July 1, 2009 **Second Quarter 2009 Client Letter**

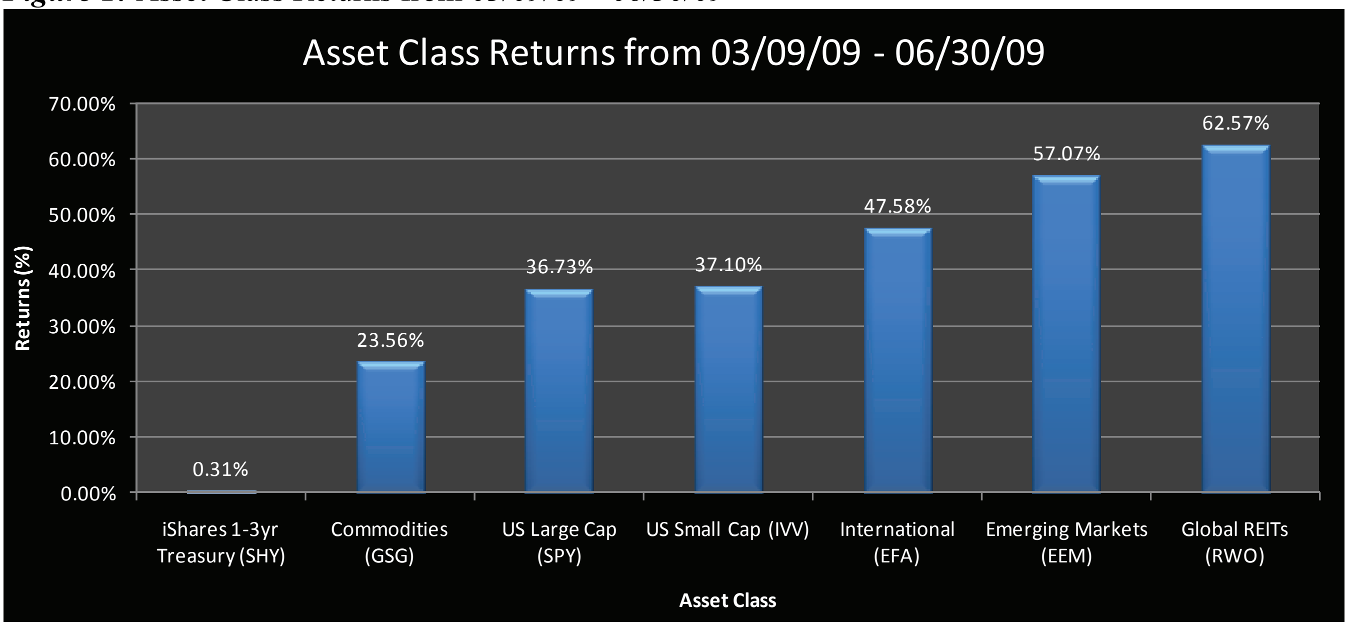
"Keys to Successful Investing"

So who still believes that markets don't work? Apparently it is only the North Koreans, the Cubans and the active managers. – Rex A. Sinquefield

Introduction

The second quarter was a pleasant divergence from the grinding decline experienced in global markets that began in October of 2007 with the financial crisis. As seen in Figure 1 global stocks rebounded significantly from the recent bottom on March 9, 2009. Global REITs and emerging markets led the way showing sizable gains from the March low point.

Figure 1: Asset Class Returns from 03/09/09 - 06/30/09



Data provided by Yahoo! Finance. Asset class returns are approximated using ETF data. ETFs used are in parentheses above.

