

notes from the assabet

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The More Things Stay the Same (or not)

In the midst of a deep and lengthy recession, it's probably natural that we fluctuate between periods of stoic resilience and impatient discouragement. From early March to mid June, the market experienced a vigorous rally. However, stock prices have retreated slightly since. Economic indicators have been mixed. As soon as we're told that economic improvement may begin near the end of 2009, we're reminded that the massive debt burden, assumed in order to avert a financial crisis, will be a drag on the economy for years to come.

In times of great financial turmoil, there always will be voices suggesting that the paradigm has changed, that there will be fundamental transformation in how things work. Not too many years ago, pundits were proclaiming the end of the business cycle, satisfied that policymakers could tweak the economy with such finesse that we no longer will have to endure the laborious journey from peak to trough. A recent headline on the MSN internet site echoed the theme of fundamental change: "What if it Never Gets Better?: Seven Ways the Economy Will Never be the Same." And today, it's easy to find articles stating that the established investment approach of asset allocation and portfolio optimization is obsolete.

Is it really that different this time? What implications are there for how we approach investing?

In the context of history, the recent severe stock market decline is one of eight since the mid 1920s in which the S&P 500 Stock Index dropped more than 20% between peak and trough.

As recently as 2000, the internet bubble caused a peak-to-trough decline of 45% over 2 years, one in which it took 4 years to regain the peak value. (Between October 2007 and March 9, 2009, the S&P 500 dropped by nearly 60%.) Measured in annual periods, the 2008 decline was unusual but not unique. In the past 80 years, only 2 were as bad or worse.

In the same way, the current recession is unusual, but not unique in terms of severity or of cause. Typical market declines relate to economic cycles. Today's recession, like the one in the 1930s, stemmed from troubles in the financial system. In the recent case, the troubles were caused by excessive leverage, the failure of certain financial instruments and a lack of transparency as risk was undervalued, packaged and sold to unwitting investors.

The current recession and the associated stock market decline, while "unusual" in terms of severity and cause, still fit a broad historical framework and don't portend a total change in paradigm. Yet there are implications for how we manage money going forward. Most of these can be summed up in how we think about, plan for and describe risk.

Traditionally, the most common measurement of risk has been standard deviation (STD): the variation of returns around a mean return. It's a form of average. While STD is a reasonable measure of return volatility (the average breadth of the ups and downs), it doesn't provide a clear picture of the possibility or the impact of extremes, such as what we experienced recently.

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the more things stay the same

STD gives equal weight to both upside and downside risk, as both contribute to volatility. Yet it's not return fluctuations but loss, particularly extreme loss, that concerns investors. Also, extreme losses affect investment programs more severely than "expected" or average returns. We need to give greater emphasis to downside risk and to the potential impact of significant declines. Gaining 20% for two years and losing 40% the next, feels worse than losing -4.8% 3 years in a row.

The adjustments we plan to make going forward are measured ones. We'll give slightly more weight than before to a client's personal risk tolerance not just for volatility but for interim and extreme loss. This may result in slightly lower equity allocations. We also will renew discussions about risk, speaking less about "expected" returns and volatility (which are based upon averages) but placing greater emphasis on what *can* happen. It's important for investors to have a realistic sense of the probability of extreme declines.

Our goal is not to drive investors from stocks. An allocation to equities is essential to long-term growth. Rather, the goal is to set expectations so effectively that investors will weather the downside more comfortably, without retreating from stocks when the going gets rough. A realistic expectation of market behavior leads to investors who can offer reasonable estimates of their own

tolerance for interim losses, who stay the course in the midst of market turmoil, and who reenter the market to rebalance to an asset allocation target.

In some cases, we will consider broadening the asset class diversification of client portfolios. We always have offered unusually broad diversification both on an asset type and an individual security level. But since the start of the recent turmoil, we've been considering adding exposure to commodities or TIPs in order to further reduce the impact of extremes.

More important is what will not change. We will continue to emphasize long-term asset allocation and the use of asset class "passive" investment options as the best way to help clients reach individual financial goals. Some investors who speculated through market timing and security selection outperformed in the past few months, but many did not. Moreover, those who did have no assurance of being "right" in all seasons. Active investing may impart a reassuring sense of mastery and control, but that can be illusory and not what we would responsibly suggest for clients.

