

# Market Commentary



Transformative Investing for Socially Conscious Investors

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## A Great Quarter for Stocks!

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The third quarter of 2009 was a quarter to behold—three consecutive up months and one of the best quarters for stocks in decades!

### Good News Outweighs the Bad

It began with stock mutual funds posting the strongest performance for any July in over 40 years. Investors shrugged off disappointing news on unemployment and the economy and focused instead on the positive news: most companies were exceeding second-quarter earnings expectations, durable goods orders improved, June home sales were up, and consumer confidence jumped. Momentum continued into August as the parade of positive surprises continued.

In September, the Lipper Average Diversified

Equity Fund gained nearly 5%, capping the strongest third quarter in over 30 years. The Lipper U.S. Diversified Equity Funds Average gained 61% from the early-March market bottom through September 30th.

Manufacturing has been rebounding, as indicated by the [ISM Index](#). Construction spending and personal income are up. Gains in the stock market have provided welcome relief. And, although many worry about rising healthcare costs and taxes, it does not appear that those increases are imminent. Overall, there has been a lot of good news recently.

However, the unemployment rate rose to 9.8%, the highest in 26 years. There is a concern that employers' reluctance to hire will lead to a "jobless re-

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## Quarterly Performance Benchmarks

Passive Benchmarks*	Q3-2009	Y-T-D	1 Year	3 Year†	5 Year†
S&P 500 Index	15.6	19.3	-6.9	-5.4	1.0
FTSE KLD 400 Social Index	16.2	22.6	-3.7	-4.2	1.1
DJIA (reinvested dividends)	15.8	13.5	-7.4	-9.7	1.9
S&P MidCap 400	20.0	30.1	-3.1	-1.4	4.5
Russell 2000 (Small Cap)	19.3	22.4	-9.5	-4.6	2.4
MSCI EAFE (Europe, Australasia, Far East)	19.5	29.0	3.2	-3.6	6.1
Barclays Capital Aggregate Bond	3.7	5.7	10.6	6.4	5.1
Lipper Mutual Fund Benchmarks*					
Average US Diversified Equity	16.7	25.2	-4.7	-3.2	1.8
Large Cap Growth	14.1	26.4	-2.7	-3.4	1.4
Large Cap Value	16.3	17.5	-7.9	-7.0	0.7
Mid Cap Growth	17.5	34.5	-2.7	-2.8	3.2
Mid Cap Value	21.0	29.8	-2.5	-4.2	3.0
Small Cap Core	18.6	26.1	-6.4	-4.8	2.2
International Equity	18.9	29.2	1.9	-3.7	5.8
Real Estate	32.5	20.1	-26.4	-12.6	0.4
Intermediate-term Bond	5.9	11.2	11.7	4.3	3.9

Performance data represent past performance and do not guarantee future results. Investing involves risk, including loss of principal. Passive benchmarks are unmanaged groups of stocks not directly available for investment. Lipper Mutual Fund Benchmarks are compiled by Lipper, Inc., a Reuters company. Information has been obtained from sources considered to be reliable; however, neither First Affirmative nor its agents guarantee the accuracy of the numbers reported.

\* Sources: *The Financial Times*, KLD ([www.kld.com](http://www.kld.com)), and *The Wall Street Journal*.

† The 3-Year and 5-Year returns are average annual returns for that benchmark.

covery.” And lenders, wary of potential losses in both residential and commercial real estate, are still holding on tightly to their government bailout money.

Despite improving economic indicators and the rally in stocks, to assert that a full-blown recovery is underway, or that “things are back to normal,” would be an exaggeration. For the millions of unemployed and underemployed, retirees and those nearing retirement, ordinary citizens who approach investing as something one must do, rather than a pastime, events of the past year were unsettling, to say the least.

We now await earnings reports. Earnings quality will offer important guidance for investors and the markets in the fourth quarter. Meanwhile, trillions of dollars remain in low-yield money market funds. The rate and extent to which money flows back into stocks will have a lot to do with how long this rally lasts and how high stocks climb before the next pullback.

