

Looking Back, Looking Ahead... What Do We See on the Stock Market Horizon?

By Johann Klaassen, PhD, AIF® | Vice President

December 31, 2009 marked the end of the fourth quarter, the year, and the first decade of the 21st century. Such a moment prompts many of us to review our recent experiences and look to the future. In this commentary, we will take a quick look backward to see what history might be able to tell us about the future.

Fourth Quarter of 2009

Continued good economic news has some econo-

mists arguing that the recession that began in December of 2007 has run its course, and that the U.S. economy is expanding again. Housing prices in most of the U.S. have stopped falling, and in some areas they have begun to rise. Inventories have stopped falling, and industrial production has turned positive. Although many remain skeptical that the economy is really getting better, consumer confidence and spending have risen, slightly.

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Quarterly Performance Benchmarks

Passive Benchmarks*	Q4-2009	Y-T-D	1 Year	3 Year†	5 Year†
S&P 500 Index	6.01	26.50	26.50	-5.64	0.40
FTSE KLD 400 Social Index	7.47	31.73	31.73	-3.85	0.73
DJIA (reinvested dividends)	8.04	22.68	22.68	-3.22	1.83
S&P MidCap 400	5.56	37.38	37.38	-1.83	3.27
Russell 2000 (Small Cap)	3.87	27.17	27.17	-6.07	3.27
MSCI EAFE (Europe, Australasia, Far East)	2.18	31.78	31.78	-6.04	3.54
Barclays Capital Aggregate Bond	0.20	5.93	5.93	6.04	4.97
Lipper Mutual Fund Benchmarks*					
Average US Diversified Equity	5.39	32.03	32.03	-4.95	0.75
Large Cap Growth	7.10	35.03	35.03	-2.69	0.89
Large Cap Value	4.55	23.09	23.09	-7.59	-0.25
Mid Cap Growth	5.80	40.40	40.40	-3.27	1.63
Mid Cap Value	5.03	37.29	37.29	-5.25	1.66
Small Cap Core	4.54	31.90	31.90	-5.66	0.65
International Equity	2.74	32.72	32.72	-6.03	3.62
Real Estate	8.92	30.34	30.34	-13.43	-0.74
Intermediate-term Bond	1.08	12.85	12.85	4.60	3.90

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), and *The Wall Street Journal*.

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

Bonds Rally, Then Rest: Defense Is the Best Offense

Charles Sandmel, CFP®, AIF® | Portfolio Manager

The bond market rally ended abruptly in the fourth quarter, with total index returns marginally up on the taxable side (+0.20%), and down slightly on the municipal side (-1.21%). Still, 2009 produced very strong returns overall (5.93% taxable, 9.80% municipal).

The rapid deceleration in the fourth quarter recognizes that the economic downturn, which had sent investors scurrying to the relative safety of bonds, had run its course, and that recovery—usually associated with higher rates/lower prices for bonds—appeared to be waiting in the wings.

Weaknesses were apparent in longer maturity bonds and U.S. government obligations. Such weakness in the U.S. government market arises from a number of sources:

- the prospect of lingering deficits which must be financed with bonds,
- a concern that the low-rate policies that pass for stimulus may end, and
- the relative attractiveness of the debt of other nations.

When long-term rates are much higher than short-term rates, it means that all interest rates are likely to rise. Weakness in bonds is often associated with (expected) stock market rallies, such as the one experienced between March and the end of 2009, as investors reallocate away from bonds to stocks.

If the expected economic recovery that has caused the stock market rally is truly imminent, reports of real progress are fairly well hidden. Although housing sales volume appears to have troughed, prices have not advanced materially, and while mortgage rates are low, credit standards remain high. Regional housing markets, especially in the South and Southwest are still in deep trouble.

Employment, which we expect to revive only after the economy picks up, is still in the dumps,

and managers are wringing productivity increases out of already overworked staff, rather than hiring new people.

At the same time, improvement in some economic sectors is more or less inevitable. Replacement of depreciated or obsolete capital goods such as computers, vehicles, and other machinery and equipment cannot be delayed indefinitely. The economic stimuli applied by government will likely bear some visible fruit in 2010. And with the leading edge of the baby boom reaching retirement age, we may see a demography-driven improvement in labor supply and demand in the years just ahead.

During the past two years, many investors fled the stock market for the safety and higher returns of bonds, or allocated significantly more of their portfolios to bonds. Looking forward, if the budding economic recovery becomes real and sustainable in 2010, it is likely that interest rates could rise from current historic lows, which would drive bond prices down. Prudence suggests that investors with overweight bond allocations should carefully review their fixed income allocations in light of this newly forming reality.

We have consistently advocated treating bond investments as defensive, and not trying to make them heroic. That means sticking with high quality, relatively simple products, not reaching for high yield by sacrificing quality or locking up funds for long periods of time. Weakness in local government finances makes our ongoing caution even more important in the municipal bond market. The economic and market conditions we see today do not encourage us to move away from this strategy.

Charles Sandmel, CFP, AIF, is a First Affirmative Investment Advisory Representative. A 30-year veteran portfolio manager and past Director of the National Federation of Municipal Analysts, Mr. Sandmel manages fixed-income separate accounts for First Affirmative clients.

But, remember the old saw, “it’s a ‘recession’ when you lose your job, but it’s a ‘depression’ when I lose mine.” Many investors have breathed a sigh of relief that their portfolios are recovering, but the official analysis of unemployment, as reported by the [Federal Bureau of Labor Statistics](#), moved to just over 10% nationally in the fourth quarter. Using broader measures, which include the “under-employed,” those who are working part-time because they cannot find full-time work, suggests that unemployment is over 17% nationwide, and much worse in some areas.

