EMPIRICAL
WEALTH MANAGEMENT

Successful Investing

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2009 Market Recap

The first decade of the new millennium will likely be remembered as a tough period for investors. In fact, the Wall Street Journal has called this period "The Lost Decade", while Time magazine labeled it "The Decade From Hell". It is easy to see how these headlines emerged: the S&P 500 produced an annualized return of -0.95% from 2000–2009, we experienced two of the largest stock market declines in history, the dot-com bubble popped, there was a bubble and subsequent crash in real estate, Wall Street villains bilked investors along the way and let's not forget a global financial crisis that many thought would collapse the entire financial system. In spite of all that, an investor who engaged in a diversified strategy could have held on to their capital and produced positive returns for the decade, a period which experienced relatively low inflation.

There are sixteen equity indices listed in the Quarterly Market Update (included), only three of the major indices that we track produced negative returns. Aside from US large cap, US growth stocks and international growth stocks, every other stock asset class listed had a positive return for the decade. Many of them, including US small value, international small cap and commodities soundly outperformed the 4.51% annual return of short term treasuries. In fact, a few, including emerging markets value stocks and REITs, experienced a stellar decade with over 10% annualized returns. While this past decade was not carefree for any investor, those who stuck with a globally diversified strategy the entire time avoided negative returns. No one could have predicted all of the events that took place over the last decade. However, the lesson from the experience is that investors do not need to predict events if they take the correct approach to investing.

The Deficit And The Dollar

With the subsiding of the credit crisis after March 2009, many investors have focused concerns on the burgeoning federal deficit and the declining US dollar. Understandably, some investors are worried about the rising national debt causing a future increase in inflation, and whether the recent weakness in the dollar in the second half of 2009 was a sign of the permanent decline of the American currency. We have received questions on how both of these scenarios could have a significant impact on investment results over the next decade. In this article we first analyze the major concerns surrounding the deficit, and then we address the issues with the weakening dollar. After careful consideration of these risks, we find there is no evidence that an investor should alter their course assuming they have a prudent, diversified strategy in place. We find after examining historical data that there is no relationship linking high current deficits or a weakening currency to lower future returns for the diversified investor.

Government deficit: *the difference between the amount of money the government spends and the amount it receives in the form of taxes.*

National debt: *the sum of all previous deficits representing the total amount owed by the government.*

The Growing Deficit

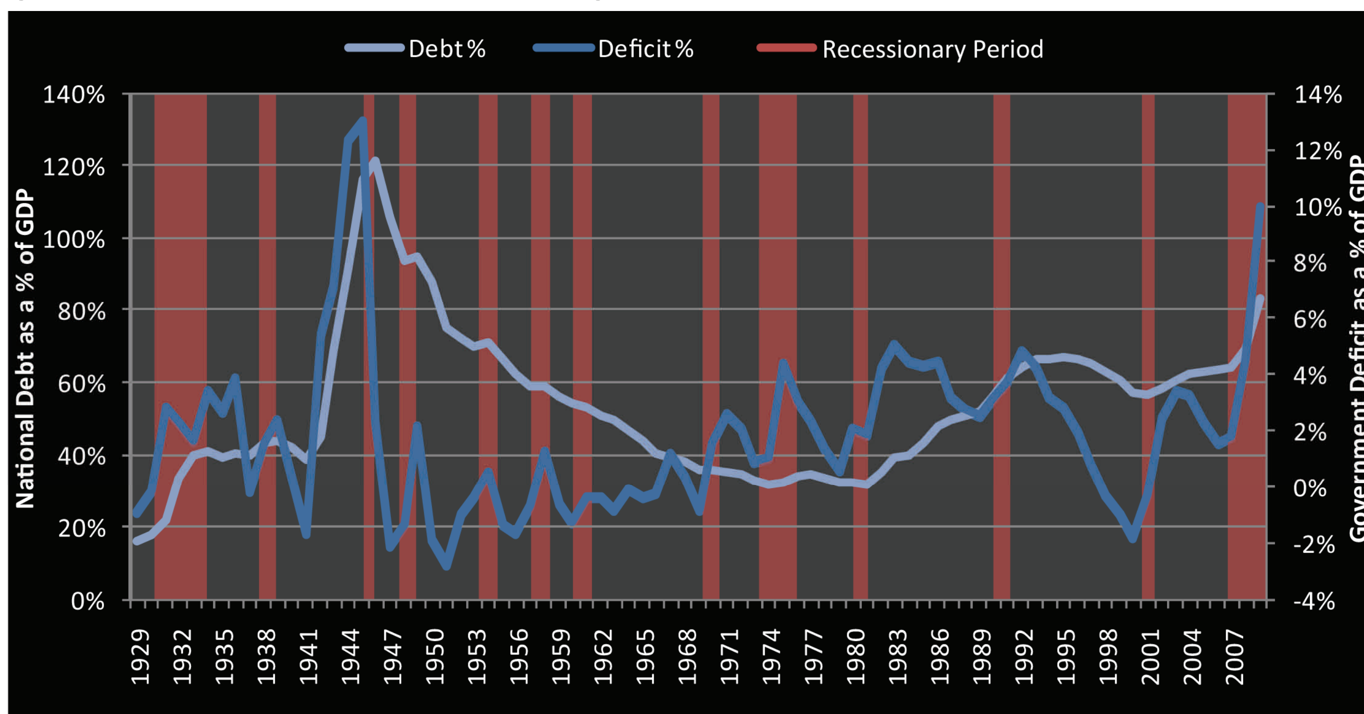
The government budget deficit for the fiscal year of 2009 was $1.4 trillion, the largest ever in dollar terms. This represents 10% of the total economy, a proportion not seen since 1945 when the US was still fighting World War II. The national debt has reached 80% of GDP, another post-war high.

