

# SA-KG ADVISORS QUARTERLY



## How Economic Myths Distort Investment Outlook

Investors and analysts alike look to economic conditions and trends for clues to the direction of prices for stocks, commodities, and other investments. Often enough, however, what we think we can learn from the economy and what it actually tells us are two different things. Consider these widely accepted “truths” that turn out, on closer inspection, to be false.

**High unemployment is a drag on the economy and the stock market.** For people who can’t find a job, high unemployment rates are a source of pain and anguish. However, for investors the jobless rate is one of the most misleading economic factors. That’s because unemployment is a lagging indicator when it comes to economic recovery.

After the recessions of 1990-1991 and 2001-2002, unemployment remained high for 15 months and 19 months, respectively, after the economy got back on track. That means if you wait to jump back into the stock market until jobs come back, you can miss out on rising returns by two years and more.

**Manufacturing jobs pay more than service or public sector jobs.** When jobs start to come back after recessionary periods, critics often say too many are low-paying “service industry” jobs. They lament the long-term erosion of manufacturing jobs, which supposedly offer higher wages.

However, a check of payroll data at the U.S. Bureau of Labor Statistics gives the lie to this belief. Manufacturing workers rank sixth among the 10 basic categories of “private industry” workers, behind information, educational services, financial activities, “transportation and warehousing,” and “professional and business.” Bringing up the rear are workers in wholesale trade, “health care and social,” retail trade, and “leisure and hospitality.”

**Americans are tapped out.** We spent all our money in the run-up to the global economic crash, failed to save for a rainy day, and now are out of work or working fewer hours. That may be the common perception, but data from the U.S. Bureau of Economic Analysis shows that Americans’ disposable personal income and personal

spending are near record levels, while savings have rebounded. In fact, consumer liquidity (cash, checking, savings, and retail money market funds) is near a record, totaling 75% of annual personal income.

**Core inflation isn’t an accurate measure because it leaves out food and energy prices.** The government says inflation remains low, yet we all see our grocery

*(Continued on page 4)*

## Retirement Saving Takes Time And Must Be A Priority

The bad news: If you’re like most people, you haven’t made adequate plans to ensure a comfortable lifestyle throughout retirement. The good news: You may still have time to do something about it.

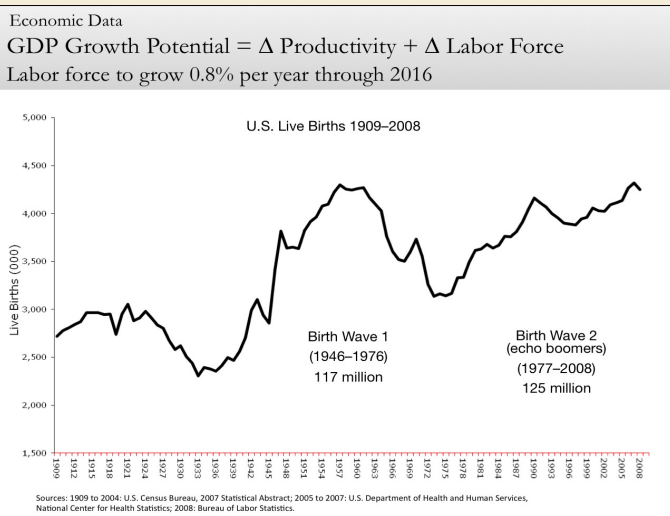
According to a new study of almost 1,500 Americans by the National Bureau of Economic Research (NBER), many people lack essential financial literacy, and for most, prospects for a secure retirement may be even dimmer than feared.

According to NBER:

- Fewer than one in 10 respondents was able to answer basic financial questions correctly.
- About 50% said they had trouble keeping up with monthly bills.
- Only about half had “rainy day” funds large enough to cover expenses for three months in case of lost income.
- Almost a third had done something resulting in an interest charge or fee for credit card charges.
- Only 42% said they have tried to figure out how much to save for retirement. Of those between the ages of 45 and 59, more than half said they hadn’t calculated how much they’ll need for retirement.
- Only 51% had a retirement account with an employer, and just 28% had another retirement account such as an IRA.

• During the past year, 9% of those with a 401(k), IRA, or another retirement account tapped the account prematurely.

The takeaway? Start now, during your working years, to get up to speed on financial matters and take steps to protect your future.



# Modern Portfolio Theory Is Alive And Well

For more than 50 years, Modern Portfolio Theory, or MPT, had been an article of faith for investors. The basic idea was that you could keep investment risk and reward in balance by choosing a diverse mix of assets. But then came the bear market of 2008 and 2009, during which nearly every kind of stock, bond, and most alternative investments plunged simultaneously. That led some analysts to pronounce Modern Portfolio Theory dead. What good is diversification, they asked, if everything sinks together?

But Modern Portfolio Theory never asserted that asset classes couldn't fall at the same time. Moreover, a look back over the past decade shows that investors who stayed diversified, continuing to rebalance during the downturn, enjoyed healthy returns. In fact, the market meltdown has proven a powerful validation of MPT.