We encourage clients to rebalance to their original (or an updated) asset allocation target, but gradually in order to minimize market timing risk.

Grace Under Pressure

Want to feel smug about your state of mental health? Scan through some recent issues of the periodicals of our trade: Financial Advisor (FA), Financial Planning (FP), Investment Advisor and the like. You'd have trouble finding one that doesn't contain an article on battling stress—the advisors' or their clients.' Olivia Mellan writes in the May, 2009 issue of FA: "I'll wager that more of your clients are exploding in anger, dissolving in tears or launching into tirades on topics that once would have seemed over the edge." She would lose that bet. Apparently our clients have greater maturity and stability than the norm. No explosions, no tirades, or at least none in our direction. Writing about advisors in the July, 2009 issue of FP, Amy Florian talks about how "significant loss, death or transition plunges us into the depths of painful emotions and knocks foundations out from under our feet." She describes advisors at a recent conference "pour (ing) out their grief." It seems that we're as relatively unflappable as our clients. No outpouring, still upright.

These and other writers on the subject offer coping methods to deal with the anger, grief and pain that they assume we are experiencing. If you're having trouble, consider these (actual) suggestions: "do things you enjoy - play golf, listen to music, soak in a bath, get a massage." "Make a gratitude list and read it daily." "Decide to smile throughout the day." "Find non-destructive ways to express your sorrow: pound on wood with a hammer, rip paper into little shreds." "Practice centered breathing." Or my own personal favorite: "imagine (yourself) surrounded by a protective membrane of golden light particles that block other people's negativity." Whatever works.....

Ernest Hemingway defined courage as "grace under pressure." We're grateful for our gracious clients.



Quarterly Economic and Financial Review

The S&P 500 Stock Index climbed by 15.2% in the second quarter on a rally that began after the market low on March 9 and persisted through mid June. Financial stocks posted the greatest comeback, but energy, materials and technology stocks also outperformed.

Stocks were up on the confidence that the economic and financial environment was “less bad” than it had been in recent months. With the strenuous activities of the federal government, the financial system averted collapse and big banks and broker-dealers were able to strengthen balance sheets. Investors showed themselves to be more interested in direction than in magnitude. They were buoyed by evidence that the pace of the contraction in housing and manufacturing was easing, and that indicators such as personal income, consumer confidence and initial jobless claims were at least capable of recovery.

Such tepid enthusiasm isn’t likely to sustain the rally. Stocks tend to be leading indicators, but at a certain point, investors need conviction that the economic growth will follow. For this reason, many analysts believe that continued stock market advances will require an improvement in economic fundamentals and in corporate profits. A majority expect to see that improvement near

the end of the year, yet few argue for a robust expansion.

Credit markets strengthened as fears alleviated and financial markets across the globe stabilized. Investors who had clung to the “safe harbor” of Treasuries suffered from the recent decline as government issues fell sharply and riskier assets rallied. Corporate bond prices rose by 11% during the period, high yield bond prices by 23%. Spreads between the yields of corporate bonds and Treasury issues contracted back to levels seen just before the collapse of Lehman Brothers in September, receding from a high in late March.

The yield curve steepened as yields on longer term Treasuries climbed. The Federal Reserve Board bought large amounts of Treasury and Agency mortgage-backed securities, and signaled its intention to maintain the low rates required to make mortgages accessible and to sustain the rally in riskier fixed income securities.

Currency strategists are divided on the future of the dollar which has declined against global currencies. Some believe that as long as economic weakness persists, the dollar may recover. Others fear that the massive government spending will weaken the dollar, thus raising inflation.

Ready to Convert in 2010?

Many advisors point out these advantages of converting your Traditional IRA to a Roth IRA:

- Contributions to a Roth are made on an after-tax basis, they grow tax-deferred, and withdrawals are 100% tax-free, whereas contributions to a Traditional are made with pre-tax income, they grow tax-deferred, and withdrawals are taxed as ordinary income.
- There is no mandatory withdrawal from the Roth, yet for the Traditional, Required Minimum Distributions start at age 70 1/2.

