The New Three-Legged Stool
....Update

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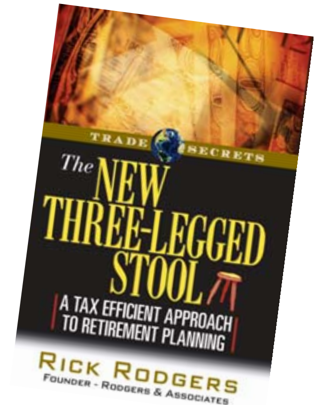

Looking Ahead to 2010

What's not to like about this economy ... especially when you compare it to 2008? Yes' unemployment is still high, but it may have peaked in October and the Labor Department reported on December 4th that the official unemployment rate declined from 10.2% to 10.0% for November. Competition for available jobs is still fierce and significant improvement in the job market is still probably six months away.

Economic growth in the United States is also showing signs of improvement. According to the U.S. Bureau of Economic Analysis (BEA), "Real gross domestic product -- the output of goods and services produced by labor and property located in the United States -- increased at an annual rate of 2.8 percent in the third quarter of 2009, (that is, from the second quarter to the third quarter), according to the "second" estimate released by the Bureau of Economic Analysis."

As a nation, we are growing stronger balance sheets, both on the business and the household sectors. Corporate profitability is up, and helped by historically low interest rates, corporations have strengthened their balance sheets and have plenty of cash on hand.

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What's ahead for 2010?

Asset Allocation for Today

Asset Allocation, long thought of as a basic tenet of a good investment strategy was heavily criticized in 2008 for not doing a good job of protecting principal. Controlling risk is important to most investors especially when markets are going down. A good asset allocation model relies on the premise that a portfolio balanced between various asset classes will help control or mitigate investment risk.

In theory, this is true over time. But in practice, many investors lack the discipline to make this a truism. The basic problem stems from the emotional disorder afflicting many investors...they buy and hold when the markets are good and sell when markets are bad.

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Looking Ahead to 2010

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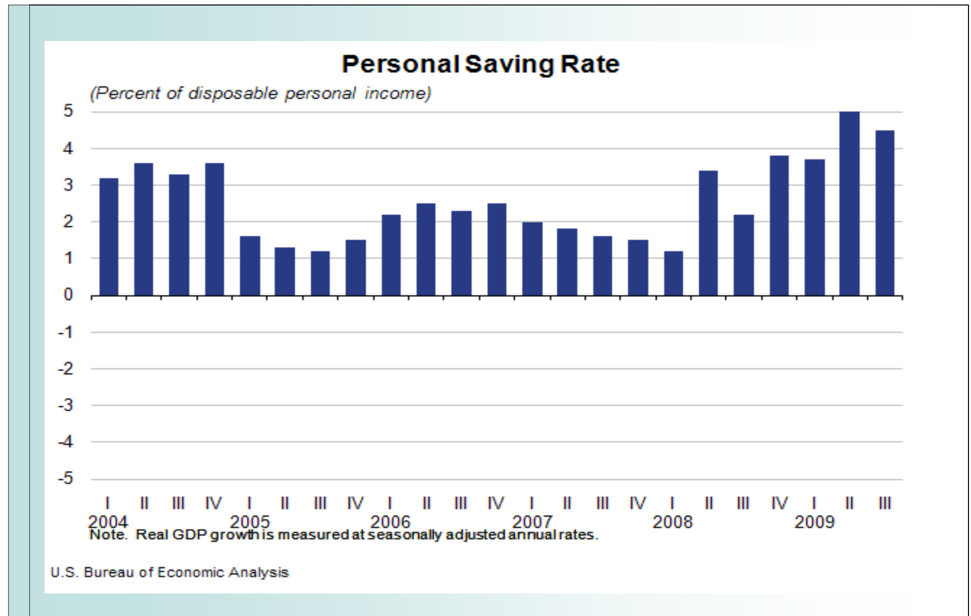
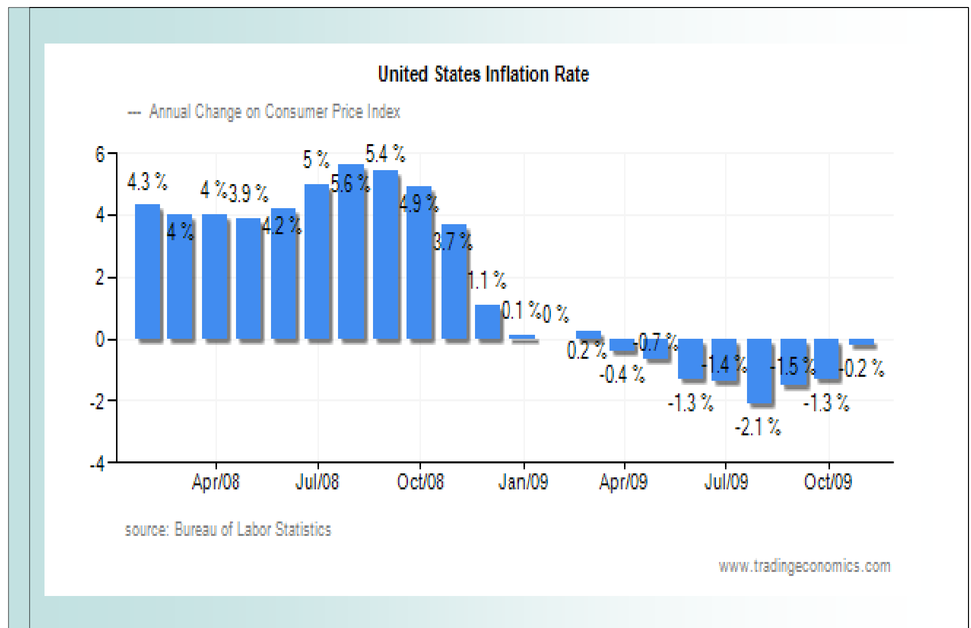
Household debt is shrinking as consumers work to pay down outstanding balances and increase their savings. BEA reported that the personal savings rate continued to improve in the third quarter. (See graph at right.)



