

**IN THIS ISSUE**

**P2** Protecting Your Portfolio From Inflation

**P4** Pause... Deep Breath... Think



**“GO GREEN” WITH e-DELIVERY**

**Convenience? Conservation? Less mail?**

**Consider e-Delivery**

e-Delivery is now available for all your *Structured Investing* statements and reports.

And if you sign up for e-Delivery between Memorial Day and Labor Day, we will plant a tree in your honor through the nation’s oldest non-profit citizens’ conservation organization: American Forests (for more information, go to [www.americanforests.org](http://www.americanforests.org)).

Enrollment is easy and takes less than two minutes. Just go to [www.loringward.com](http://www.loringward.com) and click on the “Client Log-In” button in the upper-right corner.

**DO ACTIVE MANAGERS OUTPERFORM IN BEAR MARKETS?**

By Joni L. Clark, CFA, CFP®, Chief Investment Strategist, Loring Ward

Bear markets tend to foster an abundance of investment myths. As shell-shocked investors assess their losses, they search for answers and solutions to avoid losing money in the future. Many investors begin to question their faith in long-standing investment principles, and pundits challenge conventional wisdom as they try to capitalize on an opportunity to promote new investment ideas.

It is important for investors to understand that abandoning prudent techniques may expose their portfolios to additional risks and potentially lead to higher costs.

One of the most enduring investment myths is the belief that active managers have a distinct advantage in bear markets.

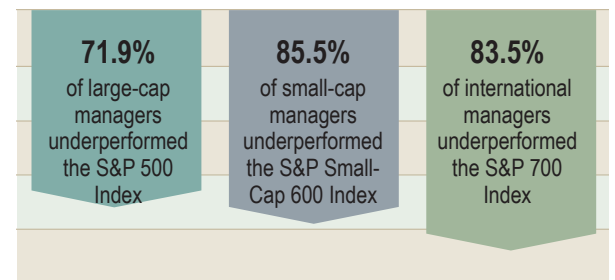
Active managers attempt to outperform the stock market rate of return by actively trading stocks and/or engaging in market timing — deciding when to be in and out of the market. Many investors believe that active managers earn their keep in bear markets, because they avoid losses by hand-picking superior individual stocks or by shifting out of stocks altogether before steep market declines occur.

Standard and Poor’s has been measuring the performance of active managers against their index counterparts for several years now. Their recent Indices Versus Active Funds (SPIVA) Study specifically focuses on the bear market of 2008 and concludes that “the belief that bear markets favor active management is a myth.” They found similar results in 2003 using the case study of the 2000 to 2002 bear market. In both 2003 and 2008, a majority of active funds underperformed their respective S&P Index for all U.S and international equity asset classes. In aggregate

in 2008, actively managed funds underperformed the S&P 500 Index by an average of 1.67%.

In addition, the study found that over a full market cycle for the five years ending December 31, 2008, the S&P 500 Index outperformed 71.9% of actively managed large-cap mutual funds, and the S&P Small Cap 600 Index outperformed 85.5% of actively managed small-cap funds. The results were similar for International funds with the S&P 700 Index outperforming 83.5% of international funds.

**Active Mutual Fund Manager 5-Year Performance from 2003 – 2008**



*Source: Standard and Poor’s Index Versus Active Group, April 2009 (For the period 1/03 – 12/08). Indexes are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. The aggregate fund returns are an equal-weighted average of all funds within each category. Individual funds used are net of fees, excluding loads. The data assumes reinvestment of income and does not account for taxes or transaction costs. Past performance is not a guarantee of future results.*

**See Do Active Managers Outperform In Bear Markets? on Page 3**

## PROTECTING YOUR PORTFOLIO FROM INFLATION

by Joni Clark, CFA, CFP®, Chief Investment Strategist, Loring Ward

If you are among those who believe inflation will be the price we pay for expansionary monetary policies and ballooning federal deficits, you may be bracing for a serious bout of inflation.

The good news is that as long as economic conditions remain weak, the impact of any inflation should be negligible. In fact, a little inflation could be viewed as a positive, if it mitigates the risk of deflation and doesn't get out of hand or persist. The bad news is that if inflation persists, investors may be hurt by the decline in purchasing power of their assets.

