

The rational approach to
portfolio management...

STRATEGIC NEWS

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INSIDE

Avoid trading
mistakes

page 1

Managers cannot
outperform market

page 2

Ponzi schemes

page 2

Predictions for
municipal bonds

page 3

Fixed income as
inflation hedge

page 3

Fear versus
valuations

page 4

Points of Interest:

**For the first time ever
the Federal Reserve
Board has pledged to
keep rates stable for
a specific time period—
two years**

**Savers will be stuck
with anemic interest
rates through mid 2013**



HOW TO AVOID FREQUENT TRADING MISTAKES

The wealthy are human too—they make the common mistake of trading in the financial markets too much, even as many realize they are trading excessively, says Barclays Wealth, a division of Barclays bank.

It surveyed 2,000 wealthy investors (those with a net worth over \$1 million) of all ages and found that 40 percent believe they must trade frequently to do well in the markets.

But in a surprising finding, half of those who trade frequently said they believed they traded too much.

“There is a substantial proportion who are troubled by their behavior. This is a novel finding for me.” Greg B. Davies, head of behavioral and quantitative finance at Barclays, told *The New York Times*.

Men vs. Women

Barclays found that men were more likely to trade too much than were women. This finding replicates that of several other investor studies.

Men participating in the Barclays study reported feeling more composed than women and less subject to stress when making trading decisions. Women reported being more likely to use self control strategies to avoid financial mistakes.

The study also found that age does indeed bring wisdom.

Older investors reported being more calm, satisfied, and accepting than their younger counterparts. Older investors were less likely to endorse frequent trading. They were more likely to practice a buy-and-hold strategy, Barclays said.

Davies said these tendencies benefit older investors. “If one starts from naturally higher

level of satisfaction, you will be less anxious, less likely to trade emotionally, less likely to harm your performance over time and less likely to need assistance with self-control,” he said.

Try control strategies

Barclays offered some tips on strategies to help investors control themselves.

Investors can deliberately avoid current information about how the market or their portfolios are doing in order to stick to a long-term strategy.

They can use rules to make better decisions, such as deciding to spend only out of income and not out of capital.

Barclays recommends delegating financial decisions to others and says you can do that by having an investment advisor manage your portfolio.



Frequent stock traders are often unhappy with their results. The use of simple trading rules can help you limit the damage from your decisions.

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EVEN THE BEST INVESTMENT MANAGERS CANNOT OUTPERFORM THE MARKETS

Many investors want to believe that they can find an investment manager who, based on his or her past performance, can continue to beat the markets and offer superior returns.

Studies of the performance of mutual fund managers have found little evidence of the persistence of good performance or of excess skill among mutual fund managers.

Now three finance professors have done a detailed study of institutional investment managers who invest for public and private retirement plans, endowments, foundations, and unions.

Their results indicate that as a group these managers also provide little evidence of skill or performance persistence.

Less pressure

This is a significant finding because some have argued that mutual fund managers have a marketing handicap — they have to compete with other managers in a public marketplace where everyone’s returns are open knowledge, and they may have to take extra risks in order to distinguish themselves from the crowd.



Investment managers at institutional funds do not outperform the market on average.

Institutional money managers usually answer to sophisticated investment committees who have long-term views of the markets and may tend to pressure the managers less to make sudden moves.

A big sample

In a paper slated for publication in *The Journal of Finance*, Jeffrey A. Busse and Amit Goyal of Emory University and Sunil Wahal of Arizona State University looked at 4,617 institutional investment funds run by 1,448 management firms. Their study corrected for survivorship bias among the managers over the period from 1991 through 2008.

“Before fees, we find little evidence of superior performance, either in aggregate or on average,” they said in the paper, titled “Performance and Persistence in Institutional Investment Management.”

They said that once a manager’s style of investing and evidence of stock momentum are factored out, it appears managers offer no extra performance.

“One logical conclusion might be that plan sponsors should engage in entirely passive asset management,” the authors wrote.



DON'T GET CAUGHT IN A PONZI SCHEME

In 1920 Charles Ponzi defrauded investors for nearly \$7 million in the type of scheme that has since borne his name. Ponzi, who went to prison and died in poverty, would have been proud of his protégé Bernard Madoff, now in prison for defrauding investors of an estimated \$65 billion in his own Ponzi scheme.

Despite Madoff’s notoriety, big and little Ponzi schemes are uncovered regularly and individual investors continue to lose thousands to hundreds of thousands of dollars in them. Investment News last year reported that Ponzi schemes involving over \$9 billion in losses were reported in 2010.

Thriving on distress

These schemes seem to thrive when legitimate investment markets are in distress: Ponzi schemes usually promise generous, steady returns and attract investors trying to avoid the stock market’s ups and downs or trying to improve on low rates on bank deposits.

You should understand how a Ponzi scheme works and know the warning signs so that you can protect yourself, your family, and friends.

Ponzi schemes are pyramids: The scam artist continues to take in new money and uses that to make “interest” and “principal” payments to previous investors. Typically the

schemes collapse under their own weight as it becomes impossible for the operators to bring in more and more money to keep paying off earlier investors.

Ponzi perpetrators typically convince an initial group of investors of their investment “idea”, promise a high rate of return, and then build credibility by delivering on those promises by using new money to pay off initial investors.

Spot the Ponzi

The Securities and Exchange Commission offers these red flags:

1. A promise of high returns with little or no risk.
2. Consistent returns that don’t fluctuate with markets.
3. Irregular paperwork and a lack of third party disclosure on investments.
4. Difficulty receiving payments.

Ponzi operators typically are not federally or state-licensed and their investments are not registered with authorities. If you are suspicious of any financial salesperson or investment, check on licensing and registration with the SEC and state authorities.



