

The past year has been an especially trying one for all investors. While it is encouraging to see a recovery in account values, we remain wary of the risks and work each day to invest your portfolio to try and optimize long-term, risk-adjusted returns in a manner consistent with your risk tolerance and long-term wealth goals. Thank you for your business and continued confidence in us. We continue to strive to earn your trust.

## 2009 Recap

On March 9<sup>th</sup> of 2009, *The Wall Street Journal* ran a cover story entitled, "Dow 5000? There's a Case For It." At the time, investors were focused on just how low stocks could go and how the seemingly relentless supply of negative news could get any worse. Comparisons to the Great Depression were rampant. Stocks had fallen almost 30% below where they started the year. The financial world seemed to be teetering on the edge of a cliff as around 25% of the S&P 500 stocks traded below the psychologically important level of ten dollars per share. Job losses were reaching their crescendo, taking the unemployment rate to levels not seen since the early 1980s. Trade volumes around the world collapsed. On March 5<sup>th</sup>, just a few days before stocks bottomed, we wrote on our website's "Latest Market Comments" section:

"For a zebra, it's hard to think about your next meal when a lion is trying to make you his. Concentrating on financial goals *years or decades away* when stocks continue to fall *now* is difficult. But we believe selling stocks into today's market would be like the do-nothing zebra – more likely than not, it will be a regrettable decision. Sure, there are alternatives that are "safer." Holding cash is comfortable because its *face* value stays put. Treasury bonds are "doing well" and pay more interest than a bank's passbook account. But the lion is still hiding just outside of view. Recent government actions' implications for future inflation make it almost certain that the purchasing power of cash dollars will erode over time. And current "safe" Treasury rates may prove to be less than future price inflation, meaning investors will be *paying* to have their funds tied up in them. Stocks, on the other hand, are trading at levels that imply above-average future returns... Stock *prices* have come down dramatically, but the *value* lost has not been commensurate."

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

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As the saying goes, it is always darkest before the dawn. On the very day the aforementioned *Wall Street Journal* article ran - with the opening line "Just how low can stocks go?" - the Dow and S&P 500 hit their 2009 bottom, the S&P at the ominous level 666. The broad indexes have since advanced over 60% from those levels. When all was said and done, 2009 was a banner year for stocks. The S&P 500 gained 26.5% on the year, more than double its historical average annual return. These full year numbers obscure what was a harrowing, volatile year as the real economy saw its sharpest contraction since the second World War.

The year 2009 provided all investors with a real world test of their perceived risk tolerance and a live case study of how volatile capital markets can be. But while the all-clear signal appears to have been sounded and our economy looks to have avoided falling off a cliff, we must remind ourselves that we're not immune from future market collapses. The past year has underscored the importance of a long-term, disciplined investment plan and adherence to that plan regardless of the market environment. It has also illustrated that, absent a crystal ball, there is very real danger inherent in trying to time the market. Consider an investor starting out January 1, 2009 with \$100,000 invested in the S&P 500 Index. Had this investor panicked and sold at the market low, he would be holding just \$71,475 now, rather than \$119,672 if he had held on through the entire year. In this case, acting based on emotions would have cost close to \$48,200.†

This is not to say that investors should plow wholesale into stocks regardless of price. Later, we discuss how higher prices feel safer but can lead to sub-par future returns. But rather, it demonstrates the advantages that a long-term investment discipline can provide - a framework for decision-making that helps one adhere to a plan regardless of market behavior in order to meet long-term goals, not to salve short-term emotional wounds.

## Will This Happen Again?

The question after coming through such a trying period is, will we go through this again? The answer, unfortunately, is 'probably'. Based on market history, we are nearly certain that a similar period will occur again. Such is the nature of markets. The future can be an endless number of scenarios, the probabilities of which are unknowable. Furthermore, the consequences of very low probability events may be so great that they must be planned for regardless of how likely they are to occur. An example is tornado insurance on a home in Iowa. The probability of collecting on a loss may be low, but we pay to insure against that risk anyway because when it happens the impact is so consequential. Investing involves similar considerations; investors

must have a healthy respect for history and consider not only what could go wrong but the impact if it does. Accordingly, investors should ask themselves: Do you remember how you felt at the lows of last February and early March? How uncomfortable was it to think that your investment accounts had fallen to such low levels and might stay there for an extended period? Did you think you were taking too much risk and/or needed more cash for short-term spending needs?