## A Watershed Year

As this goes to print, the S&P 500 Index (often

consider a “proxy” for the U.S. stock market) is about where it was a year ago. But, the world has changed in many ways. Millions of Americans have lost their jobs. Housing prices have fallen in most parts of the country. Consumers have reduced spending. Banks and other financial services companies have been severely tested. Bankruptcies have rocked the automobile industry. New acronyms—TARP, TALF, and PPIP, to name a few—have entered the national debate about government’s role in rescuing the economy.

Although stocks have rallied impressively from their early March 2009 lows, most investors are not celebrating. Portfolios are down substantially from two years ago, and many investors are not on track to meet their financial goals. Many will have to save more, spend less, and delay retirement.

The plunge from last September into early March was shocking in its depth and breadth. When one’s confidence is shaken to that extent, it’s not easy to move on. Fortunately, most of us have come through it in one piece—unnerved perhaps, but not ruined.

## Keep Your Bond Investing Simple

Charles Sandmel, AIF®, CFP® | Portfolio Manager

The bond markets earned robust returns in the third quarter of 2009; the BarCap (formerly Lehman) Aggregate returned 3.74% and the Municipal Bond Index returned 7.12%. Year-to-date, the BarCap Aggregate was up 5.72% and the Muni, which had lagged toward the end of 2008, was up 6.81%. As usual, the details tell a more varied story.

U.S. Treasury and Agency bonds returned 2.03%, while U.S. credit returned 7.47%, and high yield returned 14.42%. High yield correlates closely with equity returns; the S&P 500 returned 15.6% over the quarter. The stock market rally is likely to have more staying power than the high yield rally, because default risk in low-grade corporate bonds continues to rise.

Within the municipal market, third quarter returns ran highest in the longest maturity segments, but the five-year index against which portfolios managed by First Affirmative are benchmarked returned a respectable 3.74%. The reason for this differential is that issu-

ance of taxable municipals, which are not part of the index, displaced issuance of long tax-exempts.

The latest taxable municipal bonds, Build America Bonds, are an artifact of the American Reinvestment and Recovery Act; the Federal government pays a direct interest subsidy to the issuers, which approximates their additional cost to service taxable debt. Since first appearing in April, nearly \$20 billion have been issued, mostly with long maturities. These bonds have been well-received by buyers who are not looking for tax-free returns. As a result, the supply of long tax-exempts decreased, and their value shot up on scarcity.

Looking ahead, the depth and persistence of this recession is likely greater than we anticipated a year ago. It’s not likely that short interest rates will be going up soon; but when unemployment figures improve, you can expect the Federal Reserve to begin

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to raise rates. While intermediate/long interest rates are low in historical terms, they are so much higher than current short rates that raising short rates does not necessarily mean longer bond rates would rise in tandem.

Inflation is not an immediate threat. A sharp inflationary increase is less likely to occur over the next year or so than is an unpleasant surprise on the policy front. Even OPEC says that oil production is too high for demand. High unemployment implies little wage inflation. The current 3.30% yield on 10-year Treasuries (as of 10/01/09) implies a substantial “real” rate of return, as compared to 1.5% inflation.

The “flight to quality” of last autumn plus the stock market rebound produced two overreactions in yield spreads. After widening to credit paralysis a year ago, lower quality credits rallied such that they do not currently demand enough yield premium to justify incremental credit risk. Municipal credit quality is sensitive to the business cycle because much of the

state and local government tax base comes from income and sales taxes, but we do not anticipate major issuers going into default. The likelihood of default and loss in the municipal market is far less than in the corporate credit markets.

Short term interest rates are so low today that it seems hard to justify hoarding cash in money market funds paying almost nothing. We continue to favor high grade debt over high yield on a relative value basis, except for short maturities, where we have a reasonable chance of distinguishing weakness from imminent danger. With 10-year bonds yielding a full 3% more than cash, and 30-year bonds barely yielding 4%, the reward/risk sweet spot is inside 10 years. While rates are this low, there is great temptation to “reach for yield.” That has rarely proved a successful strategy for all but the most active traders, and it runs counter to the idea that fixed income should provide investment portfolios with capital preservation, income, and a hedge against the volatility of equities.