The official debt figure is understated in that it does not include the implicit liabilities of the underfunded Medicare and Social Security programs or the debt of Government Sponsored Enterprises such as Fannie Mae and Freddie Mac. The massive rise in government indebtedness has understandably led many people to wonder about the long term viability of the US government. Figure 1 shows the US government deficit and total national debt since 1929, both as a percentage of GDP. The periods when the economy was in a recession are highlighted in red making it easy to see that government deficits tend to jump during recessions.

Because of this association with recessions, and the negative implications of debt, many people assume that government deficits are associated with poor stock market returns. However, market history tells a different story. Since 1929, there have been fifty-five years where the government ran a deficit. The average return of the S&P 500 index was 14.1% during these deficit years, versus 4.8% during surplus years. During periods of high deficits, the 14 years where government borrowing exceeded 4% of GDP, the average S&P 500 return was even better at 17.7%. While there is no solid reason to expect these trends to continue, the data clearly dispels the idea that investors should lower their exposure to the stock market because of government deficits. Similarly, in a previous paper we wrote on recessions we demonstrated how markets often begin to rebound long before the official end date of a recession is called.

Interest rates on government debt are low relative to historical averages acting as a sign that the US has not yet borrowed to the point of worrying its lenders. Basically, enough investors have confidence in the American government to continue purchasing her debt even though the interest rate is low. If the

Figure 1: US National Debt and Deficit as a Percentage of GDP



Source: National Debt: Treasury Direct. Government Deficit: Federal Reserve Bank of St. Louis. Recessions: National Bureau of Economic Research.

perceived risk was high, purchasers would demand higher rates.

In contrast with an overextended corporation, the US Treasury is unlikely to default on its debt. While there is some recent precedent for large government defaults (Russia in 1998 and Argentina in 2001), a developed economy has not defaulted on its public debt in modern times, and the US has the added security of having the world's reserve currency. Since all debt is denominated in American dollars, the worst case scenario is that US speeds up the printing presses and creates inflation to lower the real value of the national debt. A more likely scenario is that the economy will grow enough to make the current debt load less burdensome. Any shortfall will be made up with a combination of government spending cuts and increased taxes. While the doomsday scenarios appear unlikely, the growing national debt is a good reminder that investors should prepare for the ever-present risk of inflation.

The Weakening Dollar

The US dollar has declined 11% against the British pound, 12% against the euro and 17% against the Canadian dollar[1] since March of 2009. Such a steep decline has left many investors wondering whether the dollar will continue weakening for the indefinite future.

