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An Encouraging Stretch, but Equity Investors Are Still Nervous

In the investment business, discussions of historical returns carry the admonition that "past performance is not indicative of future results." So why talk about past performance at all? Because of another old adage: "Forewarned is forearmed." We look at the past to better understand the sheer range of potential outcomes and the patterns of market behavior that have echoed across those peaks and valleys.

In the relatively short run, *when* you start can make a big difference. The Performance Summary of Major Mutual Fund Categories on the next page shows unusually strong results for the trailing three-years. But the five-year numbers are quite skinny considering the fact that they fully encompass that same three-year stretch. The landscape appears to level out over 10 years, although those differences in annualized return compound into some significance over the course of a decade.

From the beginning of 1926 through the end of 2011, the Standard & Poor's 500 Index of large-cap U.S. stocks posted annualized total return of 9.8% (6.8% net of inflation). But those eight-and-a-half decades featured some extended periods of significant over- and underperformance. The accompanying breakdown of market performance by calendar decades shows wide swings either side of that very long-term annualized average.

So how does one set a plan? With plenty of margin for error. Equity markets do not conform neatly to any particular timeline or savings need. But they do have the distinction of having delivered inflation-beating results across many extended periods, and exceptional growth in some.

S&P 500 Total & *Real* Return

By Decades	*(annualized)* *Nominal*	*Real**
1930s	– 0.1%	2.0%
1940s	9.2%	3.8%
1950s	19.4%	17.2%
1960s	7.8%	5.3%
1970s	5.9%	– 1.5%
1980s	17.5%	12.5%
1990s	18.2%	15.3%
2000s	– 1.0%	– 0.1%

* Net of annualized inflation rate
Sources: Ibbotson / Standard & Poor's

Perhaps most problematic is investors' well documented tendency to see the recent past as prologue. Three years ago this month it took real intestinal fortitude just to maintain one's stock market exposure, let alone add to it. As it turned out, the rubber band had been stretched to an extreme and was poised to snap back for a robust recovery.

The impact of such return variability on investor behavior can have profound implications. Earlier this year the *Wall Street Journal* reported that many younger savers are exhibiting a high degree of risk aversion and opting for the most conservative investment vehicles. Many of these twenty-to-thirty-somethings have seen their parents' retirement portfolios whipsawed by the volatility outlined above.

To be overly influenced by such first impressions can negate the greatest single advantage younger investors have: decades of time to build equity exposure on a disci-

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Dow 13,000: Just Part of the Story

In the absence of big market-moving events, the Dow Jones Industrial Average's crisscrossing of the 13,000 threshold recently became a story in itself. Kind of silly, really; it's just a number. And we're not talking about a new high for the average. That came way back in October of 2007 at Dow 14,165.

Or maybe we *are* flirting with new highs. The DJIA is based only on the prices of its component stocks; it does not factor in the dividends those companies pay out to stockholders. A hypothetical investor holding the Dow Industrials and reinvesting dividends in that portfolio of stocks would in fact have scored positive return since that 2007 high.

The Dow was initiated May 26, 1896, at a value of 100. Over that *very* long haul, adding in the effect of reinvested dividends would place today's Dow at 1,339,411, about 100 times its current reading.

Sounds crazy, doesn't it? One need only calibrate the impact of inflation to restore a sense of reality. Meir Statman at Santa Clara University, and Jonathan Scheid of Belatore Financial, track what they call the "Real Wealth Dow" which factors in both reinvested dividends and the ravages of inflation. That calculation from the inception of the Dow would place it near the 47,000 level today.

Not many of us invest with a 116-year time horizon. And for much of the Dow's first century there was no truly efficient, cost-effective way for most investors to hold that defined portfolio, make the requisite stock substitutions, and reinvest all dividends. But in recent decades the rise of index mutual funds and ETFs has made that pretty easy. So onward we go to Dow... well, we'll see. ■

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Is Real Estate a Real Diversifier, or Not?

It's often said that many Americans' largest single investment is their home; that is to say, a piece of real estate. Once the housing bubble began to deflate five years ago, home prices traveled south pretty quickly and have shown only modest recovery in selected markets. So it may be surprising to note the strong performance turned in by mutual funds that focus on real estate.

Most such funds hold primarily publicly traded real estate investment trusts (REITs), noted in these pages from time to time especially for their diversification value. The Investment Performance Review on this page shows a recent performance pattern for real estate funds similar to other equity categories, only more so. But according to the National Association of Real Estate Investment Trusts (NAREIT), the diversification story does hold up over longer periods.

From January 1990 through October 2011, the average *one-month* correlation between REITs and the broader market was a fairly high 56.3%. But for overlapping *five-year* increments over the same two decades, those assets moved in tandem just 7.1% of the time. The same analysis applied to some other portfolio diversifiers – utilities, consumer staples, and health care stocks – actually tended to show greater correlation with the broad market as the time frame was stretched out.

