financial freedom advisors

Berthann Jones, CFP® • Craig Newkirk, CFP®
P: 203-393-9508 • F: 203-393-9518
8 Whippoorwill Lane • Bethany, CT 06524
www.finfreeadvisors.com

Advocates for financial peace of mind

Portfolio Management/Investment Views

March 26, 2009

A Quick Primer

The core investment philosophy of FFA since the Crash of 1987 has been to diversify client portfolios across multiple asset classes (stocks, bonds, real estate, cash, etc.) and to diversify within each of these asset classes. After the portfolio has been designed, we buy, hold, rebalance, and replace as necessary. (A note on buy and hold: this is not the same as buy and "hope". The managers we use are constantly adjusting their portfolios. We are constantly monitoring and sometimes replacing these managers. A buy and hold strategy is still a very active strategy behind the scenes.) For roughly 21 years, this proved a prudent and successful process for our clients.

For the prior 17 months, this investment model suffered significant wounds. A typical balanced client portfolio (stocks/bonds/cash, etc.) at FFA has dropped roughly 30% over this timeframe. The Dow Jones Industrial Average has dropped 45% over the same period. All involved have been humbled by what we refer to as the Great Recession. Formerly "safe" investments dropped alongside "risky" investments. 2008 and 2009 have reaffirmed a lesson we learned years ago: a waning tide lowers all ships.

While 17 months and 30 to 50 percent drops are torturous, they are what they are. We cannot change the event; we can only control how we react to the event. In times as scary as these, taking action seems a natural thing to do. (Or inversely, acting like a deer in a headlight and freezing.) It is the specifics of the actions we wish to address.

The Advice of Market "Gurus"

The actions being advised by the talking heads of the media and the "gurus" of the finance industry, as is typical, range from bury your cash in the yard to invest 100% of your money in gold and perhaps guns. The current rage being touted is the abandonment of buy and hold investing for alternatives that are considered "safe". These include placing long-term investment assets in instruments such as CDs, money markets, and short-term bonds. These instruments currently are paying a negative yield after taxes and inflation.

Other "hot" strategies currently are investing in sectors such as gold, commodities, bets against the market (shorting), market timing (trading in and out of stocks), etc. These strategies were banished to the woodshed decades ago but have become extremely popular of late.

Investors in stock mutual funds are selling in droves. The top investment managers who FFA has entrusted millions of clients' assets with over decades are losing clients and assets in disturbing numbers. Professional investment advisors throughout the country are losing clients who believe they can manage their money better on their own. A crisis of confidence has clearly set in.

To us, these are all significant red flags. In fact, these are flashing red sirens. As we have seen so many times in our career, investors are imploding their future for the benefit of feeling better today. The assets fleeing stock mutual funds are simply a result of investors doing what they should not be doing: selling low…very low. To compound the damage, they are placing their significantly-reduced values into instruments that are paying zero and are guaranteeing losses in the future against inflation.

FFA Conclusions

Each of these strategies, and the countless ones in-between, has their pros and cons. The challenge is determining which of the strategies makes the most sense not only for the extraordinary times we are in but also for the unknown times years in the future. Given the great uncertainty of this time, we have come to the following conclusions:

1. **Our investment process, while having worked exactly as expected, requires some adjusting but does not need a total overhaul.**

    - We have been around long enough to know that you typically do not completely destruct a system that has worked for decades. We are also wise enough to understand that times do change and that these especially-historic times require alternative strategies. Therefore, we will be adding alternative investment vehicles to our portfolios, ones we believe will provide more protection on the downside with opportunities for inflation-beating growth on the upside. Further, we will be incorporating more index funds in some of the portions of the portfolio. Finally, we will be replacing some individual holdings that existing clients are currently invested in.

2. **We need to better explain our "bucket" approach to long-term investment portfolios. In these tumultuous times, we feel the simplicity of this concept makes sense to share.**

    - For portfolios whose objective is to fund retirement, we utilize a "three-bucket" approach to investing. The three buckets represent different time periods and each holds investments that are appropriate for that period.

    - The first bucket holds assets that need to be used for emergencies or for expenses in the next two years. This money needs to be in safe, liquid, low-expense cash-type instruments such as CDs, Money Markets, Savings Accounts, etc.

- ❖ The second bucket holds assets that need to be used in the three-to-five year period. This money would be invested in short-term bonds, TIPs, and perhaps cash alternatives dependent on the current interest rate and inflation levels.