Figure 2 shows the Federal Reserve's Major Currencies Dollar Index, representing the performance of the dollar against the currencies of America's major trading partners such as Europe, Japan and Canada. As can be seen, the recent decline in the dollar is a minor movement compared with the significant long term declines in 1985 -1987 and 2002 - 2007. Counterintuitively, neither of these dollar downturns was associated with negative stock market returns. The S&P 500 index, also shown in Figure 2, had an annualized return of 18.1% during the first period and 6.07% during the second. With this historical context in mind, we can examine the major factors that will affect future movements in the dollar.

Low Interest Rates

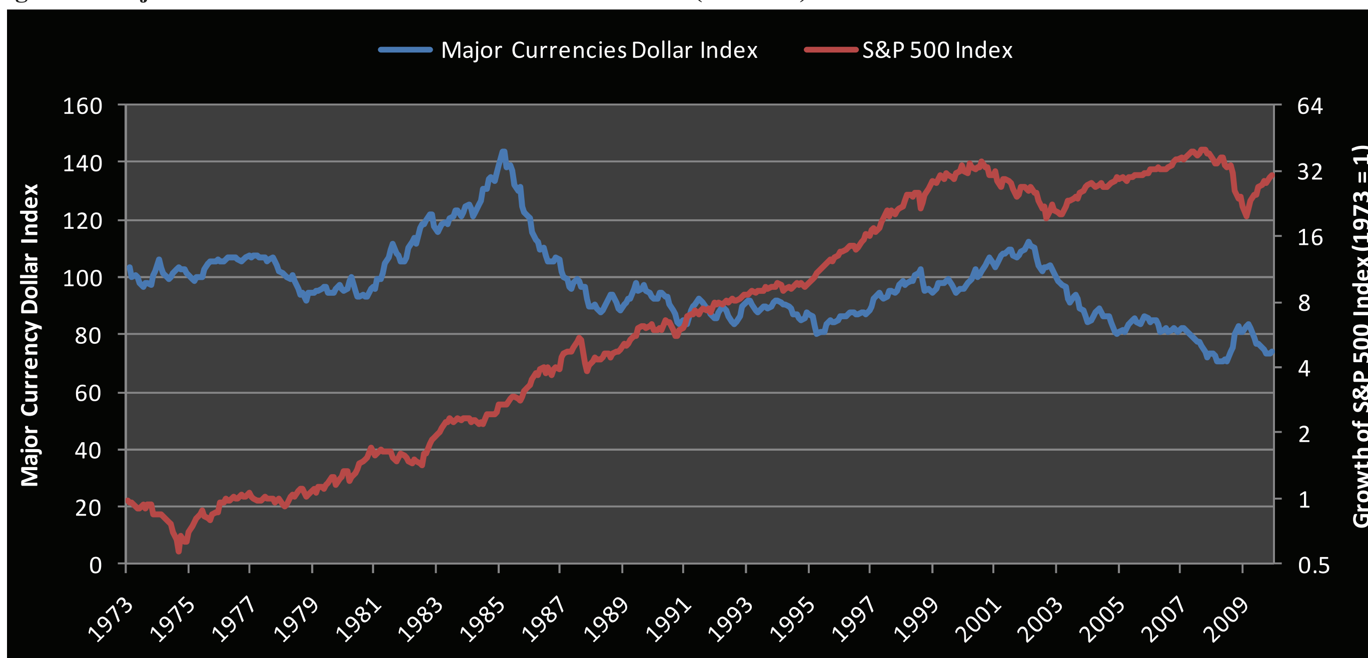
The Federal Reserve has promised expansionary monetary policy into the indefinite future as the nation remains far from full employment. Many are worried that the resulting low interest rates will provide little incentive for foreign investors to park their money in US dollars.

The current low interest rates set by the Federal Reserve will only spur a decline in the dollar if foreign central banks hold interest rates at a higher level. They have a strong incentive not to do so, because a weaker dollar puts their exporters at a disadvantage. Both the European Central Bank[2] (which manages the euro) and the Asian-Pacific exporters[3] (including Japan) have stated they are strongly against a weakening dollar. Also, despite the fact that nearly half of the US trade deficit is due to China[4], the Chinese yuan/dollar exchange rate is fixed, so that the US dollar cannot weaken versus the yuan.

