

A New Year And A New Reality

2008, a year marked by the second-worst performance for the Dow Jones Industrial Average in the last one hundred years, is officially in the record books. The best news of the year is that it's over. It seemed there was nowhere to hide for the diversified investor as stock, bond, and real estate prices declined markedly worldwide. Only government bonds and a handful of commodities were spared.

Over the past year, the economy and the financial system have undergone wrenching change. Many of these changes occurred very rapidly – confidence deteriorated, credit dried up, formerly stalwart institutions foundered, governments provided massive cash infusions, and asset prices fell precipitately. In the media, the use of the word “Depression” to describe our economic future seems to be at an all-time high. Simply speaking a lot about a possible outcome, however, doesn't make it more probable. It may occur or it may not; no one knows where the markets or the economy are going nor have they ever. The challenge is to prepare oneself for a range of possible outcomes without allowing the emotion of the situation to overtake logic.

While it is easy to evaluate the situation retrospectively, the reality is that it was impossible to have predicted both the swiftness of the downturn and its magnitude. We caution you to try not to focus too much attention on those who supposedly predicted this last year's events. There are not many of them, and most have been perpetually downbeat for years if not decades. (Even a broken clock is right twice a day.)

In uncertain times, people often focus on the negative and assume that everything that can go wrong, will. The opposite seems to occur in good times, when they don't fathom those good times ending. This is especially true in periods of very low volatility. In a relatively stable environment, it is human nature to think that tomorrow will be much like today. When it looks like there is not a large variability of outcomes (for instance, when stocks are mostly going up and haven't gone down much for long periods), defense mechanisms gradually recede. Then the “unexpected” happens, and defense mechanisms come back with a vengeance. We tend to avoid that which caused the negative feelings, even though doing so might not be the most prudent long-term decision. Mark Twain once remarked, “A

clar·i·ty: n. The quality or state of being clear.

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cat who sits on a hot stove will never sit on a hot stove again. But he won't sit on a cold stove, either." This behavior has led many investors out of stocks and bonds and into the perceived "safety" of cash in the past year.

It's clear now that some of the economic landscape has been changed for good. Hundred-year-old brokerage firms have been forced by the credit crisis to become bank holding companies, fundamentally altering their business models. Some of the nation's largest banks have failed or been sold at nominal prices. Several businesses have disappeared altogether or are now owned by the government. Meanwhile, it appears highly probable that American consumers will save more and take on less debt over the next several years, and that investors will demand higher risk premiums in the market as confidence and trust are rebuilt.

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These changes, while they hurt short-term economic growth, are constructive for our country long-term and markets will adjust to this new reality. And in spite of being in the midst of a very rough patch, there is some "good" news: stock prices largely reflect the bad economic data already. The fact that they've declined so much, *ahead of the real economy*, tells us things may get worse before they get better. But stocks' role as a leading indicator also means they can recover *even while economic data remains poor*.

How are we as investors to make practical judgments about our own financial situation in light of the current facts before us? The answer, we believe, is the same now as it was before the immediate crisis. That is, set realistic financial goals and adhere to a sound long-term plan with a strategy to achieve them, knowing that there are going to be setbacks along the way. As always, the investment strategy should be consistent with your tolerance for risk.

Most investors probably take a different view of risk today than they did a few years or even a few months ago, but one's sensitivity to risk should be relatively constant through good times and bad. Stated another way, if you are dramatically more risk averse in bad times than in good—something that is inherently human and not hard to understand—you probably are going to miss more than your share of investment upside and incur more than your share of downside. As investors, this means ignoring emotions as best we can (as difficult as that may be at times), and making rational judgments in less than rational circumstances. We cannot overemphasize the need to maintain perspective. In spite of everything that can go wrong, there are still many things that are going right.

There has been a media barrage of negative economic news

and spin, but a large portion of our economy continues to provide goods and services, albeit just fewer of them. We hear about the unemployment rate, but we don't hear that a vast majority of the nation's workers are still employed. Many people are struggling, to be sure, but over 90% of the country still has jobs and incomes. It may be at lower levels, but people will keep spending money, businesses will grow, commerce will continue and the overall economy will evolve and thrive once again.

Nonetheless, heightened market volatility is likely to persist for a while. Like an unwelcome family member overstaying a holiday visit, we can't ignore it, but can recognize it and make adjustments. In this case, we believe a more volatile market highlights the need for active management more than ever in recent history. Fundamental investment principles still apply, but the implementation of those tried-and-true principles may look different in the future. Because opportunities in a more erratic market may prove to be shorter lived, capitalizing on these is likely to require more frequent judgments of mutual funds and asset allocations, but rest assured that we remain steadfast on our fundamental principles: diversified asset allocation, our fund selection process, a long-term investment horizon, and rational over emotional decision-making.

When Liars Figure

As market conditions underscore the importance of a sound financial plan, the Bernard Madoff (pronounced Made-Off) investment scheme highlights the need to ask tough questions of investment advisers. With the revelation that Madoff may have scammed investors in his fund out of as much as \$50 billion, we are reminded of the old adage that, "Figures never lie, but liars figure."