Of course correlation is about timing and direction of price movements, but not their amplitude. Different assets can be closely correlated yet perform quite differently over time, or be non-correlated but produce fairly similar long-term results. Then there's the challenge of finding the right mix and strategic points of entry – topics for a future issue. ■

Gold Demand Prompts Need for Storage

Investor demand for gold is driving a boom in new vault space to safe-keep the stuff. The price of an ounce of gold is well off its highs of last summer, but owning the hard asset is increasingly popular, particularly in Asia. Hong Kong-based Malca-Amit Global Ltd., which stores and transports diamonds and precious metals, is expanding its storage in Singapore and Bangkok. The company recently opened a facility at London's Heathrow Airport and will open a new vault at the Beijing airport later this year.

Other large banks and security providers such as Brink's are expanding facilities as well. The World Gold Council reports that China may eclipse India as the world's largest gold market in 2012. The metal has many supporters among market prognosticators, and the first two months of the year saw gold advancing alongside stocks.

The storage issue does point up the cost drag of securely holding the metal itself. Most investors will likely continue to use gold-oriented mutual funds and ETFs to efficiently blend the yellow metal into their diversification scheme. ■

Investment Performance Review	**TOTAL RETURN *** (dividends and capital gains reinvested)			
Selected Mutual Fund Categories *	**--- Annualized thru March 5, 2012 ---**			
	1 yr.	***3 yr.***	***5 yr.***	***10 yr.***
Large-Cap Stocks (Core)	3.4 %	26.2 %	1.5 %	3.4 %
Mid-cap Stocks (Core)	0.0	31.6	3.1	6.2
Small-cap Stocks (Core) †	– 0.6	33.3	2.7	6.8
Foreign Stocks (Multi-cap) †	– 7.8	22.1	– 1.4	6.4
Emerging Market Stocks †	– 5.6	31.5	4.6	13.4
Natural Resources	– 6.9	27.7	4.6	10.7
Real Estate related	10.2	47.3	– 0.3	9.8
Flexible Portfolio	1.4	18.8	3.3	5.3
General Bond	8.9	11.0	5.6	7.8
Int'l Fixed Income †	4.1	10.4	6.6	7.4
High-Yield Taxable Bond †	4.6	22.3	5.8	7.6
General Municipal Debt	13.5	9.1	4.1	4.4

* Source: Lipper, as reported in the *Wall Street Journal*, March 6, 2012. **Past performance is NOT indicative of future results.**

† Small-cap stocks and high-yield (lower rated) bonds pose more risk and price volatility than those of larger, established companies. Securities of companies based outside the U.S. may be affected by currency fluctuations and political or social instability to a greater extent than U.S.-based companies.

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Some Encouragement...

plined basis and be positioned to experience that real growth at whatever point it materializes.

For at least 20 years the Baby Boomers have held center stage as market watchers tried to anticipate the next big investment trend. But those two decades also have seen the children of those Boomers forming households, establishing careers, rising to meet the challenges of a competitive global economy, and starting to accumulate the financial assets they will look to for sustenance a few decades down the road.

Meanwhile, hundreds of millions of people in emerging nations have risen rapidly on the economic ladder to higher levels of productivity and consumption – middle class status, if you will. Equity investing, for all its vagaries and volatility, is a fundamental bet on the long-term sustainability of such human enterprise, innovation, and progress. There are time-tested approaches to mitigating the associated risk, including diversification, time, and a healthy respect for the lessons of history. ■

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An Expanding Role for an Old Concept

Annuities are hardly new; their use dates back at least to ancient Rome. But they popped up in the news a few weeks ago when the Obama Administration proposed new rules to encourage and facilitate the use of annuities and other vehicles that convert savings into guaranteed lifetime income.

One of those proposals would encourage employers and IRA custodians to make "longevity insurance" available as an option in those retirement plans. Longevity insurance is a little different twist on annuitization. It involves the purchase of a deferred income annuity. For instance, a 70-year-old might pay a lump sum to guarantee a certain amount of income starting at age 85 and continuing for life. The Administration proposes a simple tweak: excluding the value of that guarantee from the base of IRA assets used to calculate the IRA holder's required minimum taxable distributions.

The Administration's other proposal would encourage folks who retire under a defined-benefit pension plan to take at least a portion of their retirement benefit as lifetime income rather than in a lump sum. That added flexibility sounds like a plus, but there are good reasons to think twice about irrevocably converting a substantial sum into a fixed income stream, even one guaranteed for life.

Volatile financial markets and historically low yields on conservative fixed income instruments contribute to retirees' concerns about outliving their assets. But outside the shrinking circle of traditional pension plans, investors rarely elect to annuitize a big portion of their retirement nest eggs. Those who want to leave assets to their heirs worry that they could die relatively soon after annuitizing, and that capital would be lost to their heirs. There's also the very real possibility of a return to much higher interest rates and sustained inflation that would erode the real value of a fixed income stream, especially one based on today's rates.

These kinds of concerns have found expression in the development of variable annuity contracts that package a broad menu of investments with the backstop of certain lifetime income guarantees. Investors retain the potential for market returns with an underlying baseline of future income if portfolio results fall markedly short.

