Market Commentary

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Investing for a Sustainable Future

Let Reason Overcome Fear

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The second quarter of 2010 was not an easy time for investors. There was no shortage of unsettling financial headlines—from the Goldman Sachs fraud case, to the BP oil "spill" (what an understatement!), to the May 6th "flash crash," to the continuing worries about European debt. Many investors who were just beginning to feel confident in a slow but steady economic recovery and in a lasting stock market recovery were shocked back into a protective mode.

According to Lipper Inc., the average diversified U.S. stock fund fell 10.3% in the quarter, which left those funds down an average of 5.3% for the first half of the year. On average, losses were smaller at funds invested in small company stocks.

International stock funds delivered a double dose of pain to U.S. investors. Not only did foreign stocks fall more than U.S. stocks (on average), but the strengthening of the dollar further reduced the value of overseas shares when translated back into dollars. The average diversified international stock fund lost 13.1% in the quarter, according to Lipper, down an average of 11.7% for the first half of 2010.

Continued on Page 3

Quarterly Performance Benchmarks

Passive Benchmarks*	**Q2-2010**	**Y-T-D**	**1 Year**	**3 Year†**	**5 Year†**
S&P 500 Index	-11.5	-6.7	14.3	-9.8	-0.8
FTSE KLD 400 Social Index	-11.7	-7.3	15.8	-7.9	-0.2
DJIA (reinvested dividends)	-9.4	-5.0	18.9	-7.4	1.7
S&P MidCap 400	-9.6	-1.4	24.9	-5.9	2.2
Russell 2000 (Small Cap)	-9.9	-2.0	21.5	-8.6	0.4
MSCI EAFE (Europe, Australasia, Far East)	-14.0	-13.3	5.9	-13.4	0.9
Barclays Capital Aggregate Bond	3.5	5.3	9.5	7.6	5.5
Lipper Mutual Fund Benchmarks*					
Average US Diversified Equity	-10.3	-4.8	15.2	-9.6	-0.4
Large Cap Growth	-12.3	-8.6	11.3	-8.2	-0.5
Large Cap Value	-12.2	-7.0	12.9	-11.9	-1.9
Mid Cap Growth	-9.6	-2.5	20.7	-6.9	1.1
Mid Cap Value	-10.2	-2.8	23.5	-9.0	0.4
Small Cap Core	-9.4	-2.2	21.6	-9.0	0.4
International Equity	-13.1	-11.7	7.8	-12.8	1.3
Real Estate	-4.0	5.2	52.0	-10.0	-0.8
Intermediate-term Bond	2.9	5.4	13.0	6.1	4.6

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.

Reports of Bond Market's Demise Greatly Exaggerated

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Many were reporting the bond market's demise three months ago, including this author; but investor psychology often trumps economic fundamentals. When investors are fearful, they push up the price of investments that they view as safe—for example, U.S. Treasuries and gold. Consequently, returns for investment grade bonds during the second quarter of 2010 were very good indeed.

Perhaps the most frequently asked questions from fixed income investors are these:

1. Where can I get a decent return without unacceptable risk?
2. What will inflation do to the real value of my return?
3. What happens when interest rates rise?
4. Are states and local governments going broke?

Let's take these in order.

To Question #1: In evaluating "decent return" and "how much risk is acceptable," consider this:

- If the yield on your money market fund is 0.05%, and a one-year Treasury bill is paying 0.32%, the T-bill is producing **six times** the interest on the money fund.
- Currently a five-year bond will yield **four to five times** more than a one-year bond, both in municipals and Treasuries.
- Price risk declines as the time-to-maturity declines.

For these reasons, we assert that intermediate bonds offer a decent return for the risk.

To Question #2: In our view, inflation is not a serious near-term risk. Inflation is dormant due to slack demand. Unless…

- the business cycle roars back to the point where capacity becomes constrained, or
- until full employment pushes up wages, or
- unless the Federal Reserve deliberately overstimulates the economy

…we are not concerned about inflation. That said, there is always the risk of a commodity shock, particularly in energy sources, so inflation cannot be ruled out completely (or anticipated). And, if an inflationary surprise were to occur, longer term maturities would be more adversely affected than short-intermediate maturities.

To Question #3: Interest rates and the value of bonds move inversely. When new bonds are paying 2%, a 4% fixed-rate bond will sell at a premium to face value, and vice versa. Interest rates would rise under general expectations of inflation and/or the result of the Fed raising rates, which is probably a year or more away. The shorter the time to maturity, the less price risk there is in owning a bond. If you buy a five-year bond today, a year from now it becomes a four-year bond, and so on until the bond matures. Price risk is serious with 30-year bonds, but not so much with short and intermediate term bonds.

To Question #4: States and local governments are under fiscal pressure, to be sure. Revenues are down, and there are legal constraints that limit their options. For these reasons, we feel one must be very selective. We continue to like short/intermediate high-grade municipal bonds that finance real infrastructure for established communities.

Our clients hold bonds to generate income, stabilize the value of a diversified portfolio, and to preserve capital. While it is difficult to generate very much income with today's low interest rates, investors are well served by preserving capital. As the conservative part of an overall portfolio, bonds remain attractive today.

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Let Reason Overcome Fear

Continued from Page 1

Bond funds provided happy surprises to shareholders. The average intermediate-term investment-grade bond fund produced a total return of 2.9% for the quarter, racking up a year-to-date return of 5.4%.

