notes from the assabet Vol. X No. 2

Second Quarter, 2012

Living as if Nothing Happened

Recently I heard a speaker mention a man who traveled to a rural outpost in China for a year to teach English. He left on June 6, 2011 and returned on June 5, 2012. Located in a remote hamlet, he received no news from the outside but instead immersed himself in that community.

When the teacher left the U.S., he had been concerned about his investment portfolio. After all, the first quarter of the year had been very encouraging but data in the second quarter dashed hopes of an imminent economic recovery. Analysts were concerned that QE2, the Federal Reserve Board's second program aimed at bolstering economic growth was just ending. Home prices were near recession lows. Political stalemate triggered talks of a federal shutdown if agreements couldn't be reached on a national budget. A debt crisis threatened European banks, rattling Wall Street.

On the day of the teacher's departure, the Dow Jones Industrial Average closed at 1286.17.

One year later, the teacher returned home. On the day of his arrival, the DJIA was at 1285.50. The economy was growing very weakly, a disappointment after encouraging signs earlier in the year. Home prices remained low. The political realm was in a standoff, polarized with an election approaching. Debt problems in the Eurozone intimidated US stock investors.

The teacher studied the environment, then exclaimed, "It's déjà vu all over again….I went away for a full year and while I was gone, *nothing happened!*" Things were just as he had left them.

His friend who had spent the year in the USA, was stunned. He explained that it had been a year of incredible tumult in which many alarming things happened.

While the teacher enjoyed a virtual media blackout, his friend endured the growing decibel level of news announcements. Political unrest in the mid-east raised images of expanded global warfare. Apprehension concerning a European meltdown increased as fears spread beyond the economically weakest nations to the stabler countries holding insecure sovereign debt. As a result of the Eurozone problems, commodity prices fell. Chinese growth, so dependent upon European consumers, was threatened.

The teacher's friend watched aghast as political stalemate over the debt ceiling endangered the functioning of the U.S. government. On August 5, the unthinkable and unprecedented happened: the S&P rating service downgraded U.S. federal debt. In the next week, The S&P 500 stock index had 4 consecutive daily moves exceeding 4%! (For context: during 2011, the same index had daily moves greater than 2% on 35 days. This did not happen on even one day in 2005, and only twice in 2006.) Following the extremes of volatility were robust gains in the market bond purchasers hungry for down-graded and low yield US Treasuries. Economic data showed promise in quarter 1, then dashed hopes in quarter 2. Things definitely were happening!

Over the same period, the teacher lived in ignorant serenity while his plugged-in friend suffered heartburn and sleep loss.

So, what's the lesson?

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"Nothing Happened" continued

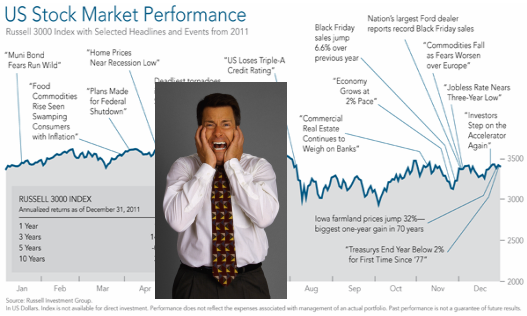
Should we cancel the daily paper and unplug the cable? Or is there a middle ground between "ignorance is bliss" and "Information is power"? By watching the response of our clients to the extreme events of last August, we think that many of our clients have found it.

Between August 8-12, 2011, a shocking week by any standard, Wayne was on vacation. We spoke throughout Monday and sent an email communication to clients that evening. On Tuesday, Wayne drove down from Maine to be available for concerned clients. It was a worthy gesture but he could have stayed biking along the rocky coast. We received only one call that could have been handled from Maine. Later, when we asked several clients about their silence, they told us that they counted on us to handle things as we had in the 2008-09 crisis. After all, we had promised to "do their worrying for them." And so we did.

By letting a capable person do your tasks and your worrying for you, whether it's cleaning your house, preparing your taxes, maintaining your cars, or watching your children, you can avoid a lot of headaches. But because you still maintain ultimate responsibility for these things, you can't put your head in the sand. You still need to be knowledgeable about what needs to be done and what the related issues are. And you still need to evaluate how well it's being done.

