Special Holiday Edition

December 2010 | Vol. 1 No 4 | HALLETT ADVISORS

Reasons for Hope

"The pessimist sees difficulty in every opportunity. The optimist sees opportunity in every difficulty." Sir Winston Churchill

As we approach the end of the year, I'm writing to share some thoughts on today's economic outlook and the pessimistic psychology many people share – a frame of mind Winston Churchill commented on in his day.

Today we're seeing a mood of widespread fear and pessimism. Many people feel overwhelmed by problems in the US, led by high unemployment, government deficits, depressed housing prices and gridlock in Washington. Clearly, these are substantial issues to be worked through. A key concern is the positive, optimistic, can-do mindset that has fueled so much of the growth and success of the US remains mired in pessimism.

What's important to remember is throughout history, people have regularly overcome problems of even larger magnitude. This is one of the themes of a thought-provoking new book by well-known science writer Matt Ridley: "The Rational Optimist: How Prosperity Evolves". Ridley makes the case for optimism about the future. Bill Gates reviewed the book in the Wall Street Journal, pointing out Ridley documents constant predictions of a bleak future throughout human history. The point is these issues too were usually blown out of proportion. As Bill Gates wrote, "Despite them, our lives have improved dramatically in terms of lifespan, nutrition, literacy, wealth, and almost any other measure you'd care to name."

With regard to innovation, Bill further wrote: "Pessimism is often wrong because people assume a world where there is no change or innovation. They simply extrapolate from what is going on today, failing to recognize the new developments and insights that might alter current trends." (Continued on Page 4.)

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Advisor Corner

Thank you for the opportunity to serve as your advisor. We appreciate your trust and confidence. Here's to a prosperous 2011.

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Achieving the Proper Balance of Risk and Return

ASK JIM

- What is an Investment Policy Statement (IPS)?
- Should I have an IPS?
- Can you help me assess my risk tolerance?
- How often should I review my risk-return profile?

An important decision that every investor must make is determining the amount of investment risk to assume while maintaining a level of comfort. Risk is simply defined as the probability that the actual return for an investment will differ from that which was expected. It is possible that some or even all of an investor's original investment may be lost. In other words, there are no sure things in the investment world.

All investments contain some degree of risk; however, some investments are considered more volatile (riskier) than others. Low levels of uncertainty, or low risk, are usually linked to investments with low potential returns. On the other hand, investments with high levels of uncertainty, or high risk, are generally accompanied by high potential returns. The relationship between risk and return is such that one must be willing to accept greater risk if one wants to pursue greater returns.

A common misunderstanding among investors is that higher risk will lead to greater returns. According to the risk/return tradeoff, however, higher risk investments provide an investor with the possibility, not the certainty, of higher returns.

Consider the table below showing the periodic returns of three hypothetical investments. Investment A fluctuates very little from period to period. It has low volatility or a low amount of risk. However, this low risk is accompanied by low average returns. Conversely, Investment B has greater periodic fluctuations from one period to the other and has even lost money in one of the periods. On the flip side, Investment B's average return is higher than that of Investment A, corresponding to this higher level of risk. The riskiest investment of the three is Investment C, which has experienced a double-digit loss in one period. The returns for Investment C have also been periodically quite high, resulting in the highest average return of all three investments.

As the saying goes, "There is no free lunch"; in many cases, investments that generate high returns also come with high levels of volatility or risk. These high returns act as a compensation for investors, for assuming high risk. Further, it is very important to realize that taking on a high level of risk in hopes of attaining a high level of return is not for everyone.

An investor's risk tolerance varies according to age, income requirements, financial goals, and other considerations particular to each investor's unique situation. It is essential to determine your attitude toward—and your tolerance for—risk, while (all the time) keeping in mind that past performance is by no means a guarantee of future results.

