

PULL A RABBIT FROM THE HAT

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August was anything but a vacation for investors. The carefree days of summer were packed with emotion requiring raw nerves to endure the heat – contentious debt-ceiling negotiations, a downgrade of the world’s risk-free asset (US debt), persistent capital inadequacy concerns among European banks, continuing Euro sovereign debt issues, an earthquake and a hurricane along the east coast. Should we wonder if locusts and toads might be next?

It seems the fate of the global economy is heavily reliant on any number of political decisions this fall that are difficult, if not impossible to anticipate their outcome. The decisions of a small number of policymakers, some democratically elected and some not, will likely keep US and foreign financial markets on uncertain edge.

For the domestic scene, public expectations are low; it seems unlikely the Super Committee of 12, Congress and/or the President will enact anything to boost economic growth and employment without increased spending or taxes. With such low expectations, it would be almost impossible not to exceed public views (and that could provide an upside market surprise).

Forecasting political direction in Europe (EU) is more daunting. There is little doubt that Europe’s political elite wish the single currency to survive. Yet, the lack of common political policy lends itself to the prospect for continued economic and financial instability – and a feeling of extraordinary bearishness. Remember though, from such pessimistic views a consensus could finally develop (or maybe it is imposed via financial market vigilantes) to create a Eurobond, unified monetary accommodation (rate cuts), and new tax system. Ultimately Europe will either get fiscally closer together, or monetarily further apart. Again, with such low expectations, it would be almost impossible not to exceed public views (and that could also provide an upside market surprise).

In the near term, it is difficult for a world public (and investors in particular) to be convinced that there is enough political will among politicians on both sides of the Atlantic to proactively move to make structural reforms in the absence of another financial crisis. It feels like desperate hope that leaders will “pull a rabbit from the hat” and make it turn out right. [Hey, this is sounding too pessimistic!]

The equity market endured a good deal of technical damage over the last 4 weeks – support failed, rallies were sold, and internals weakened. The financial markets are acting as public policy vigilantes in the developed world. August was the worst month of the year for all stock market components, and that impacted client portfolios (for the month and year-to-date).



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| Style | August | YTD |
|--------------|--------|-------|
| S&P 500 | -5.4% | -1.8% |
| Large Growth | -6.5% | -2.1% |
| Large Value | -6.6% | -5.1% |
| Mid Growth | -7.9% | -3.3% |
| Mid Value | -7.9% | -6.2% |
| Foreign | -8.6% | -6.3% |
| Small Value | -8.9% | -8.2% |
| Small Growth | -9.3% | -4.5% |

| Client Objectives (Stocks/Bonds) | August | YTD |
|----------------------------------|--------|-------|
| 20/80 | -1.9% | +0.2% |
| 35/65 | -2.7% | -0.5% |
| 50/50 | -3.8% | -1.1% |
| 65/35 | -5.1% | -2.7% |
| 80/20 | -6.5% | -5.0% |
| 95/5 | -7.9% | -6.3% |

PULL A RABBIT FROM THE HAT -CONTINUED-

During August, we ratcheted back on equity portfolio risk by slicing a percent here/there from several stock funds. These funds generally showed higher down-market capture ratios. We also trimmed some exposure from developed foreign stock funds. In essence, we adopted a “pre-cautionary caution until structural reform” occurs. “Kick the can down the street” policies are passé, or seem no longer tolerated. Policy moves, that in the past cushioned the blow but didn’t solve the physical problem, are not allowed consideration due to declining public approval of politicians. Huge debt levels (sovereign and private) must be reduced (cleared) in the financial system or confidence will remain depressed. It cannot be revived via the Fed (monetary policy), but through fiscal policy (reduced spending and flatter tax rates with fewer deductions that boost tax revenues and reduces the deficits).

Even with all the increased uncertainty, we must continue to invest client portfolios using utmost care. “Financial repression” will keep interest rates low for an extended time, and functions as a “tax” on savers owning government paper. Financial repression will also likely lead to shorter business cycles. As a result, we expect investors to search for yield and growth via investing in stocks that can look like bonds – companies that can raise dividends. Seek yield, or growing dividend rates; both have merit for investor portfolios. We expect growing dividends will provide better total return opportunities than yield alone (supported by historical info). Further, owning short-maturity bonds (though lower yielding) is safer than reaching for yield by owning long; such action is really buying duration (long maturity increases price volatility exponentially). Foreign stock exposure continues to be appropriate as most developed and developing market stocks pay dividends. Second, developing market economies remain faster growing than developed countries (with high debt, such as US, Europe, etc.). And, we anticipate more global synchronization than ever in the future, making global investing an important pursuit.

We advocate investing portfolios in easily marketable investments and using different asset classes to create a diversified portfolio. It is critical to maintain “buckets of time” components in your portfolio which provide maximum flexibility during uncertain times. Extreme uncertainty and volatility is not healthy for the markets, but often leads to compelling opportunities for investors. One of the best times to enter the markets is when everyone else is exiting. Years of investing taught us that adhering to core philosophies and strategies do work. Current times are uncertain; yet long term plans require a focus on long term proven investment processes.

Interesting thought: government policy tools “at times, it feels like there are a lot of screwdrivers in the tool box, when what one really needs is a hammer.”

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