Government Deficit

The US government deficit and national debt are growing rapidly. This has a tendency to cause higher future inflation which would put downward pressure on the dollar. However, it is important to remember that in order for the US dollar to weaken, another currency must appreciate. The ballooning government deficit leads some to predict a period of rapid future inflation. However, such inflation would only lead to a declining dollar if it were more than the inflation of America's trading partners. Figure 3 illustrates that America's trading partners in other major developed economies also have substantial national debts. As such, the national debt is

Figure 2: Major Currencies Dollar Index and S&P 500 Index (Nominal)



Source: Federal Reserve. Indices are not available for direct investment. These indices do not reflect actual account holdings nor are they meant to represent EWM Portfolio holdings

unlikely to put the US at a disadvantage in the currency markets.

Trade Deficit

The US continues to import much more than it exports, and the trade deficit, despite a recent decline due to the recession, appears to be rising once again.[5] During the credit crisis the global collapse in trade improved the US trade deficit because imports and exports declined by a similar percentage amount. When trade recovers, the opposite will happen as imports increase at a much faster rate than exports. In consequence, as global trade increases, the deficit should get much worse.

Right now, the significant trade deficit points to a declining dollar in the future. The problem is that significant trade imbalances can persist for long periods of time. Forecasters could not foresee the credit crisis that prompted global investors everywhere to seek the relative safety of US dollars. Anyone who made the seemingly obvious bet that the dollar would decline in 2008 lost big, especially those who made aggressive bets.

Reserve Currency

The brief appreciation of the dollar in 2008 was because of a flight to safety in a period of extreme financial distress. Now that the global financial system is no longer on the brink of destruction, there is less demand to hold the safety currency. The future of the dollar as the world's reserve currency is questionable. India's central bank is buying gold[6], and both China[7] and Gulf central banks[8] are talking about a new reserve currency.

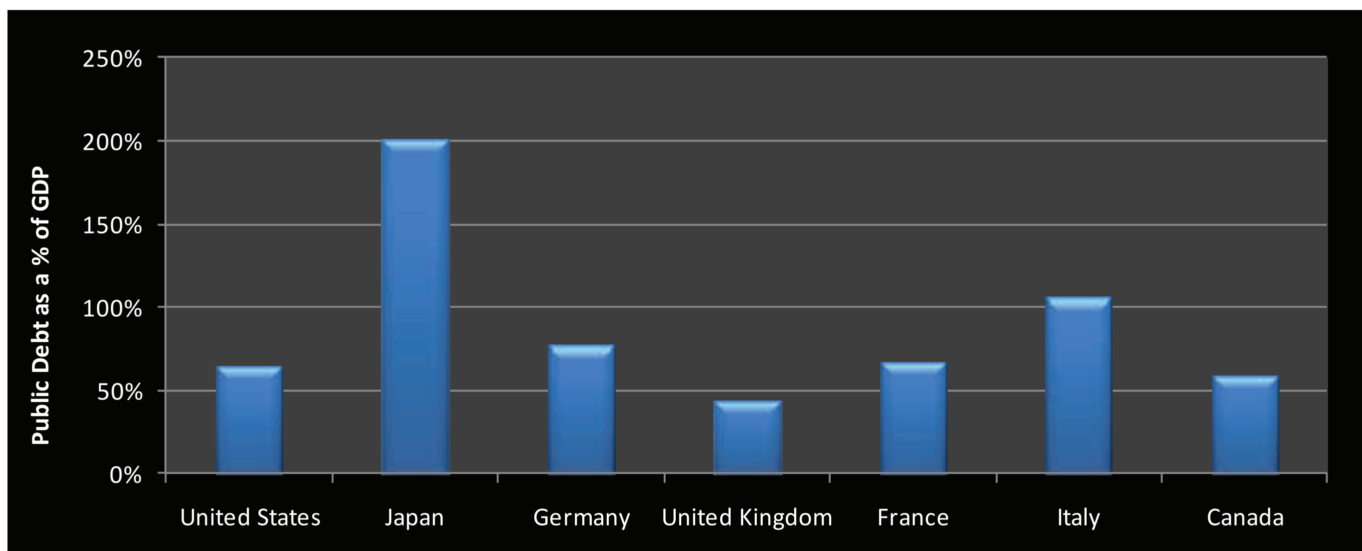
The US dollar may not remain the world's reserve currency forever; for now there is no viable alternative. The huge demand for the dollar during the recent credit crisis is a sign that the dollar is still the world's safety currency. We think that the recent stock market rally indicates most participants believe the world economy has averted a global depression caused by the financial crisis. However, betting on this trend, such as by purchasing foreign currency bonds instead of dollar denominated bonds, is particularly risky. Should the world experience another financial crisis, the dollar will rebound at the same time as the global equity markets are crashing, throwing a one-two punch at any investor who tried to bet on the dollar decline.