And finally, fears of higher inflation caused by low interest rates and massive federal borrowing have thus far been unfounded. The Bureau of Labor Statistics reports that the US inflation rate stands at -0.20 percent year-over-year. Inflation rate refers to a general rise in prices measured against a standard level of purchasing power. The most well known measures of inflation are the CPI, which measures consumer prices, and the GDP deflator, which measures inflation in the whole of the domestic economy.



The stock market has responded to the improving economy in a dramatic way. Since January 1 and through November 30, 2009 the Dow Jones® Industrial Average is up 21.52%, the S&P 500® Index up 24.07%, and the NASDAQ® Index up a whopping 35.99%! Who would have thought the stock market would have produced these kinds of returns after last years thumping? If investors finally begin to believe this economic recovery is for real, the stock market could continue this run through 2010.

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Asset Allocation for Today

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In other words they buy high and sell low.

To make asset allocation work, investors have to be willing to buy assets that no one wants, that are down in price, that look as if they will never recover. They would have to sell assets going up in price that everyone wants and that look like they are going to the moon. Not an easy bridge to cross!

The broadest and easiest form of asset allocation to understand is a model based upon equal parts stocks, bonds, and cash. Periodically the holder of this portfolio would sell a portion of the assets gaining value and buy that class going down in value. This requires faith that the asset classes will periodically cycle from low to high.

In strong up markets, this implies selling favorite stocks, for example, and buying low performing bonds. Last year, this would have required investors to sell some of their bonds as the market was falling and use the proceeds to buy stocks. This required a lot of discipline when the nightly news was reporting the latest round of economic doom and gloom. Those that practiced this discipline have been rewarded as the market has recovered. They are now faced with selling some of their stocks to buy bonds because they are over weighted in stocks. This may not be easy to do with bonds yielding less than 4%.

The stock portion of the allocation needs to be diversified as well. Asset allocation in stocks should focus on investment style. Style refers to value vs. growth, large cap vs. small cap, and domestic vs. international equities. Style analysis works well when reviewing performance of mutual fund managers where funds have a wide variety of holdings.

Stanford Professor and Nobel Prize winning economist William F. Sharpe pioneered returns-based style analysis. This allows investors the opportunity to evaluate portfolio managers by estimating a portfolio manager's style by determining the mix of passive benchmarks that best matched the actual returns of the fund.

This technique enables an analyst to develop a perspective about how the fund might behave in the future based upon historical performances. Always keep in mind that historical performance does not guarantee future performance. We are still subject to event risks that can disrupt the ordinary course of events in an economy and the investment markets.

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Rick's Tips - Do you have a *written* financial plan?

A famous general, who later became our President, once told us "Plans are worthless, but planning is everything." Much the same can be said for financial plans.

You absolutely must have a financial plan before you plan an investment or tax strategy. Those without a financial plan were the first ones to sell their stocks in the 2008 decline. They didn't know where they were going financially. Without the long term perspective that we believe is so essential to financial success, they sold their stock positions when they should have been buying.

I believe we get carried away with the idea that financial planning is a huge, complex task. In fact, it can be pretty simple. Or, as I once heard a speaker conclude at an industry conference, "We all want the same thing … that is to pay our taxes, educate our children and retire comfortably."

Over the years I have written many, many financial plans. To one degree or another, these plans touched the major areas of planning: cash flow, investments, net worth, taxation, risk management, specific goal achievement, estate plan and finally retirement. No doubt, every one of these areas is key to a good plan, but I've learned that the analysis that goes into the plan is not as important as the organization of the materials, the process of thinking through the relationship of each area to the plan as a whole, and the establishment of benchmarks by which we can mark progress. You can read more about writing a financial plan by downloading my article *How to Write a Financial Plan* at the Rodgers & Associates website.

You should keep in mind that a successful retirement is not just about money … it's about your health and well-being as well. It doesn't matter how much money one has when they enter retirement if their poor health precludes enjoyment of their financial success. Proper dietary practices and a good exercise regimen are the least expensive of all "set-asides" in life, but for some, the most difficult. There is nothing complicated about a financial plan that calls for eating right, exercise and saving a little at a time.

Setting up a dietary plan or a gym routine is beyond the scope of my expertise, but I do think we can tune up our financial lives by considering what author Thomas Stanley, PhD, "The Millionaire Next Door" describes as common denominators of the wealthy. They live well below their means. They allocate time, energy and money efficiently in ways conducive to building wealth. They believe financial independence is more important than social status. Their parents did not support them. Their adult children are economically self-sufficient.

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