Future inflation and its effects on investment assets are difficult to predict in advance, so a diversified portfolio may be the best defense for any inflationary outcome. Though diversification cannot protect against a loss or guarantee a gain, the philosophy behind a well-diversified portfolio is to combine asset classes that will respond differently to various economic and market events. Historically, every asset class responded differently to inflation, and using that as our guide, we can compare the inflation sensitivity of each asset class. However, it is important to note that each asset class' response to inflation in the past does not guarantee how each asset class will respond in the future.

### A Historical Look at Fixed Income

Contrary to popular belief, some bonds have good inflation-fighting characteristics, but their performance is greatly dependent on time horizon and/or bond maturity.

Bonds markets generally suffer from an initial inflation shock because unanticipated inflation is not priced in current yields. Yields eventually adjust, and bond investors may benefit from higher coupon payments and potentially higher real yields-to-maturity.

Long-term bond funds are typically more volatile and experience greater price declines during inflationary periods. This is because long-term bonds have a greater sensitivity to interest rate changes (as measured by duration). Duration measures the expected movement of a bond's price for a 1% change in interest rates. For example, if interest rates rise by 1%, the price of a bond with a duration of 10 years would be expected to decline by approximately 10%. On the other hand, the price of a short-term bond with a duration of 2 years would be expected to decline by approximately 2%.

Also, long-term bonds are more vulnerable to unanticipated inflation because their coupon rates are locked in for a longer period of time and may not adequately compensate investors for the current rate of inflation. Whereas shorter-term bonds are able to be reinvested sooner at maturity in order to capture rates that reflect current inflation expectations.

The graph above compares the performance of Five-Year Treasury Notes and Long-Term Government Bonds along with the Consumer Price Index and S&P 500 Index during the "hyper" inflationary period of the 1970s through the early 1980s. Five-Year Treasury Notes delivered positive returns each year during this inflationary period. The returns of Long-Term Government Bonds were more volatile and negative in five of the ten years in this inflationary period.

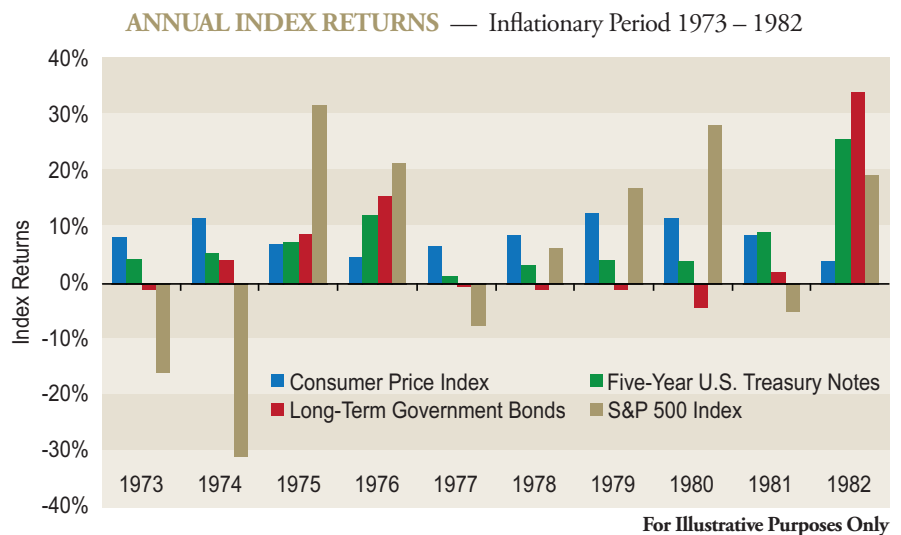
### A Historical Look at Equities

Because of their strong historical risk premium of equities (relative to bonds) one of the primary considerations to invest in them is, potentially, to earn a

higher rate of return for long-term growth. In theory, stocks should perform well during inflationary periods because they represent real assets, and as the prices of those assets rise, so should equity prices. While past performance is no guarantee of future results, in the long-term performance race against inflation, stocks outpaced inflation 9.7% to 3.0% from 1926 to 2008 (as measured by the S&P 500 Index).