**"Investors should ask themselves: Do you remember how you felt at the lows of last February and early March?"**

After the events of the past year, it is crucial to maintain a clear perspective. Market crashes don't happen often, but when they do happen they can have a tremendously detrimental impact on account values and, for those withdrawing capital for spending needs, lifestyles. Long-term investors must balance their need for long-term returns with the risk they're taking to achieve them. Portfolios with higher required returns must expect more significant principal fluctuation and are generally more exposed to market shocks. Too-conservative portfolios risk erosion of purchasing power over time.

In our view, it is best to make portfolio risk-return decisions when markets are acting rationally and assets are priced fairly. Coincidentally, we view the current environment as just the type suited to making long-term changes to your investment plan. We encourage clients to immediately inform us if changes to their financial situation and/or risk tolerance might merit changes to their long-term plan.

## On Predicting

"It's difficult to make predictions, especially about the future."

- Yogi Berra

It's difficult to turn on the television and *not* find someone making predictions. From political and social to financial events, there is no shortage of opinion on what will happen. As investors, we always try to take these with a grain of salt because we've found that accurate predictions from the same source are few and far between. (There will always be someone who got it right *this time*, but they would have to get it right every time for the information to have any value.) Predictions tend to be remarkably correlated with what is happening at the moment. In other words, those who predict are excellent at telling us *what is happening* but not *what will happen*. For example, the vast majority of predictions we heard in early 2009 involved the markets

continuing to fall (while they were falling) and the economy continuing to deteriorate (while this was occurring). There were few predicting the opposite: the substantial upturn we have seen. Now, we're seeing a shift. Many are now predicting continued strength in markets and an economic rebound sustaining itself. Some notable exceptions exist, most of whom are often called "perma-bear" or "perma-bull." In other words, they are permanently biased to see the world in one way (bullish or bearish) regardless of what is actually happening. They are correct when the world behaves the way they see it, but absolutely wrong when it doesn't. These "strategists" are invited back on television time after time, but rarely are they called to account for past inaccuracies.

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At Clarity Asset Management, we are long-term investors and are not in the business of predicting. Even though we don't invest based on explicit predictions,

we do try to make educated guesses about a future that is inherently uncertain and think about the risks to capital market valuations. At present, we are concerned with what will happen to the economy when government programs to keep interest rates low and stimulate economic activity end (or go on for too long).

Consumers drive 70% of the economy, so its strength largely depends on consumer health. On that front, things still are not encouraging. Unemployment remains persistently high. Household balance sheets hold record levels of debt. Savings rates are rising (higher savings means less consumption). Consumer credit is also harder to find. Personal disposable income has moved higher, albeit slightly, but all of the past year's advance has been due to an increase in government transfer payments and a decline in personal taxes paid.†

The economy has strengthened on the back of record-low interest rates, which have been possible only through government intervention ("quantitative easing") on an unprecedented scale, i.e., massive purchases of mortgage-backed and government securities – with newly created money – by the Federal Reserve. Low interest rates tend to stimulate activity because capital costs become lower for businesses and consumers. At lower capital costs, more projects become worthwhile investments because, for example, the cost of servicing debt is lower. Economic advances are underpinned by long-term capital investments, like business expenditures for capital, equipment and research and development. These investments drive the gains in productivity which contribute to real (greater than

inflation) economic gains. They also underpin employment growth, which feeds the growth in consumer spending. (Notice any feedback loops here?)

But there must be a real (or perceived) need for such investments in order to justify "giving them the go ahead." On that front, the outlook is not encouraging, despite low interest rates. This is because our economy still has substantial slack that must be absorbed before we see a sustainable increase in new investments. Specifically, capacity utilization remains low, at 72.0 percent, which is 8.9 percentage points below its average for the 1972 through 2008 period. As mentioned before, substantial slack remains in the labor market as well. Government interventions and stimulus actions can boost investments (and support employment somewhat) in the short term, but to make an increase in capital expenditures durable this gap will have to be closed by private capital.

