

Market Commentary

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Investing for a Sustainable Future

The Upside of Uncertainty

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The Standard & Poor's 500 Index rallied 11.3% in the third quarter, nearly making up losses suffered during the second quarter. Thanks to the strongest September for stocks in generations, the Index finished the quarter just shy of where it stood six months earlier—up 3.9% for the year.

Lack of Enthusiasm, Volume

Despite the market's gains, most investors' taste for stocks turned even more sour. According to Morningstar, investors withdrew \$43 billion more from U.S. stock

funds in the third quarter than they invested, bringing total net withdrawals since the beginning of 2009 to approximately \$100 billion. Even September's impressive gains came on extremely low trading volumes.

Concerned about the pace of the economic recovery and the upcoming mid-term elections, investors sought refuge in bonds and gold. Bond mutual funds took in an estimated \$87 billion (net) in the third quarter, according to the Investment Company Institute. Since the start of 2009, a whopping \$620 billion has been invested in bond funds. Corporations have

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Quarterly Performance Benchmarks

Passive Benchmarks*	Q3-2010	Y-T-D	1 Year	3 Year†	5 Year†
S&P 500 Index	11.3	3.9	10.1	-7.2	0.6
MSCI KLD 400 Social Index	9.7	1.7	9.3	-5.5	1.0
DJIA (reinvested dividends)	13.5	10.8	17.5	-6.6	2.8
S&P MidCap 400	13.1	11.6	17.8	-1.7	3.8
Russell 2000 (Small Cap)	11.3	9.1	13.4	-4.3	1.6
MSCI EAFE (Europe, Australasia, Far East)	16.5	1.1	3.3	-9.5	2.0
Barclays Capital Aggregate Bond	2.5	7.9	8.2	7.4	6.2
Lipper Mutual Fund Benchmarks*					
Average US Diversified Equity					
Large Cap Growth	12.6	2.9	10.2	-6.1	0.9
Large Cap Value	10.3	2.3	7.0	-9.0	-0.7
Mid Cap Growth	14.1	10.4	17.1	-5.2	2.5
Mid Cap Value	11.5	8.3	13.9	-5.0	1.8
Small Cap Core	10.6	8.3	13.2	-4.6	1.3
International Equity	16.9	3.1	6.1	-9.2	2.4
Real Estate	12.9	19.1	29.8	-6.8	1.1
Intermediate-term Bond	3.2	8.8	10.0	6.6	5.5

Performance data quoted represent past performance and are not guarantees of future results. Investing involves risk, including loss of principal. Passive benchmarks are unmanaged groups of stocks and are not directly available for investment. Lipper Mutual Fund Benchmarks are compiled by Lipper, Inc., a Thomson 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 Wall Street Journal*, *The Financial Times*, and MSCI.

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

Flight to Safety in Fixed Income Continues

Charles Sandmel, CFP®, AIF® | Portfolio Manager

The U.S. economy is plodding through an anemic recovery, with politics and fear combining to extend the pain. There have been “little green shoots” of good news, such as slow but steady job creation and increases in auto production, but economic reports and forecasts are not immediately encouraging.

And that mentality is reflected in the bond market. Fear created and now prolongs the “flight to safety,” which has run up the price of gold to record highs and pushed yields on U.S. Treasury bonds to record lows.

In the third quarter, the broad BarCap bond index returned 2.48%, just behind the Treasury sector at 2.73%. The fact that the Treasury Index, with the lowest yields, beat the overall market is a strong indicator of the level of concern for safety. The U.S. High Yield Index, which is more correlated to stocks than to investment-grade bonds, returned 6.71% for the quarter. Desperate for yield, many investors have taken on enormous credit risk, even though the shaky economy is arguably very dangerous for the companies that comprise the junk bond sector.

