

DRIVING WITHOUT A SPARE

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Anxiety; uncertainty. These are feelings one may have driving a car in unfamiliar territory on an uneven road having no spare tire. Or, similar is the discomfort about needing to travel another 25 miles to the nearest exit to find gasoline when your refuel light is on.

This is of course analogous to the economic and financial journey we currently travel. The journey will be bumpier to an unknown destination; a multi-year journey toward the "New Normal". It could well be a world of shifting risks and opportunities that provide a wider range of potential investment return experiences. Our economic ride is likely to include: weak growth in developed economies (with high debt levels) and migration of growth toward emerging markets (with low debt); a prolonged process of consumer balance sheet rehabilitation along with deteriorated public finances; and the continued uncertainty from increased politics to resolve excess debt issues and stimulate the economy, while imposing heavier involvement in private markets (especially finance, healthcare, and energy). For investors, this is a bleak and scary look at the horizon while driving in unfamiliar territory without a spare, or low on gas.

During August, investor sentiment (attitude) slid to its lowest reading since 1987, and matched the lows of March 2009 (when the recent bear market hit bottom). Sentiment deteriorated from a hope for a slow growth recovery (July), to concern for a double-dip recession (August). It also seems Washington's track is anti-business (which is needed to help recover growth and employment). Thus, all stock investment styles generated negative returns during August while bonds performed well. All client objectives slipped during the month as well, with conservative objectives being only slightly impacted; the most aggressive did much better than the S&P 500.

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Style	August	YTD
Foreign	-3.2%	-6.4%
Mid Growth	-4.5%	-1.4%
S&P 500	-4.6%	-5.0%
Large Value	-4.7%	-5.5%
Large Growth	-4.8%	-7.2%
Mid Value	-5.1%	-1.5%
Small Growth	-6.1%	-3.3%
Small Value	-7.2%	-2.1%

Client Objectives (Stocks/Bonds)	August	YTD
20/80	-0.5%	+2.7%
35/65	-1.2%	+1.9%
50/50	-2.1%	+0.7%
65/35	-2.6%	-0.1%
80/20	-3.2%	-1.5%
95/5	-3.8%	-2.8%
S&P 500	-4.6%	-5.0%

Portfolio returns for the year-to-date reveal a couple of interesting features. To be sure, in an uncertain environment, one expects that a conservative objective should perform better than a growth objective (which owns more risk). But, the other hidden idea is heavy ownership of bonds (in conservative portfolios) - investors must exercise extreme care going forward, as bond yields are historically low (prices are very high). [Caution: bond exposure in Nvest client portfolios, conservative and growth-oriented objectives alike, should not be cause for alarm; we have intentionally structured bond exposure toward very short maturities to minimize negative price action should the "bill come due", wherein low-yield (high priced) government bonds spike upward (yields would rise and prices would subsequently fall).]

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DRIVING WITHOUT A SPARE -CONTINUED-

As discussed last month, it appears “black and white” that bonds are priced in bubble territory while stocks are cheap (relative to bonds). If zero-yielding money market funds carried a price/earnings (P/E) multiple, often used to price stocks, their current P/E would be well over 100x. 10-year Treasury Notes at 2.5% would price at a P/E multiple of 33x, while many stocks with fortress balance sheets (tons of cash) sell with a P/E of 13x. Do these high P/E ratios (for MMF and bonds) sound like “irrational exuberance” where tech stocks were valued in 2000? Said differently, would you own a 2.5% 10-year Treasury bond, or 2.5% 10-year Pfizer corporate bond, or a 4% dividend yield on a basket of quality stocks like Exxon Mobil, Proctor & Gamble, Johnson & Johnson, Verizon, Pfizer, GE or Merck? Stock yields are currently more competitive with bond yields than at any time since the early 1960’s. Risk is upside down with investors pouring money from no-yielding money funds into bonds (and not investing in stocks). It’s truly a crisis of confidence (low investor sentiment). If you feel compelled to crowd into bonds, think carefully. You are courting disaster; stay short; don’t reach for yield.

With such poor sentiment, the stock market is trading like there will never be economic growth again; or that capitalism is dead. Aside from concerns about Washington actions, investor lack of confidence also stems from recent investment performance over the last two decades. At the start of 2000 (after Y2K) stocks completed a decade of fantastic almost 20% per year returns. Stocks ended 1999 at all time high values. Looking back, could it continue? No; bonds led the performance parade in the most recent decade ending 2009. As we began this new decade, bonds are the favored choice because stocks generated zero return. Now we are sitting just opposite of Y2K, stocks at low valuations and bonds at high (price, low yield) valuations. What do you think will happen? Black and white; stocks will outperform bonds; and long-term stock investors will reap rewards.

Presently investor sentiment is downright gloomy. Only 21% of individual investors are bullish, a level that matches 1987 and March 2009. Since 1987, 31 of 34 times (91%) sentiment was this low, the stock market advanced during the next 12 months; the average advance was almost 18%.

Remember the spare tire, or lack of one? While the Fed has used its traditional monetary tool of lowering interest rates to stimulate the economy, it feels like the Fed is driving the economy without a spare tire (already used it). The Fed recently stated they would “quantitatively ease” (buy US Treasury securities) to put cash into the financial system to avoid a double-dip event with the economy. Flowing cash stimulates business growth which also advances stock prices. We do not anticipate a double-dip, but expect a continued slow growth environment. With that, a broadly diversified portfolio utilizing a global tactical structure could/should provide growing portfolio values. We welcome hearing from you regarding your thoughts.

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