



# ELHOFF FINANCIAL COUNSELING

## Two critical investing lessons from Japan

“The only certainty is that nothing is certain.”

- Pliny the Elder

“It ain’t what you don’t know that gets you into trouble. It’s what you know for sure that just ain’t so.”

- Mark Twain

Two quotes written 1,900 years apart that highlight two important lessons for investors from the recent events in Japan. One is the need to construct portfolios that expect the unexpected and anticipate the unanticipated. The other relates to avoiding one of the costliest traps that ensnares investors.

## Market performance in the first quarter

Markets in January and February 2011 saw a continuation of last year’s positive sentiment. This was spurred by solid corporate profits and a broad consensus that while the global economy might not experience a strong recovery going forward, it would see growth.

March did see a setback. The earthquake and tsunami in Japan on March 11, which took a dreadful toll in human life, have also clearly reduced short-term prospects for the global economy. The turmoil in North Africa, while positive for oil prices, also had a negative impact on markets due to concerns about the effect on consumer demand.

Notwithstanding this, developed markets generally saw gains at the end of the first quarter that put them on track for solid performance in 2011. Of note, results outside of the U.S. were boosted by the weak dollar. For example, first-quarter gains in Europe were 6% in dollar terms, 2% in local currency.

### Market Performance Q1 2011

	U.S.	Europe	Japan	Emerging Markets	World Stock market
January	+2.4%	+4.0%	+/-0%	-2.8%	+1.6%
February	+3.3%	+3.3%	+4.6%	-1.0%	+2.9%
To March 25*	-1.0%	-1.1%	-8.5%	+3.4%	-1.1%
Q1 to March 25*	+4.9%	+6.2%	-4.2%	-0.2%	+3.5%

Source:MSCI index

• Note: These performance numbers will be updated to the end of March on April 4

## Interesting Facts:

**DROPS HAPPEN** Since the S&P 500 bottomed on 3/09/09, the stock index has gained +94.2% through the close of trading Friday 3/25/11 (change of the raw index not counting the impact of reinvested dividends). There have been 6 different pullbacks of 5% or more since the 3/09/09 bottom. The average depth of the pullbacks has been 8.0% over an average of 18 days. The deepest and longest was a 16.0% drop over the 49 days that ended on 7/02/10. The S & P 500 is an unmanaged index of 500 widely held stocks that is generally considered representative of the US stock market (Source: BTN Research).

**DOWN THEN UP** After losing 16.0% over the previous 49 trading days through 7/20/10 (see bullet # 1 above), the S & P 500 gained +12.1% over the subsequent 3 months and +23.0% over the following 6 months. The results were based upon the change of the raw index and do not include the impact of reinvested dividends (Source” BTN Research).

**BIG BUCKS** - 3 out of 5 richest people in the world today are Americans, but for only the 2nd time since 1994, the globe’s richest person is not an American. Mexico’s Carlos Slim (worth \$74 billion) is ranked # 1 (Source: Forbes).

**IS THAT ENOUGH?** - 72% of American workers surveyed believe that they will need to accumulate no more than \$1 million to enjoy a comfortable lifestyle during their retirement years (Source: Employee Benefit Research Institute).

## Interesting Facts:

**CONSUMING A MILLION** - A lump-sum of \$1 million in a tax-deferred account will sustain a static \$73,800 withdrawal for 25-years assuming the assets continue to earn 6%. However, if the \$73,800 annual withdrawal is adjusted upward each year to account for an assumed 3% rate of inflation, the funds are able to make only 17 years of payments. This mathematical calculation ignores the ultimate impact of taxes on the account which are due upon withdrawal, is for illustrative purposes only and is not intended to reflect any specific investment or performance. Actual results will fluctuate with market conditions and will vary (Source: BTN Research)..

**STAYING ALIVE** - The life expectancy at birth of an American male is 75.7 years today, an increase of 10.1 years since 1950. The life expectancy at birth of an American female is 80.6 years today, an increase of 9.5 years since 1950 (Source: National Center for Health Statistics).

**UP JUST ONE YEAR** - The normal retirement age (NRA) in 2011 to be eligible for full Social Security Benefits is 66 years. The NRA in 1950 to be eligible for full Social Security benefits was 65 years (Source: Social Security).

**A HEAVY LOAD** - 1 out of every 15 Americans is either suffering from Alzheimer's or is an unpaid caregiver helping a friend or family member that is living with the disease (Source: Alzheimer's Association).

**NOT RIGHT AWAY** - The latest official recession in the USA began on 12/31/07 and ended on 6/30/09 (i.e. the end date was 21 months ago). In the 2 other recessions our nation experienced in the last 25 years, the Federal Reserve first raised interest rates 34 and 31 months after the recession officially ended (Source: National Bureau of Economic Research, Federal Reserve).

## Learning to live with uncertainty

If they operate efficiently, stock and bond markets incorporate all the available information at a given point in time. That's why, when sovereign debt problems emerged in Greece early last year, other European countries seen as having potential problems along the same lines saw an immediate spike in the cost of insuring their debt. Even though they hadn't run into problems yet, the market factored this possibility in.

Market analysts spend many thousands of hours each year looking at these kinds of issues-with enough time and research, slow-forming problems like government debt issues can be analyzed beforehand.

