Gus Sauter of the Vanguard Group. "A buy and hold strategy helps prevent us from acting in a knee-jerk fashion and under-performing" by making bad decisions when the market soars or falls, he said.

The Jentner Strategy

At Jentner Financial Group, we acknowledge the difficulty of predicting short term market fluctuations. Therefore investment is made in multiple asset classes of stocks and bonds. Disciplined quarterly rebalancing reviews help investors take advantage of short term market fluctuations. When an asset class is over-weighted, it is reduced to its target percentage (i.e. sold high). The proceeds are invested in an under-weighted asset class (i.e. buy low).

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POPULAR GOLD MAY NOT BE GOOD INFLATION HEDGE

Gold has been on a roll, recently hitting an all-time high of more than \$1,200 an ounce. Investor demand has been so great that the U.S. Mint stopped producing some popular coins due to supply difficulties.

But gold's record in protecting an investor's portfolio is not very good. Despite its 25% climb in 2009, an investor who bought gold at the last high (1980) earned a total of only 44% since then, while the average interest-earning checking account grew by 92%.

What's worse, gold failed to protect an investor from inflation. After adjusting for inflation, the 1980 gold buyer is still 79% below where she started, said Bloomberg.com. Meanwhile, U.S. stocks went up 22-fold: the Standard & Poor's 500 Index increased 2,182% between gold's last high in 1980 and December 2009. Even super-safe U.S. Treasury securities in that time gained 1,089% vs. gold's gain of just 44%.

Non-productive asset

Gold is a non-productive asset, costly to hold over a long period. Bonds and other interest-bearing investments pay income. Stocks pay dividends and offer capital appreciation. Neither investment has any carrying cost, while gold is costly to store and protect.

Also, gold is volatile, with some violent swings over the years. From

1971, when Nixon abandoned the gold standard, through January 1980, it went from \$35 an ounce to a high of \$850. It fell in later years, hitting a low of \$252 an ounce in 1999.

Better hedges

The recent run-up in gold seems connected to the public's fear that the U.S. government's huge borrowing during the recent financial crisis could cause the currency to collapse or inflation to soar. Using gold as a hedge against a collapse of the dollar makes no sense, however. If the currency fails, into what currency would an investor trade his gold? Would he hide hundreds of pounds of gold coins under his bed? Dig a hole in the backyard?

The history of gold has shown it to be a poor inflation hedge; instead, stocks, especially of small companies, tend to do well in inflationary periods. Also recommended for diversification are broad-based holdings in commodities, including those that have use and scarcity value like oil, grains, coffee, and industrial metals.



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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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