- ❖ The third bucket is for assets that may need to be accessed in the greater than five year period. This money would be invested in stocks, bonds, commodities, real estate, and other alternative investments. The concern here is not volatility but long-term growth that beats inflation.

3. **Stocks are not a "dead" asset class.**

   - ❖ Contrary to popular opinion, stocks are not a thing of the past. Like all asset classes, stocks experience times of growth and contraction. We always say there are no bad asset classes, only bad <u>uses</u> of asset classes. We believe that stocks represent a smart and efficient way to participate in capitalism when used appropriately and with great research.

4. **Our government is setting us all up for a horrific day of awakening when our taxes and cost of living will skyrocket.**

   - ❖ FFA's commentaries have continuously lambasted our government for its actions (or lack of actions). We do not agree with propping up banks and auto companies; we do not agree with the flood of stimulus and tax packages; and we especially don't agree with the staggering increases of our nation's deficit. (Keep in mind, we as a nation have not even begun to address the day of reckoning in Social Security and Medicare/Medicaid.)

   - ❖ While historic times clearly call for historic measures, we believe the measures taken will harm all of us, long term. Inflation, the curse of all retirees, will surely return with a vengeance, perhaps not immediately but in due time. Our portfolios will have to adjust to this reality.

5. **Our faith in the financial system, the government, our regulators, and many of our peers has been significantly damaged and has most certainly scarred us for life.**

   - ❖ FFA prides itself on a lifelong skepticism of all things government. After spending ten years on Wall Street, that skepticism extended to all things financial. After seeing the damage our regulators and some of our peers have done to our fellow citizens, our skepticism now extends to those that are supposed to protect the public. The blatant failures of our regulators have left the average investor at a loss as to who is out there to protect them.

6. **Capitalism, as we have known it, has been suspended in many cases. However, that does not mean capitalism is dead. In fact, our faith in the capitalist system remains strong enough that we believe stocks still make sense in the appropriate situation.**

   - ❖ The morphing of our government into a quasi-socialist state has been a particularly difficult chapter of this moment in time. As pure dyed-in-the-wool capitalists, it is particularly wrenching to watch our federal government rescue whomever they deem critical to our system. Remember, the foundation of capitalism is the concept of "creative destruction"; meaning, survival of the fittest. If a company like AIG can't pay their bills, they should be put into receivership. Bailing these companies out simply delays the ultimate day of reckoning. While we can all rail against the bonuses paid at AIG, the issues are far more complex and in-depth than this topic. (For example, the bonuses that have so disturbed the public represent less than 1% of the amount we have given AIG to date.)

- Stocks, the purest form of ownership in capitalism, during normal times reflect fundamental values of the companies they represent. In these historic times, stocks simply reflect the emotion of the hour. Accordingly, volatility skyrockets and any news headline can drive results significantly positive or negative. This emotion-driven market is always there just below the surface; it is just amplified in orders of magnitude in this current time.

Some Final Thoughts

Our commitment to helping our clients achieve their financial goals has never been stronger or more personal. The doctrine of doctors, "first, do no harm", is a doctrine that FFA lives and breathes. After overseeing wealth creation for so many years, we are now witnessing global wealth declines like no other period in our collective lifetimes. We have aged due to our sadness about this situation.

Fortunately, with age comes wisdom (sometimes) and we do feel much wiser (and older) now than we did a year and a half ago. Our newfound wisdom tells us that our investment strategy must adjust for the times and in fact, has adjusted. We currently have many clients parked in cash, CDs, and money markets. Clients who were once heavily invested in stocks now have lower percentages allocated to stocks. The only clients who remain in high-stock percentage portfolios are those in their 20s and 30s who have the tolerance and time to ride this storm out.

Certainly, this Great Recession has opened all of our eyes or confirmed the futility of making predictions. The vast majority of the greatest investment and economic minds never saw the calamity of current times coming. Why should we think they know better this time?

Likewise, what makes FFA think we have any better insight than the average investor regarding where we go from here? It is a legitimate question that deserves an answer. Foremost, we have spent 25 years within the financial services arena. This experience has taught us how to filter out "noise" from reality. Further, we consume massive volumes of research in a continuous effort to improve ourselves. Finally, we have results that have consistently worked…even if those results mean we have lost less money than most others in this financial tsunami.

In closing, we will be contacting investment management clients if we believe changes need to be made within individual portfolios. In the meanwhile, please contact us with any questions or concerns.

As always, we are grateful and thankful for your trust and confidence in these historic times.

Best Regards,

Berthann & Craig