LFM&P

LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

The economy has not improved since our last letter. Economic and financial market stress has reached the front pages. How should you protect your financial future? To reach your financial goals, it is important to place economic events in the proper context and maintain a sound financial strategy. Our goal is to provide you with independent thinking that will challenge the conventional wisdom when necessary. In this issue, we hope to help you understand the current financial and economic stress and help you keep your long-term results on track.

The Economy

According to the latest GDP numbers, the economy grew again during the second quarter by 2.8%. Technically at least, we still have not seen the two quarters of business contraction that define a recession. Last quarter may be the first that fits the definition. As we read the economic tea leaves, we find that real estate is still depressed, unemployment is rising, the stock market is falling, and the Federal Reserve is reporting weak business conditions across the country. At a minimum, these conditions could be viewed as a routine cyclical slowdown.

Today's events are not routine, however. We have been dealing with the fallout from the actions of both the financial community and regular people who acquired assets like houses and mortgage bonds that were beyond their means. As you know, a lever can be like an unbalanced seesaw. When one end of the lever goes up or down a little bit, the other end moves a lot. Financial leverage, like a home mortgage, is similar. With a low (or zero) down payment, people were able to buy hundreds of thousands of dollars worth of home assets, but tolerate only small losses before their equity was wiped out. When the leveraged seesaw is going up, participants are happy as their rate of return is multiplied. When the lever starts back down, watch out. Someone is likely to get hurt. The foreclosures and the financial institution failures we have been witnessing were due both to regular people and CEOs alike trying to make an excessive and unsustainable profit by using too much credit leverage and taking on too much risk.

When the seesaw began to drop, over-exposed homeowners and financial institutions began to reduce their risk by reducing leverage. Homeowners began walking away from their homes as values sank below their small equity positions. Banks tightened lending standards. Stockholders sold their shares. What started out as a purely financial phenomenon is turning into an economic issue. Depressed housing and lack of lending may finally result in bringing about the recession that the media and politicians have been proclaiming for the last year or more.

The Financial Markets

Investment values of corporate stocks and bonds continue to drop due to the de-levering process. Treasury bonds have performed reasonably well as investors seek safety. In our last issue, we warned that energy share price action resembled a bubble and prices could drop sharply. In fact, the value of the energy index ETF has dropped 30% from July, as oil speculators reversed positions and began selling in the face of a seasonal reduction in demand.

If passed, it is possible that the government "bailout" plan will start to correct the mortgage problem. Even if it works, however, it could take time to return to a healthy economic condition. If a recession has started, continued stock and real estate market weakness can be expected until conditions are restored that promote economic growth. One bright spot is that economic problems tend to hit the headlines just as the problem is ending. For example, magazines often feature bears on their covers several weeks before the end of a bear market. The media attention to the "bailout" plan may mean that this phase is close to being over. Even if this is true, it may take years to scale back our national reliance on excessive debt and its associated risk that permeates our economy from top to bottom.

Investment Strategy. Retirement, and the Secular Bear

Over the long run, stocks have increased by 10% per year. Treasury bonds have increased by 5%. The widely accepted buy-and-hold investment strategy is rooted in these simple measurements. The returns are thought to be almost automatic. This belief has eliminated most managed pension plans, and replaced them with unmanaged 401(k) and 403(b) plans. The theory is that, if you wait long enough, market cycles will become unimportant. The key, of course, is that you must either be wealthy enough, or have sufficient time to retirement, to be able to wait out a bear cycle. A young person, with many years until retirement, will likely be served well by the conventional advice to contribute regularly to an aggressive, yet well-diversified retirement plan, throughout all economic cycles.

Retired people face a problem, however. During the younger accumulation years, the growth of their retirement fund is not affected by withdrawals. Stock market values have historically gone on to new highs after a fall. During the retirement years, the opposite occurs. Money that is withdrawn when market values are low can never recover again, because it has been spent, so investment returns suffer. This can cause increasingly lower portfolio values, especially when the portfolio becomes too small to safely generate a return that is sufficient for living needs.

There have been extended periods when market returns were significantly less than the long-term averages. This type of period is called a "secular bear market". It occurs every 30 to 50 years during periods when the economy suffers from substantial structural problems. The value of the Dow Industrial Average was 1000 or lower during every year from 1966 to 1982, representing no gain (other than dividends) over a span of 16 years. The secular bear market ending in 1942 revisited a price first achieved in 1916, 26 years earlier! This does not mean that there are no opportunities for profit during these periods. There are. Gains can be realized by adopting a strategy that is right for the period. Had there been 401(k) plans practicing buy-and-hold, instead of managed pension plans during these earlier periods, many retirees may have fallen into the trap of withdrawing too much income during weak markets. Today the value of the S&P 500 is 1166. It was also 1166 in 1998, 10 years ago. This zero long-term return suggests that we may be experiencing another secular bear market right now.

How a person deals with the current condition depends on their stage in life.

- Young workers have many years until retirement – Reduce debt. Do not fall into the financial leverage / risk trap. Save regularly and invest in your 401(k) plan. Follow a fairly aggressive, diversified asset allocation.
- People 5 to 15 years from retirement – actively consider the impact of lower returns during a portion of your planning horizon and begin considering risk management techniques to protect your capital in weak markets.
- People in or near retirement – Consider professional management that will employ a risk management approach to preserve capital before buy-and-hold turns into buy-and-hope. Develop a planned strategy that limits withdrawals to 4% of your portfolio value. Consider the risks of any annuity very carefully.

LFM&P believes that planning for a strong financial future must consider individual clients' needs and changing economic conditions. We are concerned that pre-packaged financial advice may be less than helpful, especially in stressful economic conditions. To learn more about our risk-managed investment approach and client goal-centered financial planning services, we encourage you to contact us or look at our website, www.linnardfinancial.com.

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