Historical Perspective

The second quarter stock market decline may be unsettling but it is not unusual and should be viewed in context. After all, it arrived on the heels of a four-quarter winning streak and a trough-to-peak gain of 80% in the S&P 500 index. Such corrections are typical. Since 1927, the average correction within a bull market has been a 13.3% loss. The current decline from the April high through the end of June was about 15% for the S&P 500, slightly greater than the historical average.

Since reliable stock market records have been kept (1926), there have been dozens of comparable "15% corrections" that did NOT lead to a bear market (and several that did). We can only guess at how frightened investors who experienced these 15% corrections may have felt. Certainly, in the aftermath of the bear market that ended just a little over a year ago, coupled with the dire financial headlines and forecasts that continue, it is no surprise that many investors are fearful, and that their tolerance for risk is lower than usual.

But fear and greed are counterproductive to a sound investment strategy, so let's put emotions aside and take a rational assessment of what's going on.

Heading into the Fourth of July Weekend, the S&P 500 closed at 1,023. From a valuation perspective, at that level, the P/E (price/earnings) of the S&P 500 was approximately 10 times what companies are expected to earn over the next two years. Historically, that is very cheap. So, why would investors allow stocks to become so cheap? Because the day-to-day financial headlines are so scary.

The gap between the current earnings yield on stocks (earnings/price) and the yield on corporate bonds recently reached the highest level in decades. According to Bloomberg, the correlation between the earnings yield of stocks and Treasury bond yields posted a correlation coefficient of 0.8412 in the 60 trading days through June 16th, the highest correlation between stock prices and bond yields since 1962. The last time this correlation peaked during an economic expansion was in October 2002, after which the S&P 500 rose 34% in the ensuing 12 months.

Stock prices have also been moving in tandem with commodity prices. According to Bloomberg, the correlation coefficient between the S&P 500 Index and the Thomson Reuters/Jefferies CRB Index of 19 raw materials climbed to 0.77 in May, the highest reading in at least 54 years. If global economic worries subside, asset prices could recover sharply.

Dark economic clouds do exist, but not all the news is bad. Consider these indicators of economic recovery:

- Slower overall private sector job growth in recent months is disappointing; however, labor market income growth has not slowed down. Employers have been lengthening the workweek. As a result, labor income growth has been rising at its fastest rate in three years.
- The Institute for Supply Management's (ISM) manufacturing index expanded in June for the 11th consecutive month.
- The ISM June index of non-manufacturing businesses registered its sixth consecutive positive monthly reading.
- With financial market turmoil in the Euro-area likely to persist for some time and the still-fragile state of our recovery raising concerns about a double-dip, the Fed is not expected to raise rates any time soon—probably not until early next year at the soonest.
- The economic recovery that took place last year with the help of a huge government stimulus program is evolving into a self-sustaining, albeit mod-

Continued on Page 4

Let Reason Overcome Fear

Continued from Page 3

erate, expansion. Real GDP is on pace to reach an all-time high by the third quarter of this year.

Investment Strategy, Gurus and Fear

We don't like to be in the "prediction" business. All we can predict with certainty is that the future is and will always be uncertain. But even in that patently obvious statement, there is something of value; something worth remembering.

We are often tricked into thinking that we know what lies ahead. A recent example: After the market closed on July 2, 2010, many commentators were wringing their hands over the failure of the indexes to hold key support levels. Opinions in pundit-land were mostly aligned with the expectation of an imminent 2008-style drop in the stock market. What happened next? The stock market had the biggest weekly gain in almost a year, and which, as I write this, continues to gain momentum.

Investors understand that the market fluctuates. But sometimes—I think when we are more susceptible than usual to the emotional impact of greed or fear—sometimes we think we "know" what the near-term direction of those fluctuations will be, and this is where we get ourselves in trouble.

The fact that the market often refuses to deliver on the collective expectations of investors is well known. In fact, extreme sentiment—bullish or bearish—is a "contrarian" market indicator, meaning that when sentiment is extremely gloomy the market is actually more likely to move higher than lower, and vice-versa.

"Hindsight bias" poses yet another challenge for investors. Hindsight bias is the inclination to see events that have occurred as being more predictable than they were before they took place (Wikipedia). For investors, this refers to the tendency to look back and remember (inaccurately) that "I knew that stock was going to go up and I should have loaded up on it." Or you might say to yourself, "I knew the market was going to crash. I should have sold everything." Hindsight bias emboldens us to act the next time a similar situation appears—to buy that stock we "know" will go up, or to sell everything when we "know" the market will crash.

Of course these decisions rarely work out well. In the 30 years that I have been an investment advisor I can honestly say that the stock market has never behaved as I expected it to.

However, when we start acting on hunches, the biggest problem is not so much that our hunches won't be profitable, but that we set ourselves adrift. Once we deviate from an investment discipline, we are in trouble. The only solution is to get back on the path—to recommit to an investment discipline based on reason and which includes safeguards that prevent our emotions from interfering.

Here is one of my favorite quotes, attributed most often to Mark Twain: "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." Investors who take this message to heart will avoid making the most common and most expensive mistakes that investors make. Don't think you know more than you actually do by predicting what will happen in the stock market next month or next quarter or next year; and don't give credence to smooth-talking "experts" who exude such confidence about the future. It doesn't matter if they have won a Nobel prize, or have the best investment track record of the past 20 years. Markets do not accommodate experts.

Temper your fears and stick to an investment strategy that makes sense for you, one that allows you to sleep at night while at the same time providing the opportunity for you to achieve your financial goals.

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