THE
JENTNER REPORT
Spring 2012
Wealth Management Strategies from Jentner Wealth Management

CAN WE LEARN FROM ONE OF THE WORLD'S GREAT INVESTORS?

Legendary investor Warren Buffett delights in standing orthodoxy on its head. His latest? Attacking the definition of investment "safety" as low fluctuation of principal.

As usual, Buffett succinctly nails the problem: rather than measuring risk by an investment's potential fluctuation in value, investors should concentrate on whether an investment has a "reasoned probability" that it will not cause a loss of purchasing power over time. Buffett says stocks are the best way to preserve and increase purchasing power over time; fixed income investments are not. "A non-fluctuating asset can be laden with risk," he writes.

Value Destroyers

An article in Fortune magazine adapted from Buffett's upcoming shareholder letter laid out the argument against bonds and for stocks. Investments denominated in currency – bank deposits, bonds, money market funds – are usually considered safe. "In truth they are among the most dangerous of assets," Buffett writes. "Over the past century these instruments have destroyed the purchasing power of investors in many countries, even as these holders continued to receive timely payments of interest and principal."

How does this happen? It is the twin effects of inflation (in essence, government devaluation of its currency, Buffet says) and income taxes on interest. Buffett notes that it takes $7 today to buy the same goods and services that could be purchased for $1 in 1965.

Currency-based investments pay interest rates that do not keep up with inflation, once taxes are taken out. Purchasing power falls. Occasionally interest rates will be high enough to compensate for inflation, as they were in the early 1980s. But today's rates are very low and "bonds should come with a warning label," Buffett says.

Forget about Gold

He also dismisses gold as a store of value. "Gold . . . has two significant shortcomings, being neither of much use nor procreative," Buffett writes. Gold prices go up due to fear and to enthusiasm. "As 'bandwagon' investors join any party, they create their own truth – for a while," he writes. Eventually, he said, gold prices will form a bubble, which will pop just as home prices did in 2008 and internet stocks did in 2000.

Compound Growth

Those who want their capital to grow should invest in productive assets like businesses, farms or real estate: "Ideally, these assets should have the ability in inflationary times to deliver output that will retain its purchasing power value while requiring a minimum of new capital equipment." Consumer products companies, he says, will do just that, while others such as regulated electric and gas utilities will not, due to heavy capital requirements. Productive businesses are like cash cows, delivering greater quantities of "milk" over the years. "Proceeds from the sale of the milk will compound" just as the Dow Jones Industrial Average went from 66 to 11,497 during the 20th century. Buffet says stocks will be the runaway winners in the future, "by far the safest."

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The President's Word

Chasing Yields Can Get You in Trouble

The continuing near-zero interest rate environment creates an opening for unscrupulous salespeople, says FINRA, self-regulatory authority for the brokerage industry, in a letter to members about its concerns.

- First, FINRA warns against chasing high yields. In pursuit of yields, investors may be inadvertently taking risks they do not understand or that are poorly disclosed.
- Investors should be wary of liquidity issues: some high-yield investments may lack a trading market, making it hard to cash out.
- Potential investors should be cautious about a product's future cash flows. Will they be repaid from their own principal or from capital raised from later investors?
- Mortgage-backed securities worry FINRA. Because mortgage borrowers are allowed to pre-pay on loans, investors may have "significant reinvestment risk," unable to reinvest earnings at the same yield as their original investments.
- Too-complex exchange-traded funds (ETFs) may expose investors to the risk that the fund won't track the index to which the ETF is tied.
- Finally, FINRA warned against variable annuities, which "often have long holding periods and significant surrender fees, making them unsuitable" for investors who need liquidity.

Jentner Wealth Management shares these concerns. During times of uncertainty, it is easy to be enticed by salespeople offering investments with benefits that are unsustainable or untrue. Be careful. Seek out professional opinions if you have any doubts.

Bruce A. Jentner, President
Jentner Wealth Management

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Passive Investors Beat Active Managers in Ten-Year Scorecard

Indexed and passive investing gets a bad rap from active managers out to protect their turf and the high fees they earn from buying and selling securities. Passive managers buy a portfolio that matches a market index or that covers an entire asset class. Plenty of research suggests they will do better than the average active investor who tries to beat the market by selecting the "right" investments or by timing when to buy and sell.

Good news for passive investment managers: a 10-year real-world test, the Standard & Poor's Indices Versus Active scorecard, known as "SPIVA." For a decade S&P has tracked the performance of its stock and bond market indexes against the performance of active mutual fund managers. The results reinforce the value of passive management.

Bear Market Myth

Active managers have long argued they do better during bear markets, because unlike passive managers, who must continue to be fully invested, active managers can buy and sell and play defense. But in the two bear markets covered by the SPIVA scorecard, the majority of active fund managers failed to beat their index benchmarks. In the 2008 bear market almost 84% of small-cap stock funds and 53% of large cap managers failed to beat their relevant indexes.

