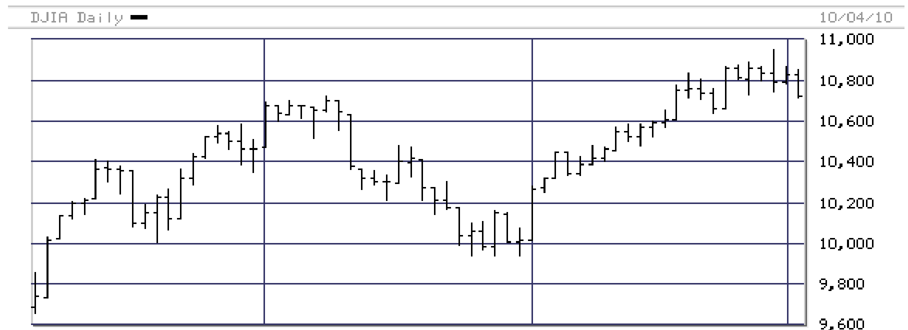
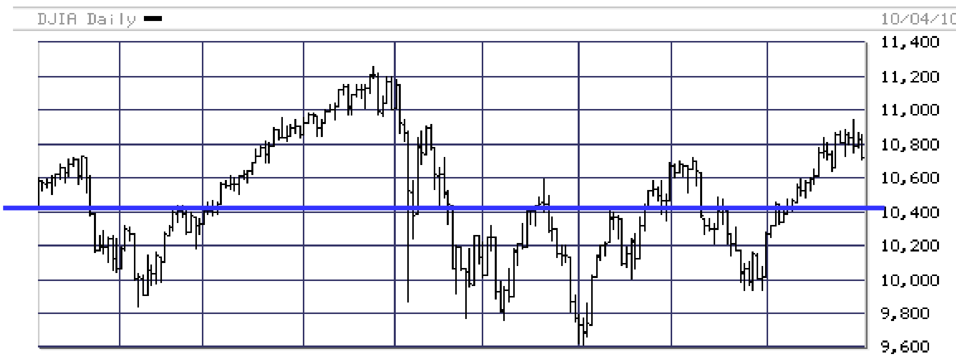
# Outlook

A Quarterly Newsletter from Roffman Miller Associates

You have to admit, with a gain of over 10% for the Dow Jones Industrials, these last three months would have made for a great year. The chart below tells the story - an early move upward, a modest pullback, and a rally at the finish:




A great quarter, to be sure, except that this rally has left the market basically where it closed just six months ago. In fact, the market traded at its lowest levels of the year in this past quarter, and despite the late rally the market traded higher in May than at the close of September. How does that impact our interpretation of the trailing quarter? First we must recognize the unprecedented volatility that began a few years ago has not gone away. In fact, since April of this year the markets have moved 4% or greater (in one direction or the other) each month. Which ultimately leads to a second observation, that the direction of the market at any given time is unpredictable. Take a look at the next chart:




This is a chart of the Dow Jones Industrial Average for the first nine months of 2010. I'm no "chartist", but it looks to me that we spent 5 months in the black and 4 months in the red (the blue line represents where the DJIA started the year, so in a simplified view when the graph falls below the blue line the index return is negative for the year-to-date).

What we believe is that the markets in general are still trading on uncertainty and fear. One way to gauge fear among investors is to observe how much is invested into or withdrawn from mutual funds over time, what we refer to as mutual fund flows. For example, investors pulled $43 billion out of US equity funds over the past quarter, while bond mutual funds took in an additional $87 billion according to the Investment Company Institute. This tells us that individual investors are still seeking to lower their risk profiles, even at a time when cash stockpiles at corporations are at all-time highs and bond yields are at historic lows. Then there is uncertainty about whether taxes will rise, revenues will fall, regulations will strangle business, the dollar will collapse, etc. Some of that uncertainty may be resolved after the November elections, but for most of it we'll just have to wait and see if the economic troubles are able to work themselves out.

We remain optimistic about a gradual recovery of the US economy. Our optimism is tempered, of course, by the magnitude of the federal debt, unemployment, and congressional gridlock. But we, along with many others, believe that further clarification on taxes and regulations will spur corporations to loosen up the restraints on the cash they've accumulated. This should lead to increasing dividend payouts and stock buyback programs (both of which have been trending positively already) and might encourage profits earned overseas to be repatriated back to the U.S. We continue to believe that stocks will outperform bonds going forward. For investors today, the fear that keeps stock prices down should continue to present opportunities to put capital to work, and the benefits of prudent security selection and patience will pay off.

Most of you will note that this is the first time I've included charts or graphs in my letter. I'm not sure yet if it will become a habit, but for now, at least, consider it a break from seeing my picture here on the front page.