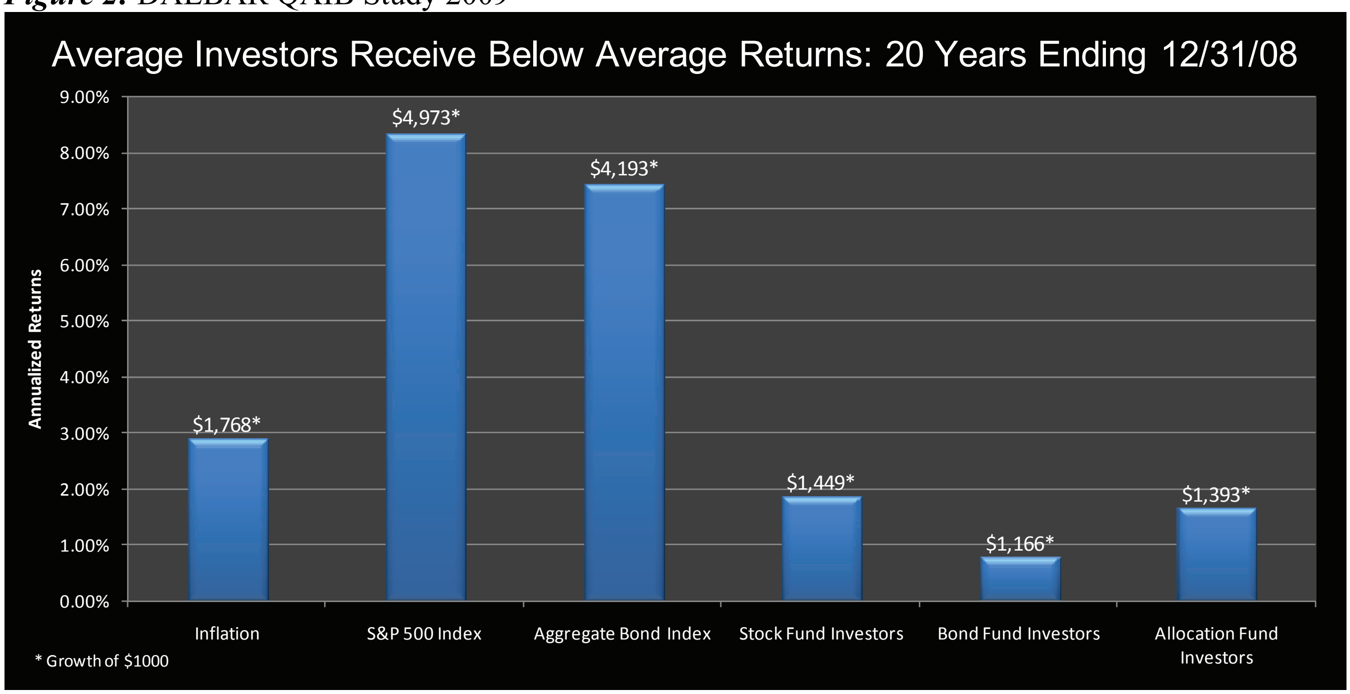
While markets finally reversed the downward trend, few are saying that we are out of the recessionary woods at this point. However, it is impossible to predict exactly how and when markets will return to pre-decline levels; in fact, we will likely be surprised when they do as we have in previous recoveries. Therefore, continued patience and discipline are required in order for smart investors to receive the inflation beating returns equity markets have historically provided. This quarter's letter is a review of three key investment concepts imperative to achieving success with your investments:

- The Foundation of Returns (investment returns stem from economic growth).
- Don't Attempt to Outsmart the Market (information is in surplus, we don't know more than the market does).
- Know Which Risks are Worth Taking [risk and return are linked, however not all risks are created equal. We will distinguish between rewarded risk (worth taking) and un-rewarded risk (not worth taking)].