Madoff reportedly created the illusion of stable, consistent investment returns over nearly three decades, using money from

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new investors to pay returns to existing investors in what was a classic "Ponzi" scheme. No doubt there are people who had entrusted their assets to an adviser, who were surprised to find out they were caught in Madoff's scandal. Beyond the personal stories of deception and damaged net worths, reputations and lives, there is a great deal to be learned from these types of situations.

Although working with a trustworthy adviser is important, it isn't enough to do business with someone you trust. Nearly every case of investor fraud involves an adviser who was trusted

by the investors defrauded. In addition, it's not enough to have a trusted adviser, because that adviser could be doing business with unscrupulous characters, unbeknownst to the adviser that has not done his or her due diligence. (Madoff duped several adviser "friends" over many years; some of them lost billions of dollars of client, as well as personal, assets.)

There are a few questions that you should ask every financial adviser. First, and perhaps most important: Does an independent custodian hold your funds? In the Madoff situation, direct investors reportedly were asked to write checks to "Bernard Madoff Investment Securities," a related firm controlled by Mr. Madoff. This alone was a red flag.

But it isn't enough to ask this one question. You should also confirm the actual independence of the custodian. In most cases, independence may be obvious. For instance, large national brokerage firms like Fidelity or TD Ameritrade are not affiliated with independent advisers. There are many smaller, independent brokerages that are trustworthy custodians, but if your adviser suggests you write your check to "John Doe Securities," you must exercise a greater degree of care to ensure the custodian is not in cahoots with your adviser and that the custodian is a viable entity. Monthly statements sent directly from the custodian—e.g., Fidelity—typically indicate that the client's assets are held with an independent custodian. A simple phone call can confirm the existence of the account. Another way of confirming custody of your assets includes obtaining online access to verify assets at the custodian's—not the adviser's—website.


Second, never give an adviser power of attorney to withdraw funds from the independent custodian. Ask your adviser what authority he or she has over your assets. The answer should be that the adviser has only limited power to direct the investment of the account. This is commonly referred to as "limited trading authority" and is incorporated into the documents that are submitted to your custodian to open the account. An independent custodian, such as Fidelity, will not make any change to an account without confirming the change by sending notice to the address of record. Likewise, they will not distribute any funds other than by check to the address of record or electronically to an account with the same name as the account holder, without the account holder's authorization.

Finally, review the list of assets in your account as well as any confirmations of new purchases. Nothing can guarantee that the securities purchased for your account are not run by bad people—ask the investors in Enron, WorldCom, etc.—but

generally public securities have a higher level of disclosure and transparency than private funds. This is not to say there aren't credible private investments, just that you should be aware if such securities are in your account and how much is known about them. If a significant portion of your account is invested in securities that are not public (i.e., not mutual funds, ETFs or publicly traded stocks and bonds), you should be asking your adviser to explain what you own in considerable detail until you are comfortable with what you actually own. If you don't like the answer, you should request him or her to liquidate the objectionable securities immediately.

Unfortunately, there will always be ways for crooks to separate unsuspecting victims from their hard earned cash, but these practical tips will greatly reduce your chances of being swindled. In addition, investors can check for any prior violations or disciplinary actions against their adviser at the SEC's website, www.sec.gov/investor/brokers.htm, a link to which can be found at our website, www.investmentclarity.com. (Note, however, that the SEC did not catch Madoff; he was able to deceive them for years.)

In the rare cases in which investors have missing assets due to the failure of a brokerage firm (custodian), the Securities Investor Protection Corporation (SIPC) replaces cash and securities up to \$500,000 per customer including up to \$100,000 of cash. In addition to the portion protected by SIPC, some firms such as Fidelity purchase additional coverage from the Customer Asset Protection Company (CAPCO) to cover the remaining net account value. This additional coverage



**“Ask your adviser
what authority he or
she has over your assets.”**

is called Excess SIPC Coverage and there is no limit to the excess amount. (CAPCO, a licensed New York insurer, has received an A+ financial strength rating from Standard & Poor's.)

It should be noted, however, that the SIPC protection does not include private investments, such as limited partnerships, which reinforces the importance of verifying what types of assets are held in your account. Furthermore, it is important to note that SIPC coverage is not insurance, since it only replaces "missing" securities and does not protect against losses from the decline in market value of a customer's investment.

In summary, here are the few basic questions that go a long way in reducing the chance of being defrauded by an investment adviser:

1. Are funds held with an independent custodian, and can you verify this?
2. Does your adviser have full power of attorney to withdraw funds?
3. Are the transactions and assets in your advised account consistent with what was agreed upon by you and your adviser at the outset of the relationship?

Above all else, the best protection is being an informed consumer. Don't be timid about asking your adviser tough questions, no matter how much you trust him or her. Simply stated, any adviser who is offended by you asking these questions doesn't deserve to be your investment adviser.

New Website Section

In October, we added a "Latest Market Comments" section to our website at www.InvestmentClarity.com. We encourage you to check it often, as we have been updating it periodically with commentary and thoughts about the stock market and economic conditions.

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