THE MUNICIPAL BOND SCARE THAT WASN'T

As we sit in the middle of the European debt crisis and the American debt crisis it is instructive to remember one recent “crisis” that got a lot of attention but never happened: the scare over massive municipal bond defaults by the states.

The call for hundreds of billions of dollars in defaults and a collapse in the muni market came late in 2010 from Meredith Whitney, a former bank stock analyst who had formed her own research firm.

In order to drum up business for her firm she produced a report that claimed to predict gigantic losses ahead as struggling states faced higher costs and lower revenues.

The 60 Minutes effect

She gained a lot of attention in an interview at the end of the year on the TV news show “60 Minutes.” She said strapped state budgets would result in a record number of bond defaults over the next 12 to 18 months.

Whitney had some credibility. As a banking analyst for Oppenheimer & Co. before and during the 2008 financial crisis, she was the first to predict that Citibank would cut its dividend. This was one of many drastic measures by financial institutions that caused investors to flee financial stocks.

Her latest prediction was that 50 to 100 counties, cities and towns would default, causing \$100 billion or more in

losses, well above the previous record year of about \$8 billion in defaults.

Her comments so unnerved individual investors in the \$8.2 trillion municipal debt market that it fell early in the year as investors redeemed individual bonds and shares of bond mutual funds.

Crash has not come

Yet bonds recovered and have been one of the best investments to own as of mid-year.

One benchmark, the iShares S&P National AMT-Free Bond Fund, gained 7.2 percent since Whitney was on “60 Minutes.”

Meanwhile, defaults on muni bonds are plunging, down 60 percent in the first half of the year compared to last, reported Bloomberg News Service. Last year in the first half there were \$2.3 billion worth of defaults, but this year only \$746 million.

States have also been slashing costs and payrolls, and getting more aggressive about revenue collection.

In recent interviews Whitney continued to stick by her predictions.



Meredith Whitney's criticism of the municipal bond market scared investors, but her forecast of a wave of defaults has not panned out yet.



FIXED INCOME WILL FAIL AS AN INFLATION HEDGE IN RETIREMENT

What do many investors who are about to retire or are in retirement worry about? They seem to focus on the stability of their principal.

This is a big mistake. Fixing the value of your portfolio at retirement in order to avoid market “losses” probably is a guarantee that you will not succeed financially in retirement.

The biggest financial foe you face over a lengthy retirement is not temporary stock market volatility; it is long-term erosion of your purchasing power.

Consider the cost of a postage stamp 40 years ago. In the summer of 1972 first class mail cost just 8 cents. Today it costs 44 cents, an annualized increase of over 4 percent per year.

Today it's impossible to put your money into just about any fixed-income instrument (except for risky high yield bonds) with a rate anywhere near 4 percent.



Stocks are the key to keeping your nest egg healthy during retirement.

In fact, a 30-year rally in bond prices has reduced yields on short-term bonds to nearly zero.

Meanwhile, consumer inflation is anything but zero. The current inflation rate, as measured by the Consumer Price index, stands at 3.6 percent.

Although bonds kept up with inflation over the last 40 years, at current prices it seems hard to believe they can over the next 40.

The stock market, however, has done a better job of keeping up. Over the last 40 years the Standard & Poor's 500 Index has returned about 10 percent per year, despite dozens of small to large temporary declines in value.

The stock market also allows long-term investors to keep more of what they have earned. Interest on bonds and bank deposits are taxed at a taxpayer's highest current regular rate.

Long-term capital gains on stocks, however, receive favorable tax treatment. The current rate is only 15 percent.



STRATEGIC WEALTH MANAGEMENT GROUP, INC

701 Colorado Avenue
Stuart, FL 34994
772.283.2300

Forwarding and return postage guaranteed
Address correction requested

First Class Mail

Kim Martin, ChFC, CLU

Investment Advisor
Representative
kmartin@RGCNcpa.com

Amy Duffett Chappel, CPA

Investment Advisor
Representative
achappel@RGCNcpa.com

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FEAR VERSUS VALUATIONS **by: Burton G. Malkiel**

“The sky is falling! The sky is falling!” Chicken Little’s admonition may strike many observers as particularly apt today. I disagree.

The headwinds restraining the economy are many. Consumers are still over-indebted and household finances are perilously balanced. House prices, after sharp price declines, threaten to fall further. The effect has been a big hit to households’ net worth and has prevented any recovery in construction activity, which normally plays a big role in the early stages of any economic expansion. The unemployment rate is stuck above 9%, and even optimistic economic forecasters see little chance of a meaningful decline, even if a tepid economic recovery resumes in the second half.

Is it time to sell all your stocks, which are still well above their lows of 2009? I think not. No one can predict what the stock market will do in this and coming weeks. Stocks may continue their decline, but I believe it would be a serious mistake for investors to panic and sell out. There are several reasons for optimism that in the long run we

will see higher, not lower, market valuations. Price/earnings multiples are just over 14 and forward P/E multiples, which use forecasted earnings, have shrunk to less than 12. These multiples are low relative to historical precedent and are especially low when considered in comparison to a 10-year Treasury yield of 2.5%.

A strong dose of modesty is clearly in order. We all need to be aware of the limits of our ability to forecast future stock prices. No one can tell you when the stock market will end its decline, but there are some things that we do know. Investors who have sold out their stocks at times when there have been very large declines in the market have invariably been wrong. We have abundant evidence that the average investor tends to put money into the market at or near the top and tends to sell out during periods of extreme decline and volatility. Over long periods of time, the U.S. equity market has provided generous average annual returns. But the average investor has earned substantially less than the market return, in part from bad timing decisions. My advice to investors is to stay the course.