## Stocks for the Long-Term, and Bonds Too!

R. Kevin O’Keefe, CIMA®, AIF® | Chief Investment Officer

### Stocks vs. Bonds: Part 1

Recently, a widely-accepted precept of investing has come under scrutiny. An [article](#) published in May 2009 questioned one of the most basic tenets of investing: do stocks necessarily outperform bonds over the long term? The article asserted that for the 40-year period ending February 28, 2009, bonds outperformed stocks.

If bonds can outperform stocks over a period of 40 years, why invest in stocks at all? Why take the risk if there’s no payoff? The answer: this particular period was very rare. Over most 40 year periods, stocks have outperformed bonds, and usually by a wide margin.

But which 40-year (or 30-year, or 20-year) period will *you* get? It depends on the price of stocks at the starting point and prevailing interest rates. The lower stock prices are at the starting point, the greater advantage stocks have going forward. And, if bond yields start low, stocks have a further advantage.

Stocks are priced well below their peak of 2007 and even well below their 2000 levels. With interest rates so low, bond returns may be limited for some time to come. If and when interest rates climb higher, bond prices will be under pressure. Assuming a gradually improving global economy, stocks should have the upper hand over the next couple decades.

Does this mean that investors should rush into stocks? No. There is more to consider.

### Stocks vs. Bonds: Part 2

Although it still makes sense to own stocks for the long term, the risk of owning stocks does not go away “if you hold them long enough.” Let me explain.

The likelihood of owning stocks for 20 years and having them worth less than where you started is extremely low. Over many decades, stock prices have moved higher at a rate of about 9% to 10% per year on average—much higher than the 5% average for

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bonds. And the longer the period, the less deviation there has been from that average.

But, the most significant risk of investing in stocks is not the possibility that your rate of return might deviate from the long-term average; it is that your portfolio may decline in value at a very inopportune time. That risk is always present when you invest in stocks, no matter how long you hang on. Owning bonds can dampen the effect of sharp stock price declines.

## Time Works for You and Against You

Having a long time frame before you need to withdraw money provides more opportunity to recover from periods of loss. But, owning stocks over a long period also provides more opportunity to *experience* periods of significant loss.

And, it can be hard to recover from loss when there is not a lot of time left. Consider the fate of retirees who assumed a reasonable growth rate from 2007 stock price levels. Many are now developing a “Plan B” for their retirement income. Many may have to revise their strategies by spending less and saving more, or working longer than they had originally in-

tended. The fact that average stock returns from 1926 to the present have “only” fallen from about 10.4% to about 9.5% does not offer much consolation.

Don’t let time be your enemy. Manage the risk of nasty price declines:

- Diversify: invest in multiple asset classes, not just one;
- Reduce your allocation to riskier asset classes as your investment time horizon shortens; and
- Move incrementally from riskier asset classes to more stable ones when prices are favorable.

It is highly likely that stocks will continue to produce greater long-term returns than bonds. With interest rates so low, bond returns will be limited for some time to come. Historically, long periods of below-average stock performance, such as we have seen over the past 10 years, have been followed by long periods of above-average performance. Of course, if you aren’t in the market, you won’t catch the updraft. So, invest in stocks for the long term, but include bonds, and manage your portfolio to achieve your financial goals on time.

## Investing for the Common Good

At First Affirmative, we understand that the ways we save, spend, and invest influence the fabric and consciousness of society. We believe that, in addition to the benefits of ownership, investors bear responsibility for the impact their money has on the world.

Every investment has two effects: our money works to generate a quantifiable return and it capitalizes corporations that impact our social culture, environment, and climate. This second effect creates the future in which we, our children, and our grandchildren will live. Every investment creates these effects—whether we pay attention to them, or not.

How you invest and how your investment strategy aligns with your financial goals and your desires for the world and future generations matters.

Socially responsible or sustainable and responsible investing (SRI) has delivered comparable performance to traditional investing. The oldest SRI stock

index, the [FTSE KLD 400 Social Index](#), is approaching its 20th anniversary. There have been periods of out-performance and underperformance vs. the S&P 500, but on the whole, screening for environmental, social, and governance (ESG) factors has not negatively affected investment performance.

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