

BUMPY JOURNEY TO NEW DESTINATION

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Let's not make trivial or dismiss the bad experience of May for investors in the financial markets. However, ...looking back, very little actually resolved in May. There were many announcements, but little progress was made. While the European Union, ECB, and International Monetary Fund extended financial support to Greece, the country remains insolvent. The BP oil rig continues to spew oil, while the price of oil floats around \$70/barrel. Both houses of Congress passed their own versions of financial reform legislation, but reconciliation may result in different regulations and protections. Instead of getting resolution, we are getting more confusion. With confusion comes volatility causing investors to become emotional about their future prospects.

Almost across the board – from bonds to stocks, international investments to domestic – the month of May was frustrating. The fits and starts reflect great expectations being dashed, but worst-case scenarios are not being realized. Extreme optimists are being proven wrong, but so too are extreme pessimists. The key question of the day, and for upcoming evaluation, is “will the bad contaminate the good”, or “will the good rescue the bad?” Structural problems (too much debt) require structural solutions; structural solutions take time, because politicians are involved and don't have a unified solution. Thus, risk aversion increases as investors are not sure of what responses will be tried or will work. Watch out for speculators who “bet” on short term volatility to make a quick buck; in the process they increase up/down market action and frustrate long-term investors.

Stocks experienced their worst month since February 2009 (near the bear market bottom) and the worst May since 1940. The S&P 500 lost almost 8%. This setback erased the total gain for the stock market in 2010. As expected, client portfolios with conservative objectives were less affected than growth objectives.

| Style | May | YTD |
|--------------|--------|--------|
| Small Growth | -6.9% | +4.1% |
| Mid Growth | -7.0% | +3.1% |
| Mid Value | -7.7% | +3.8% |
| Small Value | -7.8% | +7.2% |
| Large Growth | -7.9% | -3.1% |
| S&P 500 | -8.0% | -1.5% |
| Large Value | -8.3% | -1.7% |
| Foreign | -10.7% | -10.6% |

| Client Objectives (Stocks/Bonds) | May | YTD |
|-------------------------------------|-------|-------|
| 20/80 | -2.0% | +1.3% |
| 35/65 | -3.2% | +0.9% |
| 50/50 | -4.3% | +0.4% |
| 65/35 | -5.5% | -0.1% |
| 80/20 | -6.3% | -0.2% |
| 95/5 | -7.0% | -0.8% |
| S&P 500 | -8.0% | -1.5% |

We do not expect (nor does the research we receive) that the “bad will contaminate the good.” The various governmental stimulus actions of the past couple of years provide economic tailwinds to keep the world recovery and expansion advancing. In general, we are experiencing a soft patch. Those sovereigns with heavy debt will experience soft or backward economic growth; those with low or no debt will expand their economic opportunities. The US expansion is still in place – we have low/zero interest rates, positive yield curve, profits have expanded 31%, and employment is expanding (slowly). The base case remains for continued expansion in the US, albeit slower, despite high chances for another European dip. For the US, given its level of debt, a slow growth experience is very probable. Inflation will stay very low and contained, and deflation worries as deleveraging continues, will allow the Fed policy to remain accommodative longer than expected.

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SUPER SAVER -CONTINUED-

In search for a smoother ride, some investors have turned from stocks to bonds, as evidenced by money flows being 17 to 1 into bonds versus stocks. We understand the comfort feelings being pursued – it is perceived safety after the roller coaster ride equity investors have experienced over the past few years. Caution: “chasing” what worked in yesteryear (high quality bonds) may prove treacherous in the future. Most everyone expects interest rates to rise (they can’t go lower than current zero). When interest rates rise, bond prices will fall. That means the value of bonds will decline, and even accounting for interest received, the total value will likely be a loss. The typical risk hierarchy is likely reversed – stocks are actually less risky than bonds in today’s market. Stocks are oversold (while bonds are currently in hot demand providing low yields). It is important that we remind investors of the value of adopting and adhering to long-term investment plans which target asset weightings. Emotions often lead investors away from long-term plans, and often in the wrong direction. We endorse “buckets of time” investing, which “matches” cash needs to “buckets of time.”

Structural problems require structural solutions. Structural problems are the headwinds we feel today. During this time when solutions are tried and implemented, a bumpy journey to a new destination will occur. This is normal. Economic tailwinds exist today, unlike in 2007 and 2008 when the bear market was underway. Thus, it is very important investors not be so consumed with emotions as to “sell out” on long-term goals and plans. A soft patch is just another bump on the journey. We will continue to monitor the environment (economic and political) closely in conjunction with managing your investment portfolio.

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