Periodic Performance of Three Investments

	1	2	3	4	5	6	7	Average
Investment A	4%	7%	5%	7%	5%	2%	5%	5.0%
Investment B	2%	12%	–4%	21%	12%	1%	8%	7.4%
Investment C	5%	22%	–14%	32%	16%	–4%	13%	10.0%

Politics and Investment Performance

With the Nov. 2 elections come and gone, here's the result of an investigation into the relationship between the composition of the legislative and executive branches of the U.S. government and market performance. The data table displays the average annual returns for the S&P 500® and a 60% stock/40% bond portfolio in three different situations. The "unified" situation refers to years when the Senate, the House of Representatives, and the White House were all controlled by the same party. The "partially divided" situation represents years when the House and Senate were controlled by the same party, but the White House was held by a different party. The "completely divided" situation uses data from years in which the two houses of Congress were divided. Both the S&P 500 and the diversified portfolio averaged the highest returns during unified years, lower returns during partially divided years, and the lowest under completely divided years.

Average Annual Returns 1926–2009

	S&P 500	Diversified portfolio	Number of years
"Unified" years	14.8%	9.8%	44
"Partially divided" years	11.1%	9.6%	30
"Completely divided" years	1.0%	6.8%	10

Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Diversification does not eliminate the risk of experiencing investment losses. Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than bonds. The time period examined is 1926–2009, and the returns are average annual returns.

Stocks—Standard & Poor's 500 index, which is an unmanaged group of securities and considered to be representative of the stock market in general. Bonds—20-year U.S. government bond.

The End of the Recession

In September 2010, the National Bureau of Economic Research announced the long-awaited news: an end date for the recession that had begun in December 2007. The NBER determined the official end date as June 2009, quieting down (if not completely silencing) double-dip fears. NBER defines a recession as a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales. Looking back at the performance of the main asset classes during the recession and in the months following the official end date, gold was the best overall performer, and long-term government bonds offered consistent positive returns. Out of the investments with the worst performances during the recession, REITs posted the most-impressive return in the 16 post-recession months.

Returns During and After the Most Recent Recession

	Recession Dec 2007 to Jun 2009*	Aftermath Jul 2009 to Oct 2010*
Gold	19.3%	44.1%
Long-term government bonds	8.4%	14.5%
Treasury bills	1.9%	0.1%
Small stocks	–33.8%	42.5%
Large stocks	–35.5%	32.2%
International stocks	–39.7%	28.4%
REITs	–48.1%	81.8%

**Returns in table represent cumulative returns during time periods indicated, not geometric returns.*

Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Holding a portfolio of securities for the long term does not ensure a profitable outcome, and investing in securities always involves risk of loss. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, liquidity risks, and differences in accounting and financial standards. REITs are subject to certain risks, such as risks associated with general and local economic conditions, interest rate fluctuation, credit risks, liquidity risks and corporate structure. Small stocks are more volatile than large stocks, are subject to significant price fluctuations, business risks, and are thinly traded. Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks, REITs, and gold are not guaranteed.

Source: Gold—Wall Street Journal London P.M. closing price. Long-term government bonds—20-year U.S. government bond. Treasury bills—30-day U.S. Treasury bill. Small stocks—Dimensional Fund Advisors, Inc. (DFA) U.S. Micro Cap Portfolio. Large stocks—Standard & Poor's 500® Index, an unmanaged group of securities considered to be representative of the U.S. stock market. International stocks—Morgan Stanley Capital International Europe, Australasia, and Far East (EAFE®) Index. REITs—FTSE NAREIT Equity REIT Index®.

Reasons for Hope

As I meet with clients, we talk about broad themes for 2011. First, understand how much volatility you can live with. Markets will continue to gyrate. For some retired clients, I advise setting aside up to three years of cash needs from savings in conservative investments, something that can reduce stress in volatile markets.

When deciding on the mangers to run client portfolios, we continue to emphasize experienced managers with a conservative approach to buying quality companies at attractive prices.

Finally, we need to take a rationally optimistic view of the future, walking the fine line between dire pessimism on the one hand and blind optimism on the other. This will not necessarily pay off in the next 6 or 12 months, but history tells us we'll be well rewarded for remembering the past and focusing on the future.

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