After having been beaten down in the second quarter, municipal bonds returned 3.40% in the third quarter, despite the very real budget woes of state and local governments and cries in the political and news arenas that “the sky is falling.” Strength in municipal bonds is looking like another rush to quality—all of

the U.S. states are rated “A1” or better by Moody’s, while only 4% of non-financial corporations earn such high quality ratings. There have been no defaults on state bonds since the Great Depression, while the corporate bond default rate averages 2% annually.

Our fundamental theme is that bond investing seeks capital preservation, while stock investing seeks growth. Bonds and stocks are not designed to do what the other does.

- Cash returns are close to zero. By holding cash, we are essentially paying for the privileges of safety and liquidity. Until inflation rises from the current 1.1% (total CPI for September, 0.9% excluding food and energy), we are not going to get more return without taking more risk.
- However the markets gyrate over the short-term, bonds will generate income and may help dampen the volatility of stock-dominated portfolios due to low correlation.
- If there is a “sweet spot” in the bond market, it is characterized by high quality and moderate duration. That is where we focus our bond investments.

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embraced the opportunity presented by the combination of low interest rates and investor demand for yield by issuing near-record levels of debt.

The price of gold rose 5% during the quarter and has continued to set new records. Some investors consider gold to be a safe haven in the event of another financial market crash. And, some own gold as

protection against inflation, which is worrisome longer term, given the declining dollar, massive government budget deficits, and the potential for additional easing by the Federal Reserve.

Will the herd be right? We wouldn’t bet on it. Hatred for stocks is actually a bullish condition. Those

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who have poured their money into bonds and gold may very well look back wistfully at 2010 if it turns out to be a great year for buying stocks.

Headwinds Persist

High unemployment and low consumer confidence in the U.S., combined with record low interest rates and strong corporate profit reports are cause for confusion for even some of the most sophisticated investors. Anxiety reigns supreme, at the moment. Housing remains very weak, with the supply of vacant or foreclosed houses weighing on home prices and new construction. Both consumers and businesses are reluctant to spend. Consumers are working to reduce their personal debt.

Concerns have resurfaced recently about European debt problems, particularly in Ireland and Portugal. There also are growing worries about the potential for economically destructive trade wars, especially revolving around China's restrictive currency policies.

The Case for Stocks: Near Term

With all the uncertainty and concern, why would one own stocks? For one thing, with the national jobless rate stuck near 10%, many now expect the Federal Reserve to stimulate the economy by once again injecting money into the financial markets through purchases of Treasury securities. This course of action, which the Fed refers to as "quantitative easing," led to a surge in stock, bond, and commodity prices last year. A second round may produce a new rally.

Another potential catalyst for a stock price rally is the level of cash in corporate coffers. Consumers may not have much money to spend, but according to Standard & Poor's, as of June 30 (the most recent data available), corporations do. Industrial companies in the S&P 500 had a record \$843 billion in cash on their books, up from \$773 billion a year earlier—equal to a record high 11.6% of the market value of the compa-

nies holding the cash, and nearly double the average reading from 1980 through the end of 2007.

These companies will eventually have to do something with all that cash. Companies that repurchase their shares can help support stock prices by reducing the number of shares in circulation. Announcements of stock buybacks are down from a year ago; there is room for repurchase programs to grow.

Another potential use of corporate cash is dividends. Many corporations cut dividends during and after the crisis, and dividends have only slowly begun to recover. Increasing payouts could boost stock prices for companies paying higher dividends.

One reason often given for why corporations are reluctant to reduce their cash holdings is the uncertainty around tax laws and regulations. If uncertainties are resolved after next month's mid-term elections, we could see more announcements of dividend increases and/or significant stock buybacks.

Another way for companies to utilize excess cash is to reinvest that money in their businesses by expanding or updating equipment to improve productivity. Broadly speaking, corporate balance sheets are strong, and that bodes well for investors.

The Case for Stocks: Longer Term

Stocks have been a good long-term investment. Since the start of the modern stock market era in 1926, stocks have produced an annual average inflation-adjusted return of about 6.7% (including dividends) and an annual average nominal return of 9.9%. One dollar invested in 1926 would be worth \$2,000 today. Adjusted for inflation, that dollar's purchasing power would have increased about 200 times.