Of all of those services, there is the most help "out there" to both find and then monitor an investment advisor. The SEC's site (cited below) gives you all the required information including the client disclosure statement. You can find good lists of key factors to use in your analysis by googling "how to choose an investment adviser.". Many of the answers may be found on an individual advisor's website. Personal referrals also are extremely valuable.

We invite our clients to live as though nothing is "happening." At the same time, we welcome a regular review of our services, and the suggestion box is always available.



http://www.bankrate.com/finance/personal-finance/10-ways-to-rate-your-financial-adviser-1.aspx, http://www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_OrgSearch.aspx

How's Your Crazy Ivan Account Doing?

Sometimes those websites that you run across by accident are real gems. Balhiser.com is one of them. Dave Balhiser is a design engineer at Intel who become so interested in finance and investing that he took some courses and earned a "Graduate Certificate in Finance." He has one website aimed at helping individual investors and another far more technical site for investment professionals. In his site, Dave is unusually disarming about his own skills:

> "I am a blogger, not a registered investment adviser or representative...All opinions, ideas, stories, suggestions, predictions and other notions are general commentary and may not be right for your (or perhaps anybody's) specific situations...I am but a person with a keyboard and an internet connection. I make typos (often) and glaring errors (occasionally) so please enjoy, but use care and common sense."

Dave's own portfolio is a testimony to his knowledge and common sense. A very disciplined combination of stock and bond index funds and etfs make up the core. But he also has his **Crazy Ivan Account (CIA)** which takes care of his "financial angst, excess energy and investing whims." A mad money account, in other words. He suggests funding it with an amount up to 10% and then investing it. Never add to it. If you blow it all, it's gone. Finito! His CIA is a source of fun, excitement and discovery.

We have a few clients who would like more investment sizzle than our highly disciplined portfolios provide, including a couple of clients who get firmly held notions as to what's about to happen in the markets. They definitely exhibit "investment angst." We have offered something akin to a CIA, but without the cute name. Our advice usually runs like this: "Take $50,000 and invest it anyway you wish. Speculate on single stocks, engage in "market-timing," knock yourself out. And your wife should take $50,000 and invest it as she wishes." We know that her money is more likely to go straight into a money market account, or gifts for the kids. At the end of the day, decide who handled the funds more wisely.

Being "crazy" on the margins can keep you from being crazy where it really counts.

Economic and Financial Review

U.S. stock markets ended the second quarter on an upswing as investor confidence grew on news of a "breakthrough" announced by the European Union summit. European policymakers had arrived at a deal to stabilize banks and to start easing national debt problems by infusing European banks with money from a permanent bailout fund. Banks were thereby enabled to purchase sovereign bonds without tapping individual government coffers or raising national debt levels. This provided a temporary respite in the concerns about growing Eurozone risk.

In June, the S&P 500 gained more than 4%.The quarterly return was –2.75%. As the third quarter began, investor optimism ebbed. Economic indicators, particularly for the labor market and retail spending were discouraging. June marked the third consecutive month of declines in retail purchases and it was felt across all categories. Our domestic economy is in the 37th month of an expansion having emerged from recession on the strength of global growth, business investment and manufacturing. However, with weakening in the global economy and recent slowdown in manufacturing, GDP grew at only a 1.9% rate in the first quarter and is expected to be even slower in the second quarter. Unemployment is undergoing a "slow repair" but at 8.2%, remains high. Housing prices are stabilizing slowly. The credit cycle remains tight but has loosened somewhat. The Federal Reserve Board still tends towards monetary easing, but this seems to have less effectiveness with each new program.

Despite the sluggishness of our own economy, U.S. financial markets are the "best house in a bad neighborhood" and have outperformed global markets. Among U.S. asset classes, fixed income, benefiting from a flight to quality, outperformed equity in the second quarter as large-cap, mid-cap and small cap stocks all had negative returns. U.S. Treasuries outperformed corporates. Dollar-denominated returns in foreign markets, already poor, were further reduced by the relative strength of the dollar.

Fed Chairman Bernanke has stated that the risks to our economy have grown. These would include the deceleration in U.S. economic expansion, the threats from slowdowns in the economies of Europe, China and the rest of Asia, and the potential political stalemate in the face of the upcoming "fiscal cliff" when taxes are scheduled to increase and fiscal spending to be automatically cut. On July 17, a member of the Senate Banking Committee demanded that Bernanke address this situation, something quite beyond the Chairman's powers to do. Instead, the nation is be waiting for our elected officials to show some leadership with a fiscal response.