The Foundation of Returns

Fundamentally we believe that capital markets build wealth through economic growth. Investors participate in this growth by supplying capital to businesses in exchange for a return on their investment. The return received should be commensurate with the risk taken by the investor. For example, stocks typically generate higher returns than bonds do because they carry greater risk. Companies compete with each other to attract investment capital and millions of individual investors compete with each other to find the most attractive returns. This competition quickly drives prices to fair value, which ensures no investor(s) can consistently expect a greater return without greater risk. Conventional portfolio managers believe that securities prices do not reflect fair value, so they speculate by searching for pricing "mistakes" in an effort to beat the market. Oddly, they assume that the endeavor of beating the market is a necessary element of investing. Additionally, they often fail to discuss the risk of underperforming the market while attempting to outperform. We find continued support for this conventional belief to be strange because of the well documented failure among professionals and individuals to capture market returns, much less beat them. The study presented in Figure 2 shows that the average investor has dramatically underperformed market indexes over the last twenty years. Approaches that rely on predicting the future and uncovering "mispriced securities" are not related to the economic reasons that investors should receive a return on their investments. Therefore, the activity of stock picking or market timing should be viewed as speculation rather than investment. Remember that returns are connected to economic growth and differing levels of risk. One way we can control the level of risk is by controlling the ratio of stocks or bonds in a portfolio.

Figure 2: DALBAR QAIB Study 2009



Data provided by DALBAR Financial Services 2009.

The market should be viewed as an ally not an adversary. Rather than pinning investment success on markets failing to work properly, we gladly take advantage of the way markets work to reward patient investors. Over the long run corporate earnings and the economy have grown at a relatively stable rate, justifying a positive return on capital by stocks and bonds. In our 2008 third quarter client letter titled *Capital Market Expectations and Valuations* we explained that stock returns primarily consist of a company's dividend yield and earnings growth. Speculation surrounding future earnings growth rates drives the extreme short term market volatility we see. The volatility of returns in the stock market and earnings growth subsides as the time period examined is extended. The investment portion of return wins out over the long run while the speculative portion tends to dominate short term results.

In order to believe that capital markets have failed or will fail in the future you also have to believe that the global economy has or will fail. The reason for staying invested in capital markets should be to connect investors to the economic engine of innovation and capitalism. Though markets are not perfect and there are challenges to overcome there are also great opportunities present. The global economic soil is more fertile now than ever before in history. Author William Bernstein, in his book, *Birth of Plenty*, illustrates how the key ingredients required to foster economic growth in the world are present today in more places than during any other time in history. He attributes this condition to the following facts: the broader existence of physical and intellectual property rights for entrepreneurs, the continued evolution of scientific methods that foster advancements, the state of modern transportation and communications and the presence of capital markets to provide the funding required to innovate.

Investors should keep the focus on the long term economic reasons that will reward them for staying the course in a globally diversified portfolio. This is a winning approach and one that will serve investors far better than conventional active approaches of security selection and market timing where success is tied to market failures.

Don't Attempt to Outsmart the Market

A belief in market efficiency lies at the core of our investment philosophy. We embrace the evidence showing that markets are hard to beat through traditional stock picking methods or market timing (timing in and out of the market). This is because the value of the market or the price of a stock at any point in time reflects all available information. In order to gain a market beating edge through stock picking or market timing an investor would need to possess information that few others have, be able to forecast the future better than others, or be able to interpret existing information better than the rest of the market. While this may seem like an ordinary everyday occurrence, the fact is, it is incredibly difficult. This is so because most major price changes are due to unforeseen events, which by definition, are unpredictable. How many analysts or economists foresaw the collapse of Enron or Washington Mutual in advance of their demise? How many of them foresaw the events of September 11, 2001 or other key turning points in the market? In the book *Fortune Sellers*, William Sherden demonstrates that market forecasters and economists have horrible track records of predicting the market and the economy. If these highly trained, educated, and hard working professionals cannot call market shifts, how would the average investor do it? After the fact, there are always a handful of people who can be shown to have predicted an event, but the research shows it's no more than would be expected by pure chance, so we cannot use their existence as justification to make adjustments to our own portfolios.

In lieu of being able to predict the market, the best approach is to accept that markets are unpredictable and will fluctuate. The successful investor acknowledges this risk as necessary in order to receive higher returns.