What can't be anticipated are developments that are by their nature unpredictable. We've had at least four such events in the past year:

- Last April's volcanic eruption in Iceland that spewed ash in the air, shut down 100,000 transatlantic flights, and cost the airline industry \$2 billion
- Also last April, the explosion of the Deepwater Horizon oil rig in the Gulf of Mexico
- Commencing in December, street protests resulting in changes of leadership in a number of countries in North Africa, leading directly to the current military action in Libya
- And, of course, the earthquake, tsunami, and nuclear-reactor crises in Japan.

In light of episodes like these, investors need to take away two key lessons.

### Lesson One: Expect the Unexpected

The only way to deal with uncertainty and manage the impact of unforeseen events is to build strict risk controls into portfolios, similar to those used by the most sophisticated pension funds. While the risk of one-time incidents can't be eliminated, through diversification and risk management we can limit the damage when negative events occur-whether they be massive frauds such as Enron, sudden bankruptcies like Lehman Brothers, volcanic eruptions, oil rig explosions, or earthquakes.

I thought it might be useful to provide an overview of my approach to risk management in portfolio construction. There are three steps in this process.

Step one is to identify the target mix of stocks, bonds, cash, real estate, managed futures, annuities, and other alternatives that- based on historical precedent and current valuation levels-will over time have a high likelihood of providing the returns you need to achieve your long-term goals with a level of volatility you can live with along the way.

In step two, we and the money managers we work with carefully diversify your portfolio by placing limits on the exposure to any one asset class company, industry sector, or region. For individual holdings, it's typically an absolute percentage of your portfolio.

As well, no matter how high our optimism about an asset class, industry sector or region, its weight should never be more that 50% above its underlying importance in the market as a whole.

In the final step, at least once a year, there is an in-depth analysis of each portfolio. Over time, asset classes, industry sectors that do well will increase their presence in your portfolio and bump up against the risk control limits.

## Interesting Facts:

**OUT OF CONTROL** - Federal spending during the current 2011 fiscal year (i.e., the 12 months ending 9/30/11) is projected to be \$3.7 trillion. Federal spending for fiscal year 2021 is projected to be \$5.7 trillion. Actual federal spending during fiscal year 2001 was \$1.9 trillion (Source: Congressional Budget Office).

**FOR SALE** - The number of existing homes for sale jumped by +119,000 (to 3.5 million) from the end of January 2011 to the end of February 2011. By comparison, 4.6 million existing homes (as opposed to new homes) were on the market for sale as of 7/31/08 (Source: National Association of Realtors).

**DOUBLE DIGIT** - The average interest rate nationwide on a 30-year fixed rate mortgage was at least 10% for the 12 consecutive years of 1979-1990 (Source: Housing and Urban Development).

**HISTORICALLY LOW** - The average interest rate nationwide on a 30-year fixed rate mortgage was 4.81% last week, 64 basis points higher than the 4.17% record low set in mid-November 2010 (Source: Freddie Mac).

**BANKING** - 157 federally insured banks failed in the USA last year (2010), only the 12th time in the nation's history that at least 100 insured banks have failed in a single calendar year. The FDIC was established in 1933 or 78 years ago. 23 banks have failed in the first 2 months of 2011 (Source: Federal Deposit Insurance Corporation).

**A VERY LONG SHOT** - When last year's major league baseball season began in April 2010, the odds against the San Francisco Giants winning the 2010 World Series were 32 to 1 (Source: USA Today).

At that point, your portfolios need to be rebalanced back to the target asset allocation, and some of the positions that have outperformed might be trimmed to stay within risk control limits. Some investors find this very difficult-after all, you're selling exactly those investments that have done the best.

But it's the only way to stay truly diversified and control the risk that accompanies overexposure to any one asset class, industry sector, or geographic region. And it's also the only way to get some protection from things that simply can't be anticipated.

### Lesson Two: Avoid overconfidence

Aside from the time entailed, there is one big negative to the risk-controlled approach to portfolio construction: in the short term and mid term, there will always be someone who's made a big bet that has paid off and who is doing better than you as a result. Because it eliminates big bets, a risk-controlled approach to investing will seldom give you bragging rights on the golf course.

Investors who take the big-bet approach typically have a high degree of confidence in their investments; after all, if you're absolutely certain about a company or industry, why bother to diversify? On the other hand, research by the University of Chicago's Richard Thaler has demonstrated that overconfidence is among the most costly traits an investor can have.

Look no further than the many employees in Silicon Valley during the tech boom. They were 100% confident about the future of their firms and often had all of their retirement accounts invested in the companies they worked for as a result. These investors saw sterling results for a while-right up until the tech bubble collapsed.

The quote from Mark Twain at the start of this letter says it all. The sources of trouble aren't the things we've identified as question marks and causes for concern. Rather, what causes portfolios to crater are the things that we're absolutely positive about right until unanticipated occurrences catch us by surprise.

We've always had unexpected events and always will. And despite that unforeseen events, economies have grown, companies have prospered, and stock markets have generated positive returns. The key to benefiting from this long-term growth has been to diversify so that no single event can create permanent damage to your portfolio.

I believe that we will work through the recent events and that investors with a balanced approach and long-term view will be well rewarded. The approach to risk management I've described may not be fun or sexy in the short term, but all the evidence at hand suggests that over time it will serve you well, getting you to your goals with the least amount of stress and distress along the way.

Should you have any questions on your portfolio, the contents of this note, or any other issue, please give me a call. I'd be happy to deal with your questions on the phone or at our next meeting.

### We have a plan, we have a process and we have discipline.

As always thank you for the opportunity to work together.

The above commentary contains opinions and analysis that are provided by the author for informational purposes only and should not be used as the primary basis for an investment decision.

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