Implications for your Portfolio

After considering the four major factors above, it is clear that the recent decline in the dollar is due to valid fundamental factors, and that the dollar faces some challenges ahead. It is also clear that there is no slam dunk case for a near term dollar crash. Currency markets are just as efficient as equity markets, and prognosticators are equally unsuccessful at predicting currency movements as interest rates or the direction of the stock market. Few predicted that the ever larger trade deficits through 2007 would be followed by the credit crisis and flight to safety that caused the dollar to spike in the second half of 2008.

Once an investor appreciates the uncertainty in the currency markets they have two options: place a large bet that the dollar will decline, or protect themselves from the risks of a major decline while not exposing themselves too much should the dollar rally. A portfolio should be designed with every possible scenario in mind, not just the one that seems most likely. Investing a significant portion of your portfolio in foreign currency denominated investments is reasonable; investing the large majority of your portfolio in foreign currencies, or making leveraged foreign currency bets exposes you to too much risk.

Figure 3: Public Debt as a Percentage of GDP of Major Developed Economies



Source: 2009 International Monetary Fund staff estimates. The IMF uses a different accounting method than the US Treasury, and as such shows the US debt burden to be slightly smaller than in Figure 1.

A declining dollar sounds like quite an alarming scenario. When you examine the true risks to Americans, it appears much less distressing. Investors in the US will spend most of their portfolio on goods denominated in US dollars. The real source of worry for most people isn't exchange rates, it is the other components of the same story: rampant inflation and the decline of the US as the world's economic superpower.

A decline in the dollar doesn't necessarily mean higher inflation. From 2000 to 2008 the weakening of the dollar relative to the euro from 0.83 to 1.59 dollars per euro happened during a period of very low inflation. One reason: trade is a relatively small portion of GDP. While a weaker dollar increases the cost of imported goods, since imports represent a fraction of consumer spending, the effect is muted. Although over the long run there is a link between relatively high inflation and a weakening currency, over short periods of time inflation is not a good predictor of exchange rate movements.

A declining dollar is also not necessarily bad for the US economy. The recent dollar decline makes US exports more affordable to foreigners, boosting demand. It would also make importing foreign goods and cross-border outsourcing more expensive. These factors should cause an increase in domestic GDP.

Designing a Portfolio to Protect Against Deficit and Dollar Risks

The two main risks of both rising government deficits and a possible decline in the dollar are high inflation and rising real interest rates. The Empirical model portfolio is designed with these issues in mind to avoid the problems that can plague unprepared investors. The safest investment in the case of rising inflation is Treasury Inflation Protected Securities (TIPS) which guarantee against a loss in purchasing power. Thirty percent of our fixed income portfolio is invested in Treasury Inflation Protected Securities. Stocks have also historically kept pace with inflation over the long term. Commodities and REITs have been even better hedges of inflation, and are included in the Empirical model portfolio. The performance of short term bonds rises along with interest rates, which make up 55% of our model fixed income portfolio (the remaining 15% is invested in intermediate treasury bonds). The worst investment in a scenario of rising prices is long term bonds, since they may not pay high enough yields to offset the increasing cost of living and they decline in price when interest rates rise. Constructing a consistent asset allocation with these relationships in mind can help protect your portfolio, whether government deficits become a forgotten issue or a major structural problem.

A declining dollar is not a risk to US consumers unless it comes along with high inflation or rising real interest rates. However, a partial allocation to foreign currency denominated securities allows an investor to benefit should the dollar fall. The Empirical equity model has a 37.5% allocation to stocks denominated in foreign currencies. If the US dollar declines, this part of the portfolio will rise proportionally. The equity model also has a 5% allocation to commodities, which tend to rise in value when the dollar falls.