Muni Funds Fail

Municipal bond funds turned in the worst performance: Just 9% of national muni bond funds outperformed their indexes, while not one New York or California muni fund did so. Passive investing is cheaper than active investing because trading and management fees are low. Active muni bond funds may not have done badly vs. their indexes on a gross return basis, but since returns on munis are modest, after subtracting fees these funds trailed indexes in the end.

Passive Small Cap

The SPIVA scorecard demolishes another myth, that managers investing in stocks of small companies are more likely to outperform their relevant indexes. This derives from the idea that, while large company stocks are priced efficiently because they are so widely followed, the less well known small-company stocks provide an opportunity for savvy managers. Yet over the decade covered by the scorecard the majority of small stock funds were beaten by their indexes.

Five-Year Advantage

Active managers sometimes do beat their indexes. However, on average, given a five-year period, it appears that the majority of active managers fail to beat their indexes. From June 2006 through June 2011, 63% of large stock funds were beaten by the S&P 500 Stocks Index. During the previous five years, almost 70% of the big company managers lagged behind the index.

In fact, the scorecard may make active managers look better than they really are. Each year during the study up to 20% of active funds went out of business. Had they been included in the study, active management would have looked even worse!

Stocks expected to beat bonds

Twelve years of low stock returns, high volatility, and bear markets have driven many stock investors to the relative safety of bonds. They have profited from that move, as bond interest rates dropped sharply since 2000, pushing up bond prices to outperform stocks.

Investment experts say this trend may not go on much longer: the next 10 to 20 years it is more likely that stocks will be the winning asset class. At best, bonds might offer a return of zero after inflation. At worst, they will be losers.

No room to move

Yes, the stock market continues to look risky, but the bond market's prospects look downright dismal. "The bond outlook is extraordinarily bad," said Jeremy Siegel, finance professor at the Wharton School and author of Stocks for the Long Run.

Siegel and others say bonds are overvalued similarly to how stocks were overvalued in 1999, before two major bear markets pummeled stock prices. About the only way bond prices can continue to rise would be during a panic even worse than in 2008, when government bonds were snapped up by professional and amateur investors alike. It is more likely that interest rates will begin rising again as the economy recovers. When that happens, bond prices will fall.

"We are in the very mature stages of the secular bull market in bonds," David Rosenberg, chief economist at Gluskin Sheff & Associates, told Marketwatch.com. Roger Ibbotson of Yale University says stocks don't have to jump a big hurdle to beat bond returns.

Historically, stocks have returned about four percentage points over U.S. Treasury yields. A 10-year Treasury today yields about 2%, which suggests stock returns at 6% going forward. "Long term, it's a fine time to buy stocks," Ibbotson says. John Bogle, founder of the Vanguard Group of mutual funds, believes stocks will offer average returns of 7% per year.

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Vanguard Sees Better Years Ahead for a Balanced Portfolio

The last 12 years have been rough for investors, subjecting them to two major bear markets and returns well below the previous 18-year bull market run. Now they want to know what to expect over the next decade. Will the golden years of 14%-plus annual returns of the 1980s and 1990s reappear? Or will we face another miserable decade of lousy returns punctuated by frightening downdrafts?

Investors looking for happy days to return may have to adjust their expectations a little, but on the whole a balanced portfolio of stocks and bonds has a good chance of earning respectable profits, says mutual fund giant The Vanguard Group.

Fair Odds

"The likelihood that the average returns on a 50% equity/50% bond portfolio over the next 10 years will exceed those of the past 10 years is approximately 70%," Vanguard said after a study of prospective investment returns.

Vanguard expects returns on this portfolio to range from 4.5% to 6.5% a year. That is lower than the stock market's long-term average, but compares favorably to inflation, leading to real inflation-adjusted growth of 3.5% to 4.5% per year. The historical premium over inflation for such a portfolio has been about 5.1%.

"Overall, we find that the expected risk/return trade-offs among stocks and bonds do not warrant abandoning the basic principles of portfolio construction – balance, diversification, and strategic allocation based on long-term goals," Vanguard said.

Stocks Look Better

Vanguard did 10,000 simulations of possible stock and bond market returns over the next 10 years, based on market conditions as of September 30, 2011. "Our simulations suggest that the average return on a broad stock portfolio is likely to be higher than that for a broad bond portfolio given current equity valuations and as compensation for investors bearing greater equity-market risk," Vanguard said.

Although that might surprise investors who worry about ongoing economic headwinds, Vanguard notes that stock market valuations were at relative bargain levels in September, while bond market valuations were extremely high due to unprecedented low interest rates.

However, that does not mean that investors should give up on bonds altogether and invest solely in stocks. Such a move might bring higher returns, but also offers much greater downside risk, Vanguard said. Despite current low interest rates, it expects investors will profit from "the beneficial role that bonds should be expected to play in a broadly diversified portfolio despite their present low yields and regardless of the future direction of interest rates."

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"Strategic financial planning helps you achieve personal and objective goals by asking smarter questions, listening more carefully and applying sound financial and investment strategies. It is not something different or new; it's simply planning the right way."

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