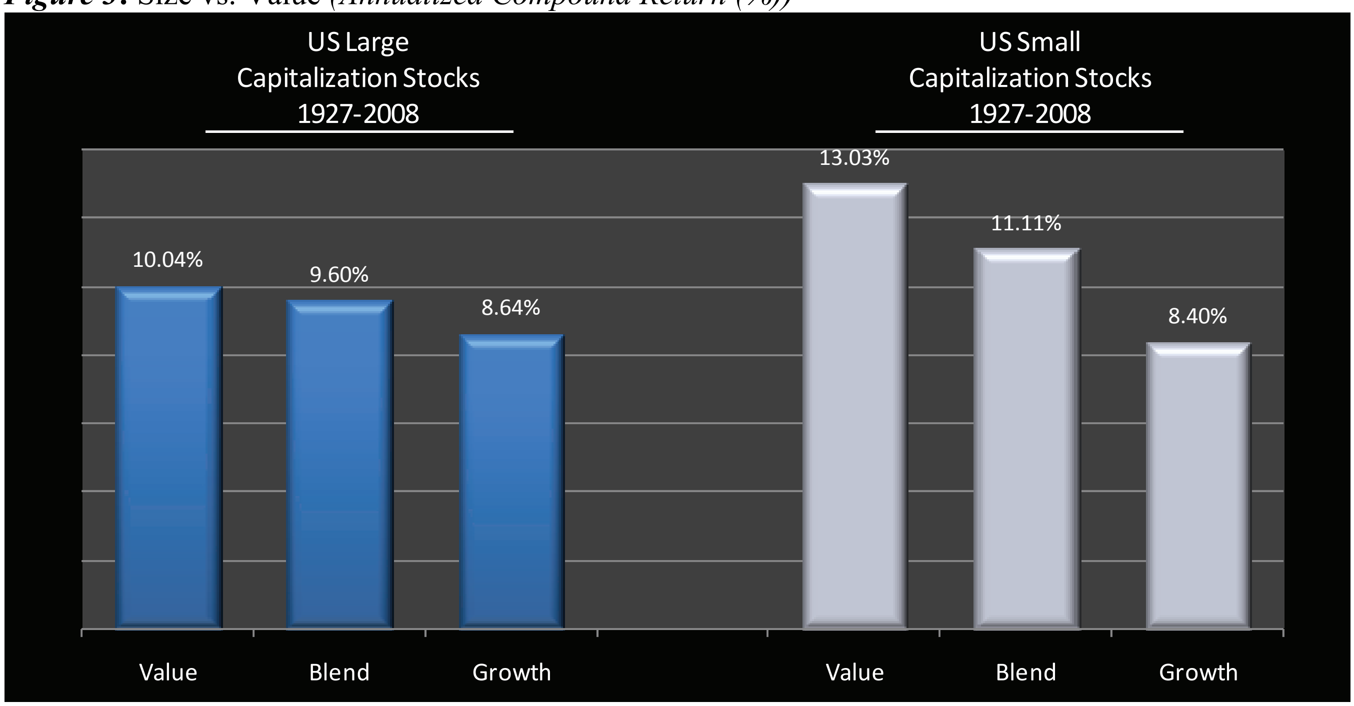
Risks Worth Taking

In the world of investing there is a name for the type of risk that describes the markets as unpredictable and volatile; systematic risk or market risk. Market risk is the risk all companies face; examples are recessions, wars, or changes in the political structure. These are risks that cannot be eliminated by diversification since they will affect *all* companies in an economy and subsequently the price of stocks. The other type of risk is non-systematic or non-market risk. Non-market risk is the type of risk that results from factors unique to an individual company, such as fraud, labor difficulties, or new technology. All of these non-market risks can make the stock's price move independently of the market.