-Peter Miller

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**Good news for shareholders:**

- 257 of the S&P500 corporations participated in stock buyback programs in Q2 2010
- S&P500 stock buybacks over that time period increased 220.9% to $77.6 billion
- Buybacks remain top-heavy, with the top 20 participants accounting for over 50% of the total amount in $US
- Among the top 20 are Wal-Mart, IBM, Microsoft, Procter & Gamble, PepsiCo, Exxon Mobil, and Disney
- During the first nine months of 2010, S&P500 companies raised their dividends by a total amount of $15 billion

## Potential Pitfalls of Bond Investing

Bonds present investors with a number of potential benefits. In general, bonds have provided investors with growth and less risk than stocks historically. Economic events that tend to decrease stock prices have sometimes increased bond prices, and vice versa. Because of this relationship, adding bonds to a portfolio might provide significant diversification benefits. Lastly, bond investors normally receive income at fixed intervals, helping to meet certain cash-flow needs. However, as with any other investment, there are some risks that investors need to be aware of when adding bonds to an investment portfolio.

**Interest-Rate Risk:** Bonds and interest rates have an inverse relationship—bonds tend to rise in value when interest rates fall and fall in value when interest rates rise. Suppose an investor purchases a 20-year $1,000 bond with a yield of 8% and interest payable annually at year-end. One year later, interest rates rise to 10%. Anybody in the market for a bond can now buy one with a yield of 10%. If the investor tried to sell the bond with an 8% yield for $1,000, nobody would buy it—the same amount of money could purchase a bond yielding 10%. In order to find a buyer, the investor would need to discount the bond price to compensate the buyer for the lower coupon payments.

**Inflation Risk:** This is also known as purchasing-power risk. Inflation is a rise in the general level of prices for goods and services. If investments do not keep up with inflation, an investor's money will purchase less in the future than it did in the past. At their best, bonds have experienced very modest inflation-adjusted returns. Long-term government bonds returned 2.3% on an inflation-adjusted basis from 1926 to 2009, and long-term corporate bonds produced an inflation-adjusted return of 2.8%. Stocks, on the other hand, returned 6.6% inflation-adjusted.

**Credit Risk:** This is the risk of a company that is selling bonds not being able to make timely payments of principal and interest. The value of a bond might also decrease because of financial difficulties or the declining creditworthiness of the issuer. It is important to keep in mind that corporate bonds aren't guaranteed by the full faith and credit of the U.S. government but are solely dependent on the company's ability to repay the money that it has borrowed.

**Liquidity Risk:** Some investments might not be widely held by the public and can be difficult to sell (are not very liquid) if prices drop dramatically. Government bonds are usually very liquid investments; corporate bonds, however, might be difficult to sell quickly in certain situations.

**Call/Reinvestment Risk:** As interest rates fall, bonds with call provisions might be called (redeemed) by the issuer prior to maturity. While a premium is usually paid to the bond owner when the bond is called, this could leave the investor with the problem of reinvesting the principal at a lower interest rate.

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 and corporate bonds are not guaranteed. Stocks have been more volatile than the other asset classes. An investment cannot be made directly in an index. Diversification does not eliminate the risk of experiencing investment losses. Past performance is no guarantee of future results.

Source: Stocks in this example are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. Corporate bonds are represented by the Ibbotson Associates long-term corporate bond index, government bonds by the 20-year U.S. government bond, and inflation by the Consumer Price Index.

*This article was provided to us by Morningstar and submitted by Lori Blum

## Duration: What is it and why do fixed income investors need to understand it?

By Ryan Crooks

There is often a lot of confusion when it comes to the use and definition of duration even amongst the most seasoned practitioners, but I will hopefully be able to convey a reasonable explanation of the term and how it is applied without getting too caught up in the many nuances involved with more stringent applications of the subject. There are several types or forms of duration, but for practical purposes the most commonly referenced is *effective duration*. Effective duration is an approximation of the *price* sensitivity of a bond or bond portfolio. Here, the duration represents the percentage price change of a bond (or bond portfolio) for a 100 basis point, or 1.0%, move in the yield-to-maturity or market rate. Expressed in terms of years, it also represents the approximate present value weighted-average maturity of all the cash flows for a given bond (editor's note: that translates to "the time it takes to get half of your money back from your bond investment). Duration can be so much less than maturities, particularly for longer maturity bonds, because the present value of cash flows (coupon payment or maturity value) 25 or 30 years out are worth less than cash flows that are only 1 or 2 years away. This is also why the duration of a zero coupon bond is always the same as its maturity (there is only one cash flow, so you receive 100% of the weighted average at maturity).

The use of a unit of time to express a *mathematical* figure is what I believe creates the confusion for most investors, and unfortunately investors usually miss out on what is the most valuable use of duration which is the measure of price sensitivity. Many investors understand duration as some reflection of the risk involved with a certain bond and that shorter duration is less risky than longer duration but have no real sense of how that is actually reflected in the pricing of a given bond and therefore its return characteristics. For example, when comparing two bond options, a 12 year bond with an 8 year duration and a 25 year bond with a 15 year duration, an investor may surmise that they are safer with the 12 year bond and choose that investment. However, if they realized that the bond will lose approximately 8% of its value for every 1.0% move upward in the market rate they may consider the bond too price sensitive for their goals or (or their interest rate outlook) and choose to find a bond with a much shorter duration. Worth noting but not explaining further, is that you also need to keep in mind that the duration is not the same at all price points and that price movements may be bigger or smaller per market rate of change depending on the price and that this change in the relationship is reflected by a measurement called convexity (editor's note again: now do you see why there is a lot of confusion?). For most individual investors, however, duration should be enough to get them by and keep them out of trouble if understood even on the most basic level.