Starting in 2010, the income limit (in 2009, \$105,000 for single persons and \$166,000 for married and filing jointly) will no longer pertain, thus opening up the conversion opportunity to people of any income level. Also, for conversions made in 2010, the tax burden that generally is payable during the conversion year, can be deferred until 2011 and 2012. In effect, this is a tax-free loan from the IRS.

Check with your accountant to see if a conversion in 2010 makes sense for you. Free online calculators exist to help you make the determination yourself, but this is too complex a matter to be decided by overly simple programs*.

Note that there is a possibility that at some point, the government will decide to tax the appreciation in a Roth, thus removing the Roth’s major advantage over the Traditional.

*William Tolson, “Roth IRA Calculators—Good for You or for Class Action Attorneys?”

<http://www.rothira.com/tolson.htm>

Confusing Noise

In the April edition of NAPFA ADVISOR, Annie McQuilken gave results of a survey of NAPFA (National Association of Personal Financial Advisors) members in which she asked what economic news sources they avoid. The overwhelming reply was “CNBC!” Why are financial advisors so antagonistic? Among the responses were these comments:

“Any 24 hour cable money show or channel is designed for traders, not investors, and should be avoided like the plague.”

While investors seek to reach financial goals over a longer time horizon, a trader’s object is to profit by quick buys and sells. CNBC makes momentous announcements (“**BREAKING NEWS**: S&P highest one-day range in 11 years”) that hold true for a span of seconds only. However, even a trader can’t move fast enough to take advantage of these news mini-blips. Advisors who have devoted considerable time and energy to educating their clients about long-term investing hate to see them churned up over momentary and nonessential data, presented as big news.

“CNBC got so political and so scare-mongering that I could not stand it anymore.” And, along the same lines, *“There’s one news show that I no longer listen to. The (analysts) are so slanted that they’ve lost all hope of providing useful information: CNBC.”*

It’s true that the personal views and moodswings of individual announcers reign quite freely on the network. In the early weeks of the current financial crisis, one hoped for Mark Haines to take a long vacation. He became so despondent and angry that it was alarming. Particularly during a financial crisis, an advisor’s most important job is to keep clients calm enough to practice wise, deliberate, and informed investing. Panic disrupts this and works to the detriment of the client.

“I do not listen to—and heavily discourage clients from listening to—Jim Cramer.” and: *“I tell (my clients) to TURN OFF THE TV. Do not watch Cramer, Suze Orman, or any financial channel. It’s just confusing noise.”*

Keeping the focus on CNBC: Cramer, CNBC’s popular wild man, shares his views of recent economic and financial events, and advises viewers on stock picks. McQuilken remembers Cramer’s own statement on Jon Stewart’s “The Daily Show” that his show is “entertainment.” Yet CNBC postures as a news network. If you visit the CNBC website, you’ll find a disclaimer a full 339 words long distancing the network from Cramer’s advice. However, Cramer’s “Mad Money” which airs on CNBC at 6 p.m. has a far briefer disclaimer and it’s certainly not presented as entertainment.

Larry Kudlow, another CNBC headliner has stated, “We are a profit-maximizing commercial network.” As such, they do what other commercial networks do to boost profits: seek to expand the audience by raising the emotional impact of the programming. While this usually is accomplished by exaggerated responses to news items, the midday show “The Call,” does it by raising the decibel level and promoting confrontation. As many as 8 different commentators speak, frequently at the same time, cutting each other off and engaging in other behavior that your mother taught you was “very rude.”

The truth is that we have CNBC turned on in our office throughout every business day. It’s addictive. Although we presume that our investment knowledge and experience immunizes us to the hysterical hype, we admit to sharing the frustrations of other advisors. On occasion, the mood-altering coverage becomes too much, and we opt for a few hours free of the clamor and drama. We’ve noticed, on a day when the Dow plummets by 150 points, how differently we feel when we learn the results at the end of the trading day, rather than by the “death by a thousand cuts” we experience when watching the market ricochet all day accompanied by the frantic ranting of the CNBC staff.

Warning label: CNBC: this network may be hazardous to your health, to your sanity, to your investments.

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