But the long-term history of returns is characterized predominately by modest inflation, with one big exception — the 1970s — when double-digit inflation contributed to a bear market in stocks. As the *Annual Index Returns* graph, the S&P 500 Index, (a representation of the U.S. equity market) declined -14.7% in 1973 and another -26.5% in 1974.

Equities were not an effective inflation hedge during this period because real interest rates (rates in excess of inflation) also rose substantially, as fixed income investors demanded a higher risk premium to compensate for the greater risks associated with future inflation uncertainty. In an inflationary environment, two conflicting forces drive real interest rates. Fixed income investors demand a higher yield to protect against further surprises, causing real interest rates to rise. Simultaneously, supply and demand forces usually



Data Source: Morningstar-Ibbotson (May 2009). Long-Term Government Bonds are represented by the Ibbotson SBBI Long-Term Government Bond Index. Indexes are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. The data assumes reinvestment of income and does not account for taxes or transaction costs. Past performance is not a guarantee of future results. Bonds and fixed income funds will decrease in value as interest rates rise. Past performance does not guarantee future results.

push real interest rates down to normal levels. One cannot forecast which of these factors will be more dominant if inflation escalates.

Higher real interest rates are detrimental to stock prices and valuations because companies' future earnings are worth less when measured in today's dollars.

### A Historical Look at Commodities

Commodities' strong recent showing has attracted the attention of investors, and commodities are currently being promoted by some as a good hedge against inflation. However, a study by Truman A. Clark concluded that "commodity futures do not appear to be effective inflation hedges for stock and bond portfolios." In addition, the study concluded that the long-term expected return from commodities may be no greater than the Treasury Bill return.

Some modern financial theories suggest that commodities, like currencies, are not investments with long-term expected return. Only projected earnings

can generate expected return, according to these theories, and since commodities do not produce anything, they have no projected earnings stream and therefore, no expected return.

A recent study by two economists at the International Monetary Fund, “Inflation Hedging for Long-Term Investors,” concluded that commodities offer short-term relief from inflation, but those benefits dissipate over time. In their study, commodities were the most effective hedge over a one-year period of inflation. But long-term investors should focus on performance of portfolios and asset classes over much greater time horizons.

One defense against inflation — or any other unpredictable economic condition — is to maintain a broadly-diversified portfolio. Each asset class should respond differently to various economic and market events, and each asset class has unique characteristics that may respond differently to inflationary forces. Some asset classes may decline during a particular period of inflation, others may thrive. Instead of trying to guess and make predictions about the future, some investors prefer to put their confidence — instead — in the broader potential of diversification. 🌐

*Diversification cannot protect against a loss or guarantee a gain.*

*Bonds and fixed income funds will decrease in value as interest rates rise. Past performance does not guarantee future results.*

## Do Active Managers Outperform In Bear Markets? *continued from page 1*

### What are the Challenges of Active Management?

One of the biggest challenges for active managers is the extreme difficulty in forecasting the economy or accurately predicting the market’s direction in advance.

Wall Street has a notoriously bad forecasting record. Amazingly enough, Wall Street’s consensus forecast has failed to predict a single recession in the last 30 years.

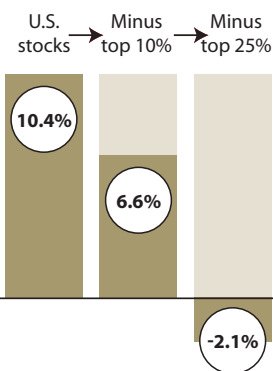
Looking back on the forecasts made for the markets at the beginning of 2008, many of them turned out to be quite optimistic. At the end of 2007, Newsday looked at the market predictions of “eight major Wall Street Securities firms” and found an average price target for the S&P 500 by year-end 2008 of 1,653, representing a 12% increase over 2007. Of course, we now know that the S&P 500 Index declined by 37% for the year 2008. And many of those major Wall Street firms experienced their own unforeseen troubles, including being sold or merged.

If Wall Street experts can’t even predict recessions or the direction of the market, it is questionable how active managers can successfully pick individual stocks, especially since a stock’s performance is often very sensitive to economic and market conditions.