At Empirical, we make sure to have a solid understanding of the important economic issues such as those discussed above. We also believe that there is little to be gained by trading in and out of markets based on predictions of future events. The benefit of researching economic issues is that it can reassure us that we are pursuing the correct strategy. The media will often present a one-sided story, making an event, like the future decline of the US dollar, seem like a near certainty. When you take a deeper look, you almost always find two things: economic activity is inherently unpredictable (such as currency movements or the effects of the deficit) and even if you are right about an economic indicator, often times the market reacts in a contradictory way. Luckily, these two facts do not make the task of investing futile, they make it simpler. The best plan is to create a globally diversified investment strategy and to stick to it.

Are Your Assets Safe?

The financial market volatility of 2008-2009 exposed a number of fraudsters such as Bernard Madoff and Allen Stanford who managed to swindle investors out of billions of dollars. The prominence of these scandals has led many people to reassess the security of their investments. In this article we will address the safety of clients' assets by examining the multiple layers of safeguards in place to prevent a loss from illegal or fraudulent behavior as well as the track record of such protections.

Are your assets safe with one investment advisor?

There are two primary questions an investor should be able to answer prior to placing money with a single advisor. First, does that advisor take custody of the assets directly or do they utilize an independent custodian? If the advisor is not taking custody or possession of your assets the greatest remaining risk of working with a single advisor is whether the advisor utilizes a diversified approach or a narrowly focused investment strategy.

It is important that the advisor uses a third party custodian, such as Schwab or Fidelity to hold your assets (rather than the investment advisor taking custody of assets). This provides an independent third party, whose responsibility it is to track, monitor, and report everything that goes on within your accounts. For our clients this is the primary function of the custodian and the reason why clients are required to receive monthly statements and trade confirmations from them. This arrangement maintains an "arms length" distance from our clients' assets and ensures there are no improprieties. Further, even though we as your advisor are "connected" to our clients' accounts, we are linked via a "limited power of attorney" which specifies the three things we have the power to do as your advisor:

1. Execute trades in accordance with our pre-agreed upon investment directive.
2. Submit advisor management fees to the custodian (the custodian deducts fees on our behalf).
3. Facilitate requests for withdrawals directly to clients – The custodian distributes checks in the name of the account holder only and will sends funds to the address on record (i.e. your address) or via pre-authorized electronic link to your bank account. Further, to change any of the above would require a new letter of authorization from you (which is verified for a valid signature each time).

You will notice this arrangement is significantly different than the "investment advisors" that have been in the news lately. In the Madoff case there was not an independent third party reporting performance or providing account statements and trade confirmations. Instead, in the Madoff case his firm was the custodian, making it easy to create and send false account documentation to the investors. In addition, the independent auditor hired to provide verification was a small unknown accounting firm and as a result, Madoff was able to solicit cooperation in perpetrating his fraud. Empirical uses independent custodians that are audited and regulated by established organizations. Clients receive account statements and trade confirmations from the custodian in addition to the reporting we provide.

The second primary consideration when determining the safety of investing with a single advisor arises when an advisor pursues a non-diversified investment strategy, such as investing exclusively in the stocks that comprise the S&P 500 (US large capitalization stocks). In this case, investing with a single advisor increases the investment risk by focusing on a single market segment. Even diversifying among advisors does not provide additional safety if each manager tends to invest in the same sector or asset class. It was a common circumstance in the late 1990s for investors to purchase a number of different mutual funds that all held the same few technology stocks. The 'diversification' between these mutual funds provided no help when the dot-com crash decimated every technology-heavy fund. A better option is to choose an advisor that offers a globally diversified investment strategy and comprehensive wealth management. Having a single firm oversee and coordinate your finances has several benefits:

- Your overall portfolio will remain consistent with your objectives at all times.
- Greater coordination among investments can be achieved, providing higher risk adjusted returns.
- Greater coordination among investments maximizes tax efficiency through tax loss harvesting and asset placement.
- Fewer transaction costs as well as lower advisory fees (many advisors offer a tiered fee schedule that lowers the advisory rate as assets under management increases).