MPT asserts that the best way to maximize returns while minimizing risk over the long term is to allocate your money among diversified classes of investments and periodically rebalance to keep the proportions in line with original targets.

MPT attempts to build a portfolio of asset types that won't necessarily move together in response to changes in the economy. The hope is that when one portion of your portfolio—say, large-cap

stocks—falls in value, another part—commodities, for instance—will rise. Rebalancing lets you “buy low and sell high,” because to keep allocations at proper levels you end up selling assets that have gained in value and buying others that have lost ground.

For long-term investors, one of the most distressing aspects of the 2008 economic crisis was the unprecedented way that nearly all asset classes—bonds, stocks, commodities—lost value at the same time. The notion that diversification ensures gains in some sectors despite losses in others seemingly lay in tatters. But diversification can't, in fact, ensure that outcome, and MPT never suggested it could. It can merely increase the likelihood of that result.

And even when, inevitably, there are times when every part of a portfolio loses value for a while, MPT has great potential value. According to economist Fritz Meyer, a global portfolio using 12 asset classes

managed according to MPT principles would have earned a compound annual growth rate of 8.4% during the volatile decade ending in 2010, compared with a 0.4% gain for a portfolio holding only stocks (represented by the Standard & Poor's 500 index).

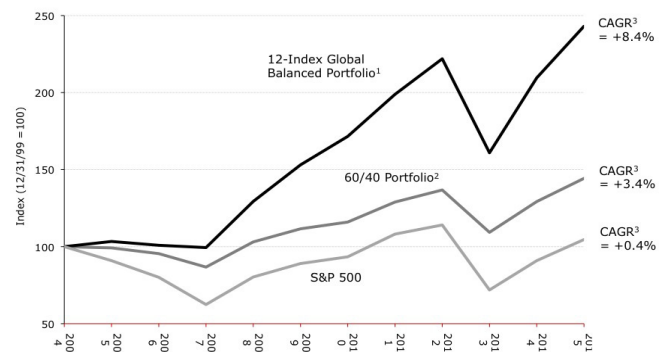
The secret is in the rebalancing, Meyer says, because disciplined rebalancing forces you to ignore macroeconomic considerations and keep emotions out of the process.

As we embark on another decade of economic and market uncertainty, we will continue to design portfolios that are properly diversified and regularly rebalanced, allowing MPT to work for you.

## Investment Strategy

### Asset Allocation — An Example

... and see how it would have performed from Dec. 31, 1999 – Dec. 31, 2010



Past performance is not a guarantee of future results. An investment cannot be made directly in an index.  
1 This hypothetical portfolio is composed of the 12 indexes referred to on the previous page, rebalanced to 1/12th of the portfolio at the end of each year.  
2 This hypothetical portfolio is composed of the S&P 500 and Barclays US Aggregate Bond indexes referred to on the previous page, rebalanced to 60%/40%, respectively, at the end of each year.  
3 Compound annual growth rate.

## Correction Creates Buying Opportunity

The stock market's midsummer swoon took investors on a harrowing ride, culminating in several days of triple-digit losses, a few days of triple-digit gains and an overall performance that, in the process, pushed the Dow Jones Industrial Average into negative territory for the year. The reasons behind the downturn were many, but largely focused on the following:

- Washington legislators lack of unity sorely worried investors. Congress and the administration argued and dithered for weeks before finding an eleventh-hour, short-term fix to the nation's deepening

long-term debt woes.

- Rating agency Standard & Poor's responded by downgrading U.S. government debt (from AAA to AA+) for the first time in history.

- And much of the economic data released in the days before the market's roller coaster ride not only reinforced the fact that the current recovery is feeble but also fed fears that a double-dip recession could be on the horizon.

While investors of all stripes endured paper losses amid the downturn, the decline gave rise to good news for those with cash in reserve and a long-term investment horizon of five years or more. Stocks, as represented

by the Standard & Poor's 500 index, are now selling at levels not seen since the market meltdown in the autumn of 2008. What's more, dividend yields on the shares of many high-quality, well-established corporations now compare favorably to the scant yields on 10-year Treasury securities.

Whether you are investing for retirement or a child's college education, or you would simply like to build wealth for an undetermined long-term goal, market downturns of this magnitude create investment opportunities to purchase stock at prices that are typically available only once every few years, though past

# Giving Up Luxuries For Peace Of Mind

**M**ichael and Susan Walker thought they had it made in the shade. After years of ups and downs, Michael's business had finally turned the corner and he was able to give himself annual compensation of \$250,000. After staying at home raising their two kids, Susan had reentered the workforce and had worked her way up to making \$100,000 a year. The couple had managed to pay off their home mortgage and to fund their children's college costs without taking any drastic measures. It looked like a worry-free retirement was in the cards.

But that was before the stock market went into free-fall at the end of 2008. The stocks and other retirement plan assets that the Walkers were counting on to help pay for luxuries when they retired—a seaside cottage, a new top-of-the-line Mercedes, and lavish weddings for their children—lost about a third of their value. The recession hit Michael's business, too, forcing him to cut back his salary to \$200,000. Now, with Michael at age 60 and Susan 58, they are left with stocks worth \$1 million, a combined \$700,000 in their 401(k) plans, and \$500,000 in Michael's IRA. Their home, which had been worth \$900,000, now would sell for \$750,000.