They're Back!

In the Quarter 4 of 2009, we published "Your Home, No Longer A Castle?" which discussed downsizing in new home construction. As a result of the market drop and the recession, and perhaps sensitivity to sustainability issues, the trend was towards smaller and less extravagantly appointed homes.

Well, THAT didn't last long! McMansions are back.

According to the U.S. Census Bureau, the average new home built in 2011 was 2,480 square feet or 3.7% larger than the 2010 average. This was the first increase since 2007. KB Homes reports that their average new home under contract in 2012 is 13% higher than last year's average.

39% of single family homes built in 2011 have four or more bedrooms. 57% have 3 baths or more. While an average of 983 square feet was adequate in the 1950s (when families were larger), today's homebuyers still want the big house.

Interest rates below 4% on a 30 year fixed mortgage, and the relatively high cost of renting, motivate people to buy. Buyers want lots of elbow room in part because the price differential between a mid-sized and a large house is currently small. In one west coast development, an additional $166 per monthly payment can buy an extra 1,050 square feet of living space. Some buyers are planning to grow into their big house over time to avoid moving later when they have need for more bedrooms, perhaps in a high interest rate environment.

Demand for large homes has revived, but not to the level of the pre- 2008 period. Except for the ultra-affluent end of the market where conspicuous consumption persists, today's buyers of the large homes are not looking for extravagant upgrades such as the vaulted ceilings and vast foyers. They prefer more bedrooms to fancy features. And there are limits. When surveyed about their "dream house," fewer people are specifying homes of over 3,200 square feet than they did in 2010.

As builders are scaling up, the downsizing movement continues. Sarah Susanka's "Not So Big House" series helps readers to "fully inhabit" a home by building or remodeling based upon how the occupants really live. The Small House Society takes sustainability even farther. Recommending houses of 500 square feet or less, small house champions seek not only to reduce waste of resources, but also to reduce the clutter and complexity of modern life. Fewer rooms, fewer things?

Www.census.gov/construction/chars, D. Wotapka, "Big Homes are Back in Business," Wall Street Journal, 6/8/ 2012, p. A2, www.info.trulia.com/index, www.notsobighouse.com, www.smallhousesociety.com

Skirts and Stocks

There are a million of them: indicators that are supposed to predict the near-term direction of the stock market. Some are more frivolous than others. Some assume a certain logical causation while some have no idea why the correlation exists. Some have a better record than others. But they all have these two things in common: 1) They exist because of Gambler's Fallacy, the very human tendency to look for patterns and to assume predictability in them. We've all been taught that "correlation does not mean causation," but it's nearly irresistible to read about an indicator with a high performance track record without being mildly tempted to follow its lead. We love them because they're easy, because we love patterns and because we love to win. 2) They are market timing strategies. There are many far more technically sophisticated market timing models but all share a belief that one can find the key to moving into and out of the market at the right time. We don't subscribe to any of them. But you might be interested in these:

Market Indicator	Market Will Go Up when:	Markets Will Go Down when:	Proponents' "Logical" Assumption
Skirt Length Indicator	Skirts are getting shorter.	Skirts are getting longer.	Skirt length is an indicator of investor confidence and optimism. Short skirts reflect optimism, long skirts gloom. Buy on optimism.
Harvard MBA Indicator	<10% new grads take jobs sensitive to financial markets.	>30% new grads take market-sensitive jobs.	When investment, banking, brokerage, have been doing extremely well, they attract new MBAs but that's when the good fortune is poised to turn.
Sports Illustrated Swimsuit Issue Cover Indicator	The cover girl is American.	The cover girl is from a foreign country.	No logical correlation to this.
Soccer Mom Indicator	She's on the sidelines talking about the kids.	She's talking about stocks.	She's one of the last to get informed about stock gains. When she knows about them, the bull market is over.
Lipstick Indicator	Purchases for higher end lipsticks are up	Purchases of higher end lipsticks are down.	An investor confidence indicator. When investors are concerned about the economy, they draw back on major purchases but buy more small luxuries.
Presidential Election Cycle Indicator	3rd year after election is the strongest. 4th year is positive.	1st year after election is the weakest of the 4 years 2nd year is average.	Executive and legislative power is depleted in 2nd half of a presidential term, allowing for less interference in financial markets.
Super Bowl Champion Indicator	NFC team wins: good market in the coming year.	AFC team wins: sorry!	No logical correlation.