But stocks have also delivered long stretches of significant below-average returns. For the ten-year period ending September 30, 2010, a period that includes two bear markets, the average annual return

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for the Russell 3000 Index, which represents the broad U.S. stock market, was a measly 0.1%. It is truly disappointing to have nothing to show for more than a decade of investing in stocks. But long, disappointing stretches have occurred before, and they have been followed by periods of reward (see right).

Why should the next decade be any better? The expectation of healthy long-term returns from stocks may be difficult to sustain during periods of economic disruption, but such an expectation might be most justified following a long stretch of underperformance.

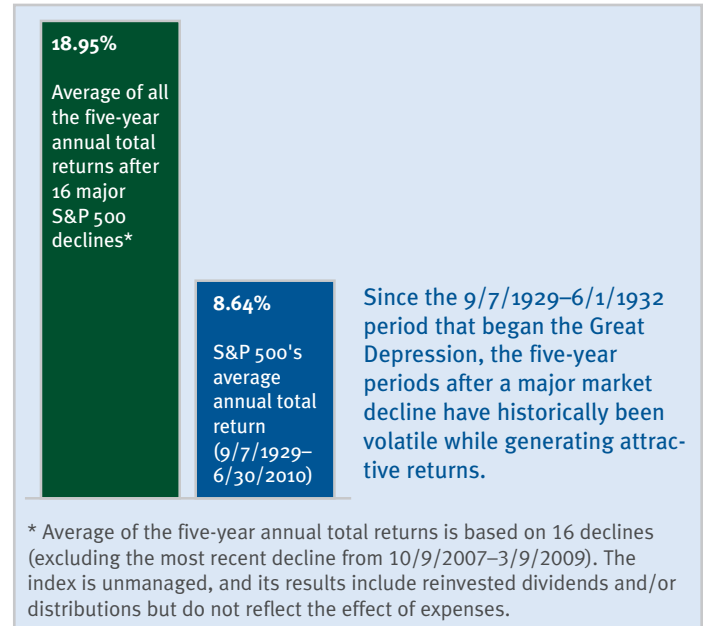
It is important to remember that stocks have been resilient over the long term because the private sector has been competitive and dynamic. To survive and prosper, companies have to take risks and embrace change. More than ever before, corporate managers understand that continuous improvement is imperative. This is why corporate dynamism and adaptability is on the rise, and why corporate cultures around the world are becoming more proactive and more responsive. Such change is good—both for companies and for their stakeholders.

Saving vs. Investing: The Upside of Uncertainty

There is a difference between investing and saving. Investing in stocks requires that one embrace uncertainty—and it is precisely because of this uncertainty that stocks have outperformed more certain investments such as bonds over the long term.

Why would anyone invest in a risky asset if the probability of reward were low? To compensate investors for enduring high volatility and uncertainty, expected returns for stocks must be higher than expected returns for safer assets. This compensation, which is known as a “risk premium,” is the excess return that investors expect from their stock holdings, as compared to investments in U.S Treasuries, or CDs, or insured savings accounts.

To increase the likelihood of realizing the risk premium, you have to stay invested even when it's uncomfortable to do so. History shows us unequivocally that investing only when it “feels safe” is not likely to produce good results.



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That's why at First Affirmative, we try to help our clients stay invested and to tolerate uncertainty. Investment discipline is the key. We continue to believe that investors should embrace the time-tested principles of investing:

1. Choosing an asset allocation strategy suited to your investment objectives and to your ability to tolerate volatility;
2. Proper diversification among asset classes, types of investments, and managers;
3. Managing investment costs; and
4. Periodic rebalancing—trimming investments that have performed well, and adding to those that have underperformed, thus “buying low, selling high.”

Kevin O'Keefe, Managing Member and Chief Investment Officer, is responsible for due diligence and monitoring of mutual funds and separate account managers.

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