



# FINANCIAL IQ

*Independent Advice. Intelligent Financial Solutions.*

## A Glimmer of Hope?

Markets never cease to amaze. In spite of all the bad news that continued to pound Wall Street and the economy on a daily basis, the markets somehow found a way to find some good news where most investors found nothing but doom and gloom. As is often the case, forward-looking equity markets once again climbed a "wall of worry".

Amazingly, in the 2nd quarter just ended, US stocks posted their best numbers in more than a decade. In addition, foreign stocks registered their highest quarterly return in at least two decades, and emerging markets posted their best quarter on record... leaving no one complaining (other than the short sellers and market timers), but many wondering why.

To those who had the fortitude to stay the course, rebalance into additional equities or commit new money to the market during this period, the rewards were significant...and helped to reduce in a meaningful way any paper losses accumulated over the past year and a half.

To quantify just what happened in the second quarter, in total return numbers, the S&P 500 gained 15.9%, the Russell 2000 small cap index advanced 20.7%, the MSCI EAFE international index showed an increase of 23.8% and the Emerging Markets Index recorded a whopping gain of 36.9%.

Perhaps more amazing, however, were the gains from the market low reached on March 9, 2009 through the end of the 2nd quarter (a period of only about 11 weeks).

Index returns from recent market low on 3/9/09 through 6/30/09:

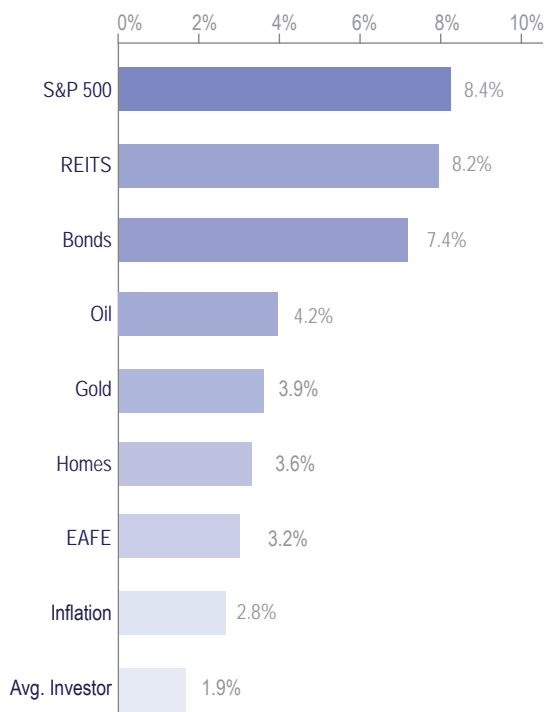
- S&P 500 Index: +35.9%
- Russell 2000 Index: +48.1%
- MSCI EAFE Index: +44.2%
- MSCI Em. Mkt. Index: +56.9%

These are serious numbers folks, that don't come around too often, and are far too good to miss out on when they do show up. And, remember, someone didn't ring a bell on March 9th to announce that markets had just seen their bottom. As is always the case, it just happened...and if you weren't there, you paid the price. Fortunately, to the credit of our clients,

most of them were there, and had the courage and strength of will to hold the line during this most difficult time...and to them we doff our hats!

### Looking for a Good Inflation Hedge?

20-year Annualized Returns by Asset Class



The indexes used are as follows: REITS: NAREIT Equity REIT Index, EAFE: MSCI EAFE, Oil: WTI Index, Bonds: Barclays Capital U.S. Aggregate Index, Homes: median sales price of existing single-family homes, Gold: USD/Troy oz, Inflation: CPI. All returns are annualized (and total return where applicable), and represent the 20-year period ending 12/31/08. Average equity investor return is based on an analysis by Dalbar, Inc. which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior.

The chart above offers some interesting insight into, among other things, just what really makes for an effective inflation hedge. You'll notice that for the 20 year period ending 12/31/2008, inflation averaged 2.8% per year, while the US stock market, as measured by the S&P 500, produced a significantly higher return at 8.4% per year. More interesting, with all the hype over gold as the perfect inflation hedge, it is worth noting that over the last 20 years, gold has only provided

a real annualized return over inflation of about 1%. Not exactly what you would normally look for from something that purports to be the inflation hedge to beat all inflation hedges.