Another challenge to active management is that the performance of individual stocks differ greatly even though stocks collectively have historically provided strong returns over long investment horizons,

When using the University of Chicago’s CRSP total market equity database to represent the U.S. market for the period 1980-2008, only the top-performing 25% of stocks were responsible for the market gains during this timeframe. The remaining 75% of the stocks in the total market database collectively generated a loss of -2.1%. This example demonstrates the difficulty in selecting the individual stocks that will perform better or even in-line with the broad equity market. It is important to note that past performance in any security is not indicative of future results.

## Annual Total Returns 1980 - 2008



Note: Figures are based on the University of Chicago’s CRSP Database of the Total U.S. Stock Market.

Source: Dimensional Fund Advisors.

*Past performance is not indicative of future results. Indexes are unmanaged baskets of securities in which investors cannot directly invest. The data assume reinvestment of all dividend and capital gain distributions; they do not include the effect of any taxes, transaction costs or fees charged by an investment advisor or other service provider to an individual account. The risks associated with stocks potentially include increased volatility (up and down movement in the value of your assets) and loss of principal. Small company stocks may be subject to a higher degree of market risk than the securities of more established companies because they tend to be more volatile and less liquid.*

One might ask: if a small percentage of stocks could possibly account for the market’s long-term returns, why not avoid all the headaches and just invest in these top performing stocks? Because one must consider that past performance is not indicative of future results, and a portfolio of even the most carefully chosen stocks could easily wind up with none of the best-performing stocks in the market — and thus could possibly produce flat or negative returns for many years. As the performance of active managers versus indices shows, very few managers are accomplished stock pickers.

Missing out on even a handful of the top-performing stocks can leave you well short of market returns. According to an article by William J. Bernstein’s *Money Magazine* (05/09), the only way you can be assured of owning all of tomorrow’s top-performing stocks is to own the entire market.

It is our philosophy that the point of investing isn’t to aim for the highest possible returns, but rather to generate returns necessary to meet your long-term objectives at an acceptable risk level. Attempting to enhance your returns by seeking out the needles in the haystack introduces an additional layer of active risk and the potential for increased volatility.

A final challenge to active management is that returns for active mutual funds may be reduced by higher expenses, since active funds generally charge higher fees, and incur heavier trading and tax costs, according to “The Cost of Active Investing,” (March 2008) a paper by Kenneth R. French, a professor of finance at Dartmouth College’s Tuck School of Business.

Professor French added up the fees and expenses of U.S. equity mutual funds, investment management costs paid by institutions, fees paid to hedge funds, and the transaction costs paid by all traders, and then he deducted what U.S. equity investors would have paid if, instead, they had simply bought and held a passive fund benchmarked to the overall stock market. The difference between these amounts was \$102 billion. Professor French says, this difference is what investors, as a group, pay trying to beat the market.

So what should a long-term investor do? The answer will vary for different investors, but given the challenges and expenses of active management, holding a well-diversified *Structured Investing* portfolio may be the prudent approach in attempting to achieve your long-term financial goals. 🌐

*Diversification cannot protect against a loss or guarantee a gain.*

## PAUSE...DEEP BREATH...THINK

By Meir Statman, Glenn Klimek Professor of Finance, Santa Clara University

All seemed lost at the beginning of this year. Many investors lost substantial proportions of their portfolios and some lost trust in the cornerstones of diversification and consistent long-term investment plans. The headline "Is Markowitz Wrong?" was plastered in giant letters across the January 2009 cover of the *Journal of Financial Planning*. Professor Harry Markowitz, as you recall, contributed the scientific framework for diversification and received the Nobel Prize for his work.

I believe Markowitz is right, not wrong. Portfolio diversification and consistent long-term investment plans continue to be wise investment policy. Moreover, doubts about their wisdom carry their own lessons about the pitfalls in our thinking and feeling, which we should guard against.

We were afraid in January 2009 and terrified by early March. Our portfolios may look better as I write at the beginning of June, but we're still afraid. It is good to pause, take a deep breath, and assess our knowledge, thinking and feeling.