We do not find sufficient cause to diversify among investment advisors to prevent fraud, assuming the assets are placed with an independent third-party custodian and the advisor retains only a limited power of attorney over your accounts. There is also no need to retain multiple advisors in order to diversify among investment strategies when an advisor uses a strategy that is diversified to the fullest extent possible. In fact, with a diversified advisor it is actually detrimental to hire additional advisors because no single advisor can then manage effectively a client's wealth in its entirety. We find that unnecessary risks, greater inefficiencies, and missed opportunities are ubiquitous with investors who retain multiple advisors or retain self-managed accounts.

Are your assets safe with one custodian?

If all of your investment accounts are held at a single custodian, what are the risks if the firm goes bankrupt? A registered broker/dealer (such as Charles Schwab or Fidelity) must comply with a myriad of regulatory laws and standards set in place by a number of regulatory bodies, including the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA). The primary protections by these authorities for investors are as follows:

- Registered broker/dealers are required to maintain adequate net capital (i.e., assets must exceed liabilities) to provide financial resources so that, if the firm fails, customers can get their cash and securities back.
- Registered broker/dealers must keep client assets segregated from the firm's liabilities. This means that

even if a broker/dealer declared bankruptcy, client assets would be safe because they are held in separate accounts that cannot be touched by creditors. Further, customer claims for funds and securities are given preference over any other claims on the company.

If the broker/dealer complies with regulations, the risk of loss due to bankruptcy is extremely small. To assure broker/dealers are in compliance, each company undergoes regular audits by an independent accounting firm, regulated by the Public Company Accounting Oversight Board (PCAOB), whose main purpose is to verify assets held by broker/dealers exist, and that customers are receiving truthful statements. In the unlikely event that fraud is successfully perpetrated by an employee of a broker/dealer, thus circumventing the above regulations, there is a second line of defense for investors:

- Registered broker/dealers are required to be members of the Securities Investor Protection Corporation (SIPC) which provides insurance for customer accounts.
- Many broker/dealers (including Schwab) have excess SIPC insurance for claims above the SIPC limits.

Created in 1970, the SIPC is a nonprofit membership corporation that is funded by its member securities firms. If your broker/dealer fails, your assets are returned to you. The SIPC is designed to step in to replace only the securities and cash that are missing from your accounts, covering missing assets up to a limit of $500,000 per account type, of which $100,000 may be claims for cash. Accounts with identical registrations are combined for the purposes of determining coverage.

The regulatory requirements and SIPC insurance have served investors extremely well over the years. During the SIPC's 38-year history it has made possible the recovery of over $160 billion in assets for more than 761,000 investors. More than 99% of investors' claims were fully satisfied.

The excess SIPC insurance coverage offers additional protection that becomes available in the event that SIPC limits are exhausted. For example, Schwab obtained a policy from the underwriters of Lloyd's of London with protection up to an aggregate of $600 million, which is limited to a maximum total reimbursement of $150 million per customer including cash up to $1 million.

Are your assets safe with one mutual fund company?

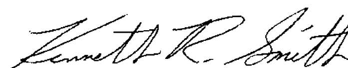
In designing our model investment portfolios, sometimes a significant portion of the portfolio will be invested through a single fund company, such as Dimensional Fund Advisors, Vanguard or iShares. While each fund invests in a diversified basket of stocks or bonds, using a single investment firm for a large amount of money worries some people. Such concern is quite warranted for certain products such as private placements, uninsured certificates of deposit, structured notes or hedge funds. These products are often unregistered and exposed to credit risk of the issuing investment firm. In contrast, mutual funds and ETFs (exchange traded funds) are one of the most highly regulated investment products available. Here are a few of the important safeguards provided by the mutual fund structure (none of which are required of hedge funds for example):

- Mutual funds are required to keep assets custodied at banks in segregated accounts that cannot be confiscated by creditors in the case of the custodian bank going bankrupt.
- Mutual funds must have their financial statements audited by an independent accounting firm annually.
- Mutual funds are overseen by a board of directors which must have a majority of directors who are independent from the mutual fund management company.
- All mutual funds, as well as mutual fund managers, must be registered with the SEC.

These various protections have had a successful track record of protecting investors. We know of no instance of a registered mutual fund company directly embezzling funds from investors.

One final matter where Empirical holds itself to the highest standard of investor safety is that we do not use any investment products that we are affiliated with or that we receive revenue from. This provides even one more layer of protection and gives us every incentive to strongly look after the safety of your assets.

Sincerely,



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

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