The stimulus package has not effectively reached its maximum impact. Bank credit is still very tight. Consumers have reduced spending dramatically. After all, fewer of us have an income to spend, and those of us who still have an income are saving more than we used to, just in case. This leads to a real dilemma:

- Until consumer spending rises substantially, many employers will be reluctant to hire;
- Until more Americans return to work, they are unlikely to increase their spending.

Despite these tensions, and despite a dramatic downswing in the last few days of December, the final quarter of 2009 was pretty good for the stock market. The S&P 500 (a common proxy for “the market”) rose just over 6% for the quarter.

2009 in the Rear View

A year ago, we were shaking our collective heads and wondering, “What went wrong?” The market’s results in 2008 were abysmal, and many pundits were predicting the same or worse for 2009. The first quarter of 2009 didn’t inspire any particular hope, as the S&P 500 hit its low point for the year in early March.

But three quarters of dramatic returns followed. The stock market jumped about 60% from the lows of early March through year-end, bringing the total return for the S&P 500 to a very good 26.5% for cal-

endar year 2009. Interestingly, financial institutions (banks, brokerages, and the like) led the way in the upswing of 2009, just as they had led us into the pit in 2008.

A Dreadful Decade

When the decade began, some market gurus were sure that it really was going to be “different this time.” They (and those who believed them) were at least partly right, as it certainly was different from the previous 20 years—just not quite in the way they presumed.

Hope gave way to worry early in 2000, with mar-

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Active vs. Passive: Active Wins in 2009

There has been a long-running and lively debate in the world of money management about which is the better strategy over the long run: active fund managers or passive invest strategies. In 2009, actively-managed mutual funds performed better than index funds for the second consecutive year on average.

Active managers try to pick only the very “best” stocks for their portfolios, often make frequent changes to the composition of their portfolios, and have to make many right decisions at the right time in order to out-perform their market-neutral benchmarks. Index fund managers, by contrast, generally own every stock in the index their fund is designed to track and only change the composition of the fund when the index they track changes (“passive management”).

Partisans of both active and passive management can point to similar long-term studies showing that their favorite management style is superior. The First Affirmative Investment Committee tends to believe that both have attractive features, and we generally recommend portfolios that blend active and passive management.

kets peaking in March, and worry gave way quickly to despair. At the beginning of 2000, some foresaw an entirely new economy and a perpetually roaring market, based on the promise of dramatic new computing technologies.

Instead, investors experienced a decade of market returns worse than any ten-year period other than the two that ended in 1937 and 1938. The average annual return of the S&P 500 for these last ten years has been about -1%, even when we include the impact of reinvested dividends. If we include inflation, the picture gets even worse. Adjusted for inflation, the decade that just ended is worse for the U.S. stock market than any since the 1820s, when we began keeping clear records.*

What Do the Tea Leaves Tell Us?

As human beings, our minds look for patterns and see them everywhere, even in places where there is no objective evidence of a pattern to be discerned. And, we are not particularly good at drawing conclusions from the real patterns we do manage to spot. Today, we see that the last year has been terrific, and the last ten years have been dreadful; so what should we say about the coming year, or the coming decade?

Many articles in popular business magazines in 1999 and 2000 seriously argued that earnings did not matter anymore, because the internet was revolutionizing the way the world would do business. Those who resisted this “new paradigm” were to be ignored, of course, because they “just don’t get it.”

Last January, a lot of us were reading articles that purported to show exactly how the current market trajectory (down!) was going to lead to the end of capitalism, the end of the modern nation-state, the end of contemporary society, perhaps the end of the human race itself. Those who did not believe these predictions were to be derided as

* “Investors Hope the ‘10s Beat the ‘00s,” Tom Lauricella, *Wall Street Journal*, December 20, 2009.

starry-eyed optimists who simply refused to see the writing on the wall.

Students of the market know that corrections are an inevitable part of bull markets. While there is much optimism that 2010 will be another overall good year for stocks, increased volatility is likely, along with a downdraft here and there. How much of a correction we will actually experience cannot be known. Historically, “normal” bull market corrections range from 5% to 10%.

Predictions for 2010 and Beyond?

First Affirmative’s Investment Committee tends to agree with Yogi Berra: “It’s difficult to make predictions, especially about the future.”

Just about the only prediction we are comfortable making about how the stock market will behave over the next year, or the next ten years, is that the market will go up, *and* it will go down. But, we are not willing to attempt to predict when or by how much.

However, we are confident in predicting that a broadly diversified portfolio, specially tailored to reflect a client’s personal tolerance for the sometimes wild variability of the market, along with their personal ethical values and social commitments, will be the best defense against the risks inherent in every investment.

Of course the best way to make sure that your portfolio is positioned to accurately reflect your view of the world and your place within it is to schedule a portfolio review with your First Affirmative Financial Network advisor.

Johann Klaassen, PhD, AIF, is Vice President, Managed Accounts Programs for First Affirmative and is a member of First Affirmative’s Investment Committee.

First Affirmative Financial Network, LLC
5475 Mark Dabling Boulevard, Suite 108
Colorado Springs, Colorado 80918
800.422.7284 • fax: 719.636.1943 • SEC File #801-56587
www.firstaffirmative.com
20% FSC fiber ♻️ 80% PCR fiber
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