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Long-Term Faith in the Face of Fear

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Economic Update

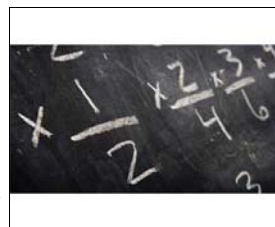
The market has been on a remarkable run over the last 15 months. The S&P 500 dropped to 676 in March 2009 and as of this writing (June 1, 2010) is trading over 1070, but is off from the 1200+ it reached in March of this year. It is hard to believe that a year ago the market was fixated on the prospect of a total financial collapse of our capital markets. By March of this year, the market seemed to have disregarded that prospect completely and acted as if the future economic picture was very bright. Now, as we are at the beginning of June, the market seems to be concerned about Europe's credit problems and the difficulties the European Union faces as it tries to stabilize its weaker members (Greece, Spain, Portugal, and to a lesser extent Italy).

Given current price levels, the market has a somewhat rosier outlook than we do at this time. We continue to see headwinds with tight bank lending, consumers remaining overextended, and the government providing much of the demand by way of stimulus spending and low interest rates. Government spending here and abroad has been financed with record budget deficits. This is leading to a huge increase in total debt outstanding, and is clearly unsustainable over time.

The portfolio managers at FPA Funds recently commented:

For 2010, the consensus is for the S&P 500 to earn \$78. To achieve this estimate, sales will have to grow 6% and the after-tax margin hit 8.1%. The sales growth seems plausible, but the margin appears very optimistic to us, since the highest net margin we've achieved in the last twenty-five years excluding fi-

nancials was 7.7% in 2007. In fact, the average net margin the last two and a half decades has been 5.3% according to a Morgan Stanley study. Thus, the 8.1% margin in the forecast implies a 50% improvement over the long-term average. We do not think this is very probable, and if it does happen, it is not likely a sustainable long-term margin. If we assume the future will be a little better than the past and use a long-term margin of 6.3% for the S&P 500, we calculate \$60 in earning power. If this is correct, the S&P 500 currently trades at 20x its average earning power. Since 1900, the geometric mean P/E ratio for the broader market has been 14x, and the arithmetic mean P/E ratio has been 16x. This means a decline of 20-30% would just put the market in line with its long-term averages.



Markets can float both above and below fair value for long periods of time, but the gravitational pull of value eventually brings markets back to their true worth.

Near-Term Outlook

On a more positive note, we feel the recent market decline is more rationally based and is starting to reflect a realization of the fundamentals facing global businesses versus the October '08 – March '09 decline that was to a certain extent driven by fear and liquidity needs. In addition to the opinion of FPA Funds, several other managers that we have high respect for also believe that fair value of the S&P 500 is at around 900.

- The market will eventually reach fair value
- We have rule of law and property rights
- Political tug-and-pull is necessary for the system to work

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However, valuation is always somewhat gray, since predicting future earnings, economic growth, and the earnings multiple are subject to a variety of factors. We do remain mindful that markets have a tendency to overshoot on both the up and the downside. Thus, it seems probable to us that any decline that moves towards fair value is likely to overshoot the mark. We have no idea how the market will reach fair value, we just know it eventually will. Markets can float both above and below fair value for long periods of time, but the gravitational pull of value eventually brings markets back to their true worth. This can be accomplished through either market declines (or in the case of undervaluation, market advances) or stagnation where the markets sit in a trading range (or slower advancement) waiting for earnings to catch up. Knowing this, we are long-term holders of stocks at these prices, but would become moderate buyers in the 950 range on the S&P 500, and strong buyers at anything below 800. Some of this strategy will be executed automatically for us through our underlying mutual fund managers that build cash when they cannot find sufficient value and deploy it as opportunities present themselves. Likewise, our managers in the Alternative space that can hedge against downside decline, may lift some of their hedges if prices decline to lower levels. In addition, we are likely to rebalance a portion of client portfolios out of fixed income and into equities as we reach the price levels listed above.

Forecasting possible economic outcomes and the implication of those on client financial plans is not easy. To simplify things, think of three future possibilities. 1) Higher inflation as governments around the world devalue their currencies through monetary operations designed to help jumpstart their economies. 2) Stagflation as moderate inflation is offset with moderate GDP growth leading to no real net growth as public debt, consumer deleveraging, and higher taxes all take their toll. 3) Deflation as economic fundamentals deteriorate further leaving too few “dollars” to chase goods and services. We continue to believe that outcomes 2 & 3 are possibilities over the next 1-5 years, but are likely to be replaced with inflation in the long-run. Thus, for people with time horizons of 10 years or longer, continuing to own stocks should be a key component of your financial plan (even though we are likely to experience periods of significant fluctuation). Money needed for goals within the next 2-5 years seems to present investors with the most challenge in respect to asset allocation. Given the risks of the next several years, we have generally taken the position of being more conservative and have recommended allocating these monies to fixed income and lower risk hedging strategies.

