

KEEP SEAT BELTS FASTENED

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October is often remembered for its big scare – Halloween tricks and stock market frights in 1929, 1987 and 2007 provide several examples. Just the opposite with October 2011; it was a sweet treat. This October follows terrible market experiences in August and September. In any case, the October rally provides relief to recent experiences while also leaving investors scratching their head concerning what's next. Volatility in the financial markets is all over the place, and only seems likely to continue. With significant political uncertainty in Europe (Greece; is Italy next), and the US Super-Committee of 12 divided along party lines, sluggish economic outlooks here and overseas, create a market backdrop of volatility which is likely to remain. Market direction seems unlikely to be clearly defined, either up or down. Guess that is why this month we encourage investors to “keep their seatbelts fastened.”

The stock and bond components of client portfolios performed well in October, as short-term traders generally employed a “risk-on” trade. Short-term traders are capricious, moving quickly to and fro with “risk-on” to “risk-off” as the political news of the day surfaces. Recently Europe garners the ongoing attention. International stocks were generally softer performing than domestic (and hurt overall performance all year) and our precautionary action move with cash to reduce portfolio volatility slowed overall rebound during October. Are we out of the woods yet? Early days of November provide testimony with Greece, that keeping your “seat belts fastened” seems prudent. We feel a heavy burden to reinvest cash, however. There will not be a perfect time to reinvest, and we expect to nibble and step back into our long-term philosophy of “time in the market.” Politics make the economic and investment environment very fluid. And we anticipate policy actions will appear like Band-Aids on the wound; maybe over time it will look like Band-Aids on Band-Aids; maybe even like a mummy.

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Style	October	YTD
Small Value	+14.8%	-6.1%
Small Growth	+14.7%	-2.3%
Mid Value	+13.5%	-4.5%
Mid Growth	+13.4%	-1.6%
Large Growth	+11.8%	+0.4%
Large Value	+11.5%	-2.8%
S&P 500	+10.9%	+0.8%
Foreign	+10.0%	-8.8%

Client Objectives (Stocks/Bonds)	October	YTD
20/80	+2.5%	+0.3%
35/65	+3.8%	-0.5%
50/50	+4.2%	-1.1%
65/35	+5.6%	-2.8%
80/20	+5.9%	-5.2%
95/5	+7.0%	-6.4%

The material swing in economic outlook from June to August to October is confusing to investors. It may also be indicative of the volatile and range-bound financial market conditions likely to exist through this cycle's end. Due to a series of poor political choices, the US and developed economies globally are caught in the course of slow economic growth over the next 18 to 24 months. Depending on the level of government debt, we truly have a variable-speed global economic outlook. Those with debt to reduce will grow slowly (at best) and those without debt will show faster growth (dependent on debt-burdened political errors). For the US, it is a struggle to identify the organic driver of economic growth that would replace government's net spending in an era of coming austerity. Best solution is 1) less regulation, and 2) a flatter, simpler (less deductions) corporate and personal tax structure, while adding entitlement reduction plans. Against this backdrop of political influence emerges “financial repression” (imposed via low interest rates), and the fact that the “bill has come due” for past decades of fiscal overindulgence. Unfortunately, the opportunity for political mistakes does not seem to be fading anytime soon; be wary of politicians clearing their throat incorrectly.

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KEEP SEAT BELTS FASTENED -CONTINUED-

In past commentary, the “New Normal” term was shared. We live in the “new normal” since the debt-bubble debacle of 2007 – 2008. As we now experience policymakers on both sides of the Atlantic attempting to deal with various economic imbalances (the result of ballooning debt), investors (businesses and individuals) are confronted with a number of anomalies, or deviations in excess of what investors would expect based on historical variations. For example, historically portfolios structured for growth, owning more stocks and thereby higher risk, earned higher returns than portfolios of mostly bonds. The last several years the risk/return experience is upside down – less risk experienced better returns. Is this the new normal?

In bond world, a weak economic outlook and political uncertainty create a flight to quality, pushing interest rates to their lowest levels in decades, with the 10-year Treasury bonds yielding below 2% (prices are way up). With inflation recently slightly elevated, investors in bonds are incurring negative real rates of return (interest rate minus inflation). This is not normal, but it is new.

Since the 1950’s, stocks yielded less than a 10-year Treasury bond and less than corporate bonds. Currently, the S&P 500 dividend yield is greater than the yield on the 10-year Treasury and many high grade corporate bonds. Dividend yields are attractive, and companies are growing their dividend rates to shareholders in each of the last six quarters because of increasing free cash flow and strong balance sheets. Prior to 1950, dividend investing was a big focus. One must ask, will this stock trait be a return to an old normal?

These two relationships – a negative real return on 10-year Treasury bonds (and money market funds) and stocks yielding more than Treasury bonds, could be a consequence of a bubble in the Treasury bond market. Bubbles are by definition transitory; so, perhaps current conditions will not prove to be a new normal after all. We unquestionably experienced our share of bubbles over the last 20 years (tech, real estate, debt, etc).

For investors, it certainly feels very uncertain, and that wears on our emotions. Investors can question proven investment philosophies and processes which seem upside down (or should we say downside up). It is new; one can only hope it doesn’t become normal.

Keep your seat belts fastened! We expect an increasing importance of dividend yield to total return (a financial wherewithal to pay growing dividends), and the impact and changing dynamics of the developing countries on the global economy. These are two new normals that we expect to influence portfolio performance success for some time to come.

P.S.—We encourage you to join us for “Talk Strategy” on Thursday, November 17 at 7:00pm at Wedgewood Golf & Country Club. We have a special guest/topic on Emotional Investing (Behavioral Finance) which you most definitely should hear. Join us, please!

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