Because it is not necessary that an investor accept non-market (i.e. company specific) risk in order to receive market returns, an investor will not be rewarded in excess of the market for bearing such risk. Thus, the only risk worth taking is market risk, since this is the only risk which fairly rewards investors. If an investor takes on non-market risk, the only thing the investor is assuring themselves of is more risk, not higher returns. This idea of systematic and non-systematic risk was developed by William Sharpe, who subsequently won a Nobel Prize for his contribution to the body of financial research commonly referred to as Modern Portfolio Theory.

Understanding the separate types of investment risk is essential in making smart investment choices. Prudent investors will expose themselves only to risks that the market can be expected to reward them for and avoid those risks that do not offer an expected return premium. Research shows that there are meaningful ways to separate market risks that allow an investor to build portfolios with different expected returns and rewarded risk levels. This research, led by two leading academics (Fama & French), shows that within the stock market the most meaningful way to divide up market risk is by size and value characteristics. For example, when constructing stock portfolios we divide the stock market into the following categories: large companies, small companies, value companies and growth companies. As shown in Figure 3, small companies and value companies have afforded greater returns to investors who were willing to accept the greater risk of experiencing larger short term losses.

***Figure 3*:** Size vs. Value *(Annualized Compound Return (%))*



Value and growth index data provided by Fama/French, ex utilities. The S&P data (US large blend) are provided by Standard & Poor's Index Services Group. CRSP data (US small blend) provided by the Center for Research in Security Prices, University of Chicago.

When the global stock market declines investors who restrict their risk exposure to market risk only hold a large advantage relative to investors taking on non-market risk. First, one hundred percent of the risk taken is rewarded risk which means it is reasonable to expect an eventual recovery in their capital. The investor who took on non-market risk has no basis to expect a recovery, especially if the few companies held disappear or are permanently diminished. Investors who reduced stock exposure and increased exposure to fixed income or cash face an equally difficult challenge. There are two groups we see here; those who make changes simply because they believe they can increase returns over the long run by getting in and out at the right times (market timers) and those who reduce equity exposure during down markets because they have become uncomfortable with the possibility of further declines. The record is clear for market timers as a group, these investors *consistently underperform* the market in the attempt to outperform. Those who find themselves unable to tolerate further declines gain peace of mind in the short term even though they too sacrifice returns over the long run. For some, the feeling of comfort may be enough to justify lower returns. However, we believe that there are many steps an investor in this category can take before completely removing themselves from the market; those steps should be discussed with their advisor and contemplated within the context of long term goals. This is why it is critical that we work with you to review your financial plans, to assure that you have the right exposure of stocks and bonds and that you have the right exposure to market risks that best meet your unique and personal circumstances.

Conclusion

When markets go through periods of prosperity or contraction it is natural for us to project the current trend indefinitely into the future. We are creatures who see patterns very quickly and make forecasts based on these perceived patterns. This is one explanation why often investors may feel that the economic setbacks recently experienced will go on for a long period of time. Author Larry Swedroe refers to our innate propensity to project recent trends indefinitely into the future as “recency”. In reality however, economies and markets tend to go through high growth periods followed by periods of slower growth or contraction, ultimately gravitating toward a long term average. This tendency is often referred to as “mean reversion” because periods of above average growth tend to be offset by periods of below average growth. We see this tendency in the long term average of stock market returns. US large companies have averaged an annualized return of near 10% in the years 1926-2008 yet it was a rare event when an individual calendar year experienced a 10% return. Simply acting on our intuition can be costly because the recency bias tempts us to make portfolio decisions that are dependent on the recent trend continuing when it is likely to reverse. This may help explain the poor returns achieved by the average individual investor as reported in the DALBAR studies.

Investors who know why they should receive a positive investment return, that markets should be participated in not outsmarted and who have the appropriate exposures to rewarded risks are well positioned to succeed and avoid being shaken by the current trend. As always, we value your trust and encourage you to contact us with your thoughts.

Sincerely,

Kenneth R. Smith

The Empirical Wealth Management Team
Kenneth R. Smith, CFP®, MS
Chief Executive Officer

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