An intermediate to long-term concern we have is not an uncommon one, and that is the rising public debt. On average, government debt rises by 86% during the three years following a banking crisis, and we are well on our way (up 24% during 2009).‡ At present, a quarter of public government debt, or \$1.8 trillion, is in the form of Treasury bills which mature in one year or less; a further 58% is in the form of notes that mature in 10 years or less. Thus, over 80% of the government's debt is short-to-intermediate term and must be continually refinanced as it matures.† This continual need to refinance short-term liabilities is what brought down Bear Stearns and Lehman Brothers and threatened others amid deteriorating confidence in their prospects. As confidence deteriorated, the interest rates demanded (if capital was even available) rose precipitously. There is historical precedent to indicate this could happen to our government or others, perhaps suddenly.

A crisis of confidence in government finances could significantly raise the cost of borrowing for not just the government, but also businesses and consumers. It will also increase the percentage of federal revenues required to service public debt interest. (In 2009, the government spent 18% of its revenues to service federal debt interest. If interest rates had remained constant from 2008 and risen with debt levels, this figure would currently consume over 27% of revenues†) The ripple effects from a breakdown in confidence could be significant. Such a scenario is not a foregone conclusion, but continuing fiscal and trade deficits and increasing debt levels without commensurate increases in tax revenue may only exacerbate the problem. As the saying goes, if an accident is waiting to happen, it eventually will.

The concerns we have make it difficult to invest, but they do lead us to keep bond positions shorter in duration should

interest rates rise. In addition, we're holding several mutual funds whose managers' value discipline leads them to hold excess cash when they're not finding enough assets at a discount. While the future is unpredictable, we believe our investment approach is well suited to multiple scenarios – not just the one the strategists are certain will happen next.

## Future Returns Fall as Stock Prices Climb

We know that investors as a group tend to funnel more cash into stocks and bonds when prices are rising, rather than when they're falling. This phenomenon is well documented. Why does this happen time after time? When stocks are rising, volatility tends to be lower so the range of outcomes appears narrower. That is, recent experience tells investors that stocks rise and fall, but not by dramatic amounts. Also when prices are rising steadily, investors tend to extrapolate that trend into the future. This low volatility and the knowledge that we're "making money" makes humans more comfortable and leads us to believe that we're taking less risk than when prices were lower. Unfortunately, this is not the case and investors must guard against this proclivity to buy and sell at the worst moments.

Our view is that the higher prices go, the greater the risk and lower the potential reward. For instance, consider an investor buying into an asset that is growing at 5% annually and is worth 15 times its earnings. A decade on, her return would be the per annum growth in earnings of 5%, assuming she received the same multiple to earnings when she sold. But what if this investor paid too much – say, 20 times those earnings but received just 15 times at sale? The decade-long per annum return drops to just 2.0%, a difference of \$40,722 on a \$100,000 investment over ten years.† Paying too much can be detrimental to long-term wealth.

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When we develop asset allocations for clients, these considerations are paramount. As stock and bond prices fluctuate, we note the effect on probable long-term returns and attempt to position portfolios based on the relative risk-reward of asset classes. Our methodology is certainly more art than science, but we believe it helps our chances of avoiding overpaying for assets while achieving satisfactory long-term returns.

## Welcoming a New Member to the Clarity Family

On January 9<sup>th</sup>, a new member of the Clarity Family arrived. Sayer and Erica Martin welcomed Leighton Alane, a 6 pound 1 ounce healthy baby girl. Mom and Baby (and Daddy) are doing well! Leighton will be helping her Dad around the office in no time.

† Numbers calculated by Clarity Asset Management, Inc. For return calculations, no fees, expenses or dividends are assumed.

‡ According to research by Carmen Reinhart and Kenneth Rogoff.

*The S&P 500 Index and Russell 3000 Index are market-value-weighted indices and the Dow Jones Industrial Average is a price-weighted average; each consists of stocks chosen for market size, liquidity, and industry group representation. Numbers do not reflect fees, brokerage commissions or other expenses of investing. Economic and fiscal numbers obtained from official U.S. government publications.*

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