Long-Term Outlook

Please do not confuse the headwinds we see facing the U.S. and global economy over the next several years as a negative opinion about the long-term prospects for the U.S. economy. We think the adjustments that are

being made now and over the next few years are necessary in order to put our economy on solid footing going forward. We are likely to face a period of discomfort as consumers and businesses fully recognize the new economic environment. However, we also feel this period of discomfort will provide the U.S. with great opportunities over the long-term as capital is re-deployed more productively and into industries of the future (rather than the financial diversions of the last several years). Please don't diminish the heartfelt empathy we feel for the social cost this will cause our country as we go through this adjustment. We hope the Federal Reserve in the future will support a more solid foundation for economic growth by discouraging excessive risk taking through prudent monetary policy. In addition, we hope our Congress will become more fiscally responsible in addressing our deficit and debt.

We also feel the traits that have made the U.S. the most productive and economically successful country the world has ever seen are still in place, even though we clearly got off track. In our studies on the long-term success of the U.S. economic model, we have identified four traits that have contributed significantly to our success relative to most of the world.

1. We have **rule of law**. Contracts can be trusted or resolved in a court of law. We always have a bad apple or two, but our government is largely free of corruption and follows a system of rules. In many countries of the world, bribes and bureaucracy greatly limit the functioning of free market economics.
2. We have **property rights**. Intellectual property rights are respected and upheld by law. Companies know that if they invest heavily in a new idea, process, or product their patents and copyrights protect them. Compare this to the sheer number of knock-offs and forgeries coming out of China each day.
3. We have a taxation system that has been relatively stable and has generally encouraged the taking of business risk. Our system allows an entrepreneur or business to invest capital (with risk) in order to bring a new product or idea to market in the hopes of success and significant reward. Without the prospect of significant reward, capital will not be invested at significant risk. Likewise, our political system has ebbed and flowed between the need for certain levels of regulation while also seeking to encourage the taking of business risk. This balance has been a fundamental advantage to our system relative to the more socialized countries of the world.
4. We reallocate capital more quickly than most other countries of the world. This has generally been a boon to us as our businesses adapt to changes in the business climate more quickly and with fewer restraints than other countries. In exchange for this freedom, we also experience the effects of capital misallocation more profoundly. As we continue to

Financial Planning and Market Commentary

discover the multiple causes of the recent recession, the Federal Reserve's accommodating monetary policy of the second half of the past decade appears to have encouraged capital investment into financial instruments rather than new advances in technology, medicine, and manufacturing. In addition, our government will need to end the "too big to fail" policy, because socializing risk and privatizing reward always leads to misallocation of capital. The unintended consequences of having millions of people out of work and the adjustments our economy will need to make to get back on track will certainly prove to be painful and expensive, but when done will place us on a much stronger footing for the future.

As we look around the world today, we see that the U.S. still has a competitive advantage with these traits. We also face an unprecedented deficit, debt load, and a reallocation of business capital to other sectors that will likely put many out of work. The competition we face from China, Brazil, and India is real, and those countries will continue to grow at a fast clip. However, these countries also face multiple hurdles as they change their cultural heritage to incorporate the traits listed

above. For instance, the rule of law and property rights are somewhat loosely followed in China (just ask Microsoft how many copies of Windows are pirated each year). Without the first two traits in place, China's long-term economic growth will be limited as investors will be reluctant to invest capital in higher level industry. We feel the U.S. is gifted in how we have culturally ingrained these traits into economic model. There will always be talk and adjustments made to "improve" the system and limit "risk," but we do not see a large scale shift to the right or the left given the embedded belief system of our people. The political tug-and-pull is necessary in order to make the checks and balances of the free market economic system and regulation work.

In summary, we expect the next few years to be challenging as our country and the global economy adjust to the reallocation of investment capital, reduced consumer spending, higher savings rates, higher tax rates, and larger levels of government debt. We then expect this period to be followed by a period of stronger opportunity as new industries grow and the country is on a firmer foundation. To paraphrase Warren Buffet, our children's future will be better than ours and the best days for our country and the world are still ahead of us.

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value-weighted index. The Russell 2000 Index measures the total return of small capitalization U.S. stocks and is a market value-weighted index of the 2,000 smallest stocks in the broad-market Russell Index. The MSCI EAFE is a Morgan Stanley Capital International Index designed to measure the total return of the developed stock markets in Europe, Australasia, and the Far East. The S&P 500, Russell 2000, and EAFE are unmanaged indexes. One cannot invest directly in an index. Past performance does not guarantee future results.

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