You may also notice that over this 20 year period, the S&P 500 has produced a significantly higher return than the EAFE (the International index closely aligned with the S&P 500). However, if we extend the period back another 5 years to the 25 year period ending 12/31/2008, the returns for the S&P 500 and EAFE are very similar at 9.78% and 9.25% respectively. This is much more typical of what we expect to see over time, and yet over 20 of this 25 year period we saw something quite the opposite.

Another point of interest in the chart is the small difference in returns between US equities (S&P 500) and fixed income.

One can look at the risk/return relationship in two ways... either it makes little sense to take the risk of owning equities when bonds have produced returns similar to equities with significantly less risk over the past 20 years, or that owning equities today might make even more sense going forward because the risk return relationship between stocks and bonds should eventually return to normal...which would suggest there's the chance we could see outsized equity returns in the future to make up for their underperformance over the last 20 years. Add to this scenario the fact that, with interest rates near historic lows, the possibility for significant gains in bonds over the near term seems remote. So, take your pick, but we'd like to think the smart money is on the comeback of the equity premium.

Finally, you'll note the bottom entry on the chart. It shows the return of the average investor during this 20 year period of time at 1.9%. This number is the result of an analysis done by Dalbar, Inc. which utilized the net aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. Not sure how scientific it is, but it does offer some insight into the impact human behavior can have on investor returns.

### Does Newsweek Have it Right?

In the February 16, 2009 issue of Newsweek, the magazine created a minor firestorm with the following cover story: "We Are All Socialists Now". The story went on to say that "Whether we want to admit it or not...the America of 2009 is moving toward a modern European state."

With all this talk about the direction our country might be heading, and yet, without wanting to get into the political pros and cons of the Newsweek claims, we thought it might be interesting, from an investing standpoint, to go back and take a look at how equity markets in countries that are considered at least partially socialistic have fared over the years.

You'll note that the return for the US market over the 39-year period (which is as far back as good data is available) was fourth from the bottom, while a number of the countries with

### Government Intervention and Stock Returns

Annualized Return (%) in US Dollars for Thirty-Nine Year Period  
Ending December 31 2008

Hong Kong	14.68	Germany	9.90
Sweden	12.84	United Kingdom	9.87
Denmark	12.57	Spain	9.77
Netherlands	12.16	Japan	9.75
Switzerland	11.47	Canada	9.43
Belgium	10.72	USA	9.12
Singapore	10.65	Austria	8.69
Norway	10.51	Australia	8.45
France	10.35	Italy	5.99

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definite socialist leanings finished near the top...a bit of a surprise in our minds.

Maybe what this tells us is that while we may not want to live in a socialist country, investing in them may not be such a bad idea!

### Understanding the Monte Carlo Planning Tool

As most of you are aware, Plancorp uses a statistical modeling technique called Monte Carlo simulation as part of our client's Financial Independence Analyses. Monte Carlo simulation is a tool that uses statistical models to assess the likelihood of a client meeting cash flow needs in the future. The inputs include expected return, which is derived from the mean (average) historical return (using data from 1926 through 2008), the variance of such returns and inflation. Prior to using Monte Carlo simulations, advisers would often use a simplified average return targeting a particular dollar goal in the future with no variance whatsoever in the returns, which is very unrealistic.

The Monte Carlo model produces hundreds of random simulations using client data and then calculates a probability of success of a client achieving their goals based upon values generated by the model. The model is especially useful in highlighting that expected returns are NOT a guarantee. Further, the analysis assumes a normal distribution, which has been a source of some criticism because in real life, extreme returns occur more often than would be expected if returns were normal. However, as academic research has shown, for passive investors none of this matters much beyond being aware that such outlier returns, both positive and negative, are more common than would be expected if return distributions were normal, and the central implications of modern portfolio theory remain valid under any reasonable distribution of returns.

Presently there is no better simulation available than Monte Carlo simulation for portfolio returns, and Plancorp is diligent about updating these analyses for our clients on a regular basis. Regular updates allow Plancorp to take into account the ever changing conditions of the market and our clients' individual financial situations, thereby minimizing the impact of abnormal distributions.

Until next time...