

FEELING CAUGHT IN THE BACKFIELD?

Bill Henderly, CFA, Nvest Wealth Strategies, Inc.

Investing for the long-term seems so contrarian these past couple of years. Contrarians don't always relish the opportunity to be contrary. Rather, it's more that they are guided by a nagging belief – a belief in “that which is ‘certain’, is certain to be wrong.”

When talking with investors, we often review the cycle of market emotions. It basically reveals that too many investors act when they “feel good”, meaning they invest in stocks, bonds, or tech stocks when all the news seems positive and their friends are touting the same hot idea. Vice versa, they sell when all the news is bad (and prices have already dropped). In essence, many invest in ways similar to their emotions, AND the long-term results are never attractive. The key to successful long-term investing is to invest opposite of one's normal intuitions or emotions; easy to say, but hard to do. This is being contrarian (often feeling a bit out of synch).

It's never easy to play offense in the market when it feels like one is repeatedly crushed in the backfield by players you never even knew were on the field. Last year Greece, Ireland and Eurozone were unexpected tacklers and the flash-crash assaulted investor confidence; who would have identified Egypt as a source of economic dislocation in 2011? It only takes a few instances of having to pull turf out of your facemask to get a little “gun-shy”. (Hey, it's Super Bowl weekend, and we need some football analogies - even Ben Bernanke is aware that one team playing has a quarterback named Ben.)

January proved to be influenced by domestic and world news events. It started well, but was caught in the backfield by negative headline news on municipal bonds, and Egypt. And, the offensive players even changed without notice. Last year, small- and mid-cap stocks with a growth-style bias performed best. Investors pulled money from money market funds and stocks continuing to invest heavily in bonds. In January (2011) money is starting to move from bonds into stocks. The best performing stocks were mega large-cap and yield oriented. Investors are reaching for yield – buying stocks that look like bonds, and owning bonds that have some stock characteristics. The search for yield means buying duration (longer maturity) since short maturities offer very low yields. Buying duration (in bonds) will prove very uncomfortable as interest rates rise this year and/or next.

Stock fund performance was mixed in January, and bonds generated diverse results as well (corporate bonds performed well; while Treasuries and municipals sold off). Client portfolios moved upward in positive fashion.

Style	January
Large Value	+2.4%
<i>S&P 500</i>	<i>+2.4%</i>
Mid Value	+1.9%
Large Growth	+1.7%
Foreign	+1.3%
Mid Growth	+1.3%
Small Growth	+0.5%
Small Value	+0.5%

Client Objectives	
(Stocks/Bonds)	January
20/80	+0.7%
35/65	+0.8%
50/50	+1.0%
65/35	+0.7%
80/20	+0.5%
95/5	+0.5%
<i>S&P 500</i>	<i>+2.4%</i>

CONTACT US:

2310 Home Road
Delaware, Ohio 43015
740.917.9234

WWW.NVESTWEALTH.COM
Email: info@nvestwealth.com

The key for long-term success is to invest using style diversity. However, January proved just the opposite - being narrowly focused (in mega-cap, yield focused stocks and stock-like bonds) would have worked best.

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FEELING CAUGHT IN THE BACKFIELD? -CONTINUED-

Tension exists for all investors (contrarians, timers, or long-term “time in the market” investors) between what appears to be a cyclical upturn in the economy and the growing and seemingly unsolvable issues surrounding the developed world’s financial health (too much debt). There is a guarded optimism for an improving economic trend and the outlook for equities in a very uncertain world.

History would suggest it is too early to fade either the economy or the stock market advance. Our current recovery is 20 months old while the average recovery’s duration is 45 months (over the past 110 years). And, since 1928, the average bull market lasted 57 months providing a 164% average gain. Our current “baby” bull market furnished investors a 91% price return in 23 months. Thus, it would seem both the economic expansion and stock market rally have additional room to advance.

The economy seems likely to continue because global policymakers are trying to move “heaven and earth” to prevent deflation via a generous mix of low interest rates and a tsunami of fiscal and monetary stimulus. Yet, emerging/developing countries are pressured with rising commodity prices and too-fast economic growth, creating fear of inflation. As a result, investor’s fear the Fed will act too late, after inflation rises too far (inflation is a lagging economic indicator like the unemployment rate).

Please recall from our year-end client newsletter article, “All Hands on Deck” that the third year of a president’s term is historically the best; Obama wants unemployment down with economic expansion continuing. We expect 2011 should be an attractive year to be invested in stocks. Stocks are more a catalyst than a discount (at this point); meaning, as Bernanke expects “higher stock prices will increase confidence” (business, bank lending, and consumers).

Meanwhile, bonds remain an important portfolio diversifier, but require significant care in utilizing at this time. It is normal to see interest rates rise as the economy expands. After QE1, bond yields surged 150 basis points to 4%. In similar fashion, bond yields are on the rise with QE2, already rising 90 basis points to over 3.6% (probably headed to 4%). Steepening yield curves are a fairly reliable indicator of impending stronger economic growth (Barron’s, 2/7/2011). In the past 45 years, bond rates were much higher than today with faster GDP growth. Interest rates have a ways to rise before stock investors should worry.

Near-term (February is a seasonally soft month), the stock market looks tired. It may be trading at a near-term peak. But, fund flows into stocks (from bonds) just started. To us, it appears the market is positioned for short-term consolidation (of 5% - 6%). It remains difficult to find any evidence that a major topping process is developing or the economy will stall out (even when QE2 concludes or fades mid-year; no QE3 is expected). We would greet any near-term market weakness as a buying opportunity; not a reason to sell and expect 2011 to be an attractive performance experience. The “can is still being kicked down the street”; but the “bill will come due” (unlikely in 2011).

Egypt – What Are the Implications?

The uprising in Egypt provides the US and many world financial markets an opportunity to sell-off (albeit slightly) following strong advances over the past 8 weeks. Egypt’s political unrest, on the heels of similar events in Tunisia, is about political ideology and representation. Its root cause however, relates to rapid increases in agricultural commodity prices. Citizens in developing countries spend an inordinate amount of their disposable income for food. When food commodity prices rise quickly (from weather and/or hedge fund speculative activities), poorer developing nation’s citizens are keenly impacted. As in the past, the result is riots that can create political and government adjustments. These events can cause temporary financial market dislocation.

Nvest Wealth Strategies, Inc. | *Delivering financial peace of mind.*

www.nvestwealth.com

Ph: 740.917.9234

2310 Home Road

Fax: 740.917.9234

Delaware, Ohio 43015

Email: info@nvestwealth.com

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