Of course there's a cost for that insurance. Some argue that those charges are either excessive or unnecessary, but it is worth noting that a few major insurers have curtailed their offerings of such guarantees in view of the long-run risks and reserve requirements they entail.

There are degrees of separation between competing variations on the guaranteed income theme. Accommodative tax policy may help at the margin, but the real impetus comes from the profound challenges and choices faced by millions of retirees, innovative offerings from investment and insurance companies, and critical analysis by personal financial advisors. Somewhere in that mix, the concept of annuitization looks to play a larger role. ■

IRS Issues Alert on Tax-related Scams

With the onset of tax season the Internal Revenue Service recently issued its annual "Dirty Dozen" list of tax scams. These range from identity theft to fraud perpetrated by tax preparers. We focus here on the half-dozen areas most likely to trip up the unsuspecting.

Identity Theft is used to commandeer a taxpayer's information to file a return and claim a fraudulent refund. The tipoff may be an IRS notice informing you that multiple returns were filed in your name, or that you received wages from an employer you've never heard of. If you believe your personal information has been stolen and used for tax purposes, contact the IRS Identity Protection Specialized Unit (see *www.IRS.gov/identitytheft*).

Phishing is typically carried out via unsolicited email or fake websites posing as legitimate to induce victims to provide personal and financial information. If you receive an unsolicited email that purports to be from the IRS or an organization closely linked to the IRS, such as the Electronic Federal Tax Payment System (EFTPS), report it to *phishing@irs.gov*. The IRS does not initiate contact by email to request personal information from taxpayers.

Return Preparer Fraud may include refund skimming, inflated fees, refund guarantees, basing fees on a split of any refund, and encouraging the submission of false information on returns. A paid preparer should have a Preparer Tax ID Num-

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Rise of the Centenarians Revisited

A few years back we noted the predictions for rapid growth in the number of Americans over the age of 100. But the latest research by a pair of the nation's leading demographers suggests the reality may not turn out to be quite so dramatic.

Leonid and Natalia Gavrilova recently released a study challenging their own and many of their colleagues' view that the decline in mortality was continuing. We *are* living longer on average, but Social Security's latest consolidated data on births and deaths suggest there's more of a natural cap on that process than experts had thought.

In 2004 the Census Bureau estimated there would be 114,000 Americans over age 100 by 2010. But 2010's census turned up only 53,364. The Bureau has cut its estimate for 2050 from 1.1 million centenarians to just 592,000.

On the other hand, there's still a backlog of studies documenting the plateau in mortality rates that drove those prior predictions. Settling the issue will take some... time. ■

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IRS Alerts on Tax Scams

ber (PTIN) and enter it on returns.

"Free Money" from the IRS & Scams Involving Social Security often target the elderly and have been appearing in community churches and other "affinity" groups. Promoters charge to prepare and submit a claim for a credit or refund that is either nonexistent or grossly inflated. Such filings can trigger a $5,000 penalty.

Abuse of Charitable Organizations and Deductions includes efforts to shield income or assets from taxes while keeping control of the assets and associated income. Overvaluing gifts to inflate tax deductions is a common problem. The Pension Protection Act of 2006 raised penalties for inflated appraisals and set new appraisal standards.

Misuse of Trusts often arises from promoters' bogus claims of income and/or estate tax savings. There are many legitimate uses of trusts in tax and estate planning, but the IRS has seen a rise in the improper use of private annuity trusts and foreign trusts to shift income and deduct personal expenses. Seek the advice of a trusted professional before entering a trust arrangement.

When it comes to taxes, an old adage from the investment world is equally apt: *If it seems too good to be true, it probably is.* ■

Measuring Stuff, All Sorts of Stuff

These days it seems there's an index for just about everything. Consider the People-Snowed-In Index. *Business Insider* reports that the December-January count of people not at work due to bad weather hit its lowest level in a decade. Department of Labor statistics showed just 167,000 people snowed in this past December-January compared to 533,000 a year earlier. Tamer, more temperate weather may have helped economic boosters like construction and retail sales. Growth for the fourth quarter did come in a little better than most economists had expected.

Then there's the Momma's Boy Index which tracks the number of 25-34-year-old males living with their parents. Hedge fund manager Boaz Weinstein recently pointed out an apparent correlation between this reading for various euro zone countries and the cost of insuring against default of their sovereign debt. Suffice it to say that Greece's reading on the Momma's Boy Index is about three times higher than Germany's.

Finally there's *The Economist*'s Big Mac Index, tracking prices for McDonald's iconic burger in different countries as an indicator of currency overvaluation and undervaluation. The Index recently pegged Big Macs at an average of $6.81 in Switzerland, $4.20 in the U.S., and just $1.62 in India, where it's called a "Maharaja Mac" and uses chicken instead of beef.

That points up some imprecision. Even across the U.S. there are differences in the make-up of a Big Mac, so it's hardly a uniform, internationally traded commodity. And don't even get us started on a cross-cultural comparison of the Happy Meal. ■

For information on any of the items listed below, please call:

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