I understand this can be a tedious conversation even just having scratched the surface of the topic but investors need to understand, especially in the trough of an interest rate cycle, what type of risk they are subjecting themselves to. We continue to be in a very difficult interest rate environment for savers with no signs of letting up especially given another proposed round of quantitative easing on its way (this, you'll remember, keeps rates artificially low). In our search for incremental yield we need to be very mindful of the risks involved and make sure that they are matched with our expectations.

I hope this was of some help and gives some defense to why we are not overloading portfolios with any and all bonds that offer what seem to be flashy yields in this low-rate market environment. Your total return, not simply current yield, is our concern. If you would like to have a follow-up discussion about duration, please give me a call.

## Recent Bond Issuance:

Falling Treasury yields and an investor appetite for stable returns gave many corporations the opportunity to sell bonds at historic low rates. If you thought your money market rate was low, check out these alternatives which all came to market in the past quarter:

- MICROSOFT, one of only a handful of triple-A rated U.S. companies, sold a 3-year note (bond) at 0.875%...the lowest corporate bond rate in more than thirty years
- IBM issued three-year bonds paying 1.0%
- DuPont is paying 1.95% on a new five-year bond
- JOHNSON AND JOHNSON sold 10-year bonds yielding *less than 3%*, which according to Thomson Reuters is a record low in the U.S.

What will a company like Microsoft do with *more* cash? It is possible that they'll make an acquisition, but it would be fine with us if they would just buy back stock and hike the dividend.

## Company Visits

Below is a sampling of the companies we have visited (or have visited us) during the past quarter:

- Oracle
- UGI
- RPM Inc.
- Nordson

### Reassess your risk

Rather than come up with my own theme for this column, I'm going to pick up the topic that Peter focused on and discuss how it may affect our thinking at a portfolio strategy level.

If you had asked me three months ago, I would have predicted that a 10+% rally in the markets would have had a pacifying affect on investors; as it turns out, I would have been wrong. My premise for the original assumption had to do with short-term and long-term market fundamentals – in the long run, the market should be a reflection of the health of the economy. In the short run, though, the market is greatly influenced by emotion, basically by how we feel. Going back to the mutual fund flows for 2010, the flows into equity funds were positive early in the year when the market was rising through the first quarter and into the second. Then, as the market turned, so did the fund flows and they continued to be net negative through September.

A great question is "do fund flows drive the market, or does the market (sentiment) drive fund flows?" Let's save that general debate for another time and focus specifically on this September rally – equity fund flows were extremely negative, even in the face of the rally. It is quite possible that there could be a lag effect we will see spilling over into the fourth quarter, as investors opening brokerage statements (this week) are pleasantly surprised at the impact September had on their portfolios and those light on equities begin to chase the rally.

My experience, however, with the calls we've been receiving lately provides further evidence to Peter's observation that fear is definitely playing a role influencing investor decisions today. Some, after witnessing so much volatility this year, are asking now if we should reallocate some of the equity (ie 'take some profits') and instead put it to work in cash or bonds. Strike that – they're also tired of cash not working for them, so can we find something else to do with the cash please?

I believe this is the beginning of a very healthy stage for investors: a new recognition of what 'risk' means in investing, and an opportunity for all of us to reassess just how much we're willing to take. Think about it.. investing is taking your hard-earned savings and putting it at risk with the intent to make a greater return than you would if you had simply left it in the bank or under the mattress. If you never expected some banks to fail, or the market to both rise *and* fall, then why did you think you could possibly make a return greater than government bonds? Something I have described to a few of you in person recently is my feeling that the discomfort investors are experiencing today is really indicative of what investing is *supposed* to feel like. Should the feeling persist, I could see it playing out like a long, drawn-out market bottoming experience where returns are below average, and money in stocks will only be made through profits being paid out to shareholders (e.g. dividends and stock buybacks). That's a pretty dark scenario; it doesn't mean investors can't make money, but it isn't very encouraging either. Instead, I believe, investors should be *prepared* for that scenario and take advantage of it by owning the right types of companies within a properly allocated account, but they also should be open to the idea that other countries around the world will enjoy terrific economic success over the same time period, and those countries will provide us with myriad opportunities to participate in that success.

Changes in market dynamics do require us to make tactical changes to our portfolio strategy. For example, in 2009 we expanded the average number of stocks in a portfolio and cast a wider net in an uncertain market. We were early on the idea that dividends would be a big component of return, and that some bonds were undervalued. Now, we are narrowing our stock list and have a keen eye towards companies with revenue streams coming from the fastest growing corners of the globe. We are extremely cautious with our fixed income portfolios.

At Roffman Miller Associates we utilize a methodology we believe will limit downside risk *as well as* allow us to participate in a rising market. We aim to have your investments properly allocated to give you the best chance to meet your individual goals for both risk *and* return. If you feel one or both of these goals has changed, then please make an appointment to visit us and discuss your portfolio.

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