In this hypothetical example, analyzed with a professional software package, it turns out that the Walkers

will do well to live comfortably during retirement, let alone be able to afford all of those nice extras they'd been anticipating. By giving up the second home and the fancy new car, they can increase their probability of success to 82%, based on the software package. But they'll likely have to watch what they spend, and another downturn could leave them in perilous circumstances.

In today's post-recession world, there are millions of people forced to come to grips with new financial realities. Yet there are still ways to improve the odds of success and reduce anxiety over what's ahead. If your situation is similar to the Walkers, here are several ways to improve your future outlook.

**Tighten the monthly budget.** Take a long, hard look at how you're spending your money. Do you really need to dine out at pricey restaurants each week or keep season tickets for the local sports teams? By making a few sacrifices now that won't dramatically alter your lifestyle, you may be able to preserve more cash for the future. Furthermore, whatever you save can be invested, generating even more income. This reduction in standard of living has the most dramatic impact on your retirement because you get used to spending less which continues for your 20-30 years in retirement.

**Ramp up retirement plan contributions.** In our example, both Walkers were deferring just 5% of their salaries to their retirement plans. But that's considerably less than the maximum they could give to their tax-deferred accounts. The current ceiling for annual 401(k) contributions is \$16,500—or \$22,000 for those, like the Walkers, who are over age 50. In addition, as a business owner, Michael could consider switching the company to another kind of retirement plan that permits much larger tax-deductible contributions.

**Postpone retirement.** In this example, Michael and Susan will both retire at age 66, the normal age at which they can collect full Social Security benefits. Yet if each one delays retirement by a single year, together they'll earn an additional \$300,000 from their jobs, or more if Michael's business rebounds. That will also knock a year off the length of their retirement, and if they delay taking Social Security, they'll be able to draw larger monthly amounts. Putting off retirement longer would help that much more.

**Get off the sidelines.** The recent bear market hurt the Walkers, and after most of the damage had been done, they moved all of their 401(k) assets out of stock mutual funds and into cash. But that means they'll have trouble keeping up with inflation and gives them no chance to make up lost ground. Over extended periods, stocks have outperformed other assets, and with a few years left until retirement—and perhaps decades of life after they stop working—they need to consider moving part of their money back into equities.

How much or little you'll need to adjust your post-recession retirement savings depends in part on how long you have until you leave the work force. The closer you are to your retirement date, the more you may have to skimp now in order to be comfortable later. If you'd like us to review your plan and see what changes may be needed, please call our office for an appointment. ●

performance is no guarantee of future success.

Indeed, there's no near-term guarantee that the summer market troubles won't continue into 2012. After all, Washington politicians have yet to find a solution to the damaging debt crisis, another downgrade of U.S. government credit by S&P or another ratings

agency remains a possibility (though at this juncture seems unlikely), and few seasoned market observers believe the country's economic troubles will

reverse course soon. Unemployment remains very high and consumer confidence is shaky.



The best advice now may be to revisit your investing plan and overall strategy to identify opportunities that have emerged that could help you achieve your long-range objectives. If the market downturn has been unsettling for you—as it has

been for almost everyone—we could also revisit the risk exposure in your portfolio to ensure that it fits your personal comfort level. ●

## Myths Distort Outlook

*(Continued from page 1)*

and gasoline bills rising. Because the government's "core inflation" measure leaves aside food and energy prices (because they are volatile), critics consider the core inflation rate a bogus indicator.

But food and energy together make up just 13% of total personal expenditures, trailing housing/utilities and health care, and so not counting those outlays may still result in a relatively accurate assessment of where consumer prices are headed. Also, housing/utilities and health care costs have increased far more than food and energy costs since 1980.

**Productivity is on a long downward slide because of the aging of the U.S. work force.** The oldest baby boomers hit retirement age in 2011, and millions of

workers will leave the work force during the coming years. But there is an even larger group right behind the boomers that will more than replace them. People born between 1977 and 2008, known as "echo boomers," account for 125 million Americans and outnumber the 117 million baby boomers.

As a result, the U.S. Bureau of Labor Statistics estimates the nation's gross domestic product should grow 2.5% to 3% a year during the next 30 years. GDP drives corporate earnings, which in turn drive the stock market.

Demographic trends also favor the U.S. on the global stage. The only country expected to see higher growth rates in the population aged 15 to 64 between now and 2050 is India, according to United Nations projections.

**Social Security will bankrupt the**

**nation as the baby boomers age.** The specter of bankruptcy hovering over the nation's Social Security system is exaggerated, according to Congressional Budget Office projections. The CBO forecasts that Social Security spending will actually decrease as a percentage of GDP during the next seven decades, because the "echo boomers" will be paying into the system.

The real threats lie in rising costs for Medicare and Medicaid and a coming explosion in the cost of paying interest on the federal deficit, according to CBO projections.

So the next time you hear a piece of received wisdom concerning the economy, stop and think twice. And please call our office if you want to discuss economic trends and how they might affect your investments. ●

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