All major stock markets plunged in 2008, so it seems natural for us to believe that diversification has betrayed us. Isn't diversification designed to prevent such joint plunges? Unfortunately, the answer is no. A common misunderstanding of the benefits of diversification is that when U.S. stocks lose, international stocks are likely to gain, such that one compensates for the other and the portfolio does not sustain a loss. This misunderstanding is based on the assumption that the correlation between the returns of U.S. stocks and international stocks is negative.

In fact, almost all correlations between returns of investments are positive, such that when U.S. stocks lose, international stocks are likely to lose as well. But the magnitude of losses is likely to be different. U.S. stocks, measured by the S&P 500 Index, plunged 37% in 2008, but international stocks, measured by the EAFE Index, plunged 43%. The difference between the two returns was 6%. The fact that an investor who concentrated her portfolio in international stocks lost more than an investor who diversified between U.S. and international stocks seems like cold comfort, but diversification did help.

We can see the more comforting side of diversification in the returns during the first five months of 2009. While U.S. stocks increased 3%, international stocks increased 12%. This time we are relieved by gains rather than being pained by losses, but the 9% difference in the magnitude

of the gains is evidence for the benefits of diversification.

Notice two differences between 2008 and 2009. First, while returns in 2008 were negative, returns so far in 2009, through the end of May, are positive. Second, while U.S. stocks beat international stocks in 2008, international stocks beat U.S. stocks so far in 2009. I did not know at the beginning of 2008 or 2009 whether returns would be positive or negative, and I did not know whether U.S. stocks would beat international stocks or be beaten by them.

Not all agree. The article which asked if Markowitz is wrong quoted financial advisors who recommend that investors abandon diversification and long-term investment plans for market timing, jumping from bonds to stocks and from U.S. stocks to international stocks. But I believe market timing is folly and jumping into it is like jumping from the frying pan of the present into the fire of the future.

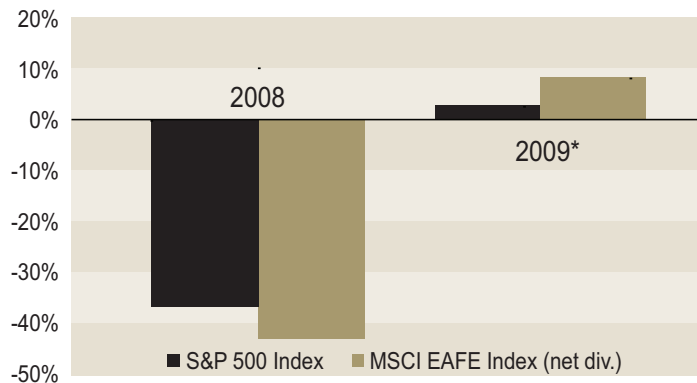
We must guard against the cognitive errors that hide the pitfalls of market timing. Hindsight error makes us think that it was easy to see in 2007 that global stock markets would plunge in 2008. But, in truth, what is clear now in hindsight was not clear in foresight. Confirmation error leads us to see facts that support claims that the plunge of 2008 should have been anticipated, and ignore facts to the contrary. We hear much about Nouriel Roubini, the economist who did see the coming collapse of banks, but we hear much less about Ben Bernanke, a better economist and Chairman of the Federal Reserve Bank, who did not foresee that collapse. Representativeness leads us to

believe that the future will be similar to the recent past. So we forecast stock market increases following increases and stock market plunges after plunges. Forecasting further declines in stock markets might come naturally in March 2009, but it would be wrong in the following two months as markets soared. The emotion of fear often compounds the effects of cognitive errors. We were afraid of the stock market in March 2009, and we are still afraid now.

We may be angry when we think of savings that evaporated during the last decade. But anger is a poor guide for wise decisions. I cannot forecast the returns of investments in the second half of 2009. Nobody can. But we should recognize our cognitive errors and emotions and the pitfalls they may hide. ☹

*Diversification cannot protect against a loss or guarantee a gain.*

### U.S. and International Index Returns 2008 and Five Months ending May 31, 2009



\* Five months ending May 31, 2009

Data Source: Morningstar-Ibbotson (May 2009)

*Indexes are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. The data assumes reinvestment of income and does not account for taxes or transaction costs. Past performance is not a guarantee of future results.*