



FAI Advisors, Inc.

# Monthly Investment Commentary

## JANUARY 2011

A strong fourth quarter rally, punctuated by a December sprint, turned an okay year for stocks into a good one. The large-cap Vanguard 500 Index gained nearly 11% for the quarter, and ended 2010 up 15%. The small-cap iShares Russell 2000 and iShares Russell Midcap both returned in the mid teens in the fourth quarter, and gained 25% and 27% for the year, respectively.

Looking abroad, the story was similarly positive for emerging markets, with the Vanguard Emerging Stock Index climbing 7.5% in the quarter and 19% for the year. Developed-market foreign stocks also had a good year, but returns for the benchmark Vanguard Total International Stock Index were restrained by concerns over government fiscal problems earlier in the year.

### Updated Market Data

### “A Year in Review”\*

	December	YTD		01/10/11	01/10/10	% Chg
<b>Large Cap Benchmarks</b>			<b>Consumer Rates</b>			
Vanguard SP 500	6.70%	14.90%	6 Month CD	0.41%	0.31%	32.26%
Russell 1000 Growth ishares	5.50%	16.50%	30 Yr. Mortgage	4.82%	5.18%	-6.95%
Russell 1000 Value ishares	7.90%	15.30%	Prime Rate	3.25%	3.25%	0.00%
<b>Small Cap Benchmarks</b>			<b>Commodities</b>			
Russell 2000 Growth ishares	7.60%	29.10%	Gold	1367.00	1130.25	20.95%
Russell 2000 Value ishares	8.30%	24.30%	Crude Oil	88.03	82.66	6.50%
<b>Other Benchmarks</b>			Gasoline	3.07	2.67	14.98%
Vanguard REIT Index	4.60%	28.30%				
Vanguard Total Intl Stock Idx	8.30%	11.10%				
Vanguard Total Bond Mkt Idx	-1.20%	6.40%				
Merrill Lynch High Yld Cash Pay	1.70%	15.20%				
Citigroup World Govt Bond Idx	1.80%	5.20%				
DJ-USBCI (Commodity Futures)	10.70%	16.80%				

\* Source: JP Morgan Weekly market recap

Turning to fixed income, the Vanguard Total Bond Market Index Fund, a proxy for high-quality intermediate-term bonds, saw most of its 1.4% fourth-quarter loss come in December. Still, its strong performance earlier in the year left it with a full-year gain of just over 6%. Foreign bonds also struggled through the fourth quarter, with the Citigroup World Government Bond Index falling 1.8% and the emerging-markets JPMorgan GBI-EM Global Diversified Index down 0.4%. Each index was in the black for the year, with emerging market debt returning a notable 16%.

## Summary

Throughout the year, we share our analysis including the broader context that forms the basis of our views. We have several goals in sharing these views, such as: The desire for you to be informed about what we are doing for you and why. Secondly, it helps to build confidence in our competence. Our ability to do the best job we can for you is partly dependent on that confidence because it allows us to make long-term investment decisions with the expectation that you will have the patience for those decisions to play out. Confidence should be based on the strength and clarity of an entire investment approach, starting with fundamental beliefs and including an investment process and ability to execute it in managing your portfolio.

In this edition of the 2010 Year End commentary, we hope to not only summarize 2010 and discuss thoughts and strategies moving forward, but we will talk about how our set of core beliefs governs our decision making and serves as an important source of your confidence in what we do.

## The Recovery and the Fed

As we close out 2010, it appears that global econo-

mies continue to move further away from the “crisis” mode, and there is no doubt that we have witnessed economies recovering, albeit slowly. The recent strength in the stock market along with a gradual improvement in the economy should not lull us into a state of complacency. Though the economy is improving and could exhibit stronger growth in 2011, structural risks remain. In fact, the story is not very different from the one we’ve been telling for the past year.

In the US and Europe, the slow recovery process, defined in the US as a jobless recovery, is causing central banks to aggressively stimulate. We’re pessimistic that the rewards will be commensurate with the risks. The Fed’s actions could have a marginal economic impact, yet exists the very real risk of currency depreciation, asset-bubbles, as well as high inflation in the future (not in the near term). It’s too early to tell what the economic impact will be, but the risks mentioned are likely.

**Household Debt Levels:** The trend in household debt levels is down and that’s good. On an absolute basis and relative to income, household debt has declined at the fastest rate on record. However, much of the decline is due to defaults. And despite a meaningful reduction, the overall level of household debt remains excessive relative to disposable income. The income comparison is important because it indicates the long-term ability of households to pay down their liabilities. Compared to assets, debt levels have improved but still remain very high relative to long-term history. Overall, household wealth is still 17% below its 2007 peak.

**The Weak Labor Market:** In short, the labor market is recovering but it’s a wimpy recovery compared to past expansions and in light of the number of

jobs lost. It will get better. There are multiple indicators that suggest the job market should strengthen, but we have a long way to go to bring employment back up to acceptable levels. It will take years and the improvement will help growth. However, it is unlikely to be robust enough to support a strong or quick recovery in income, the housing market, or domestic consumption. In addition, the concern amongst many economists at this time is the long term impact of an extended period of high unemployment. Washington DC appears to have finally come to realize that jobs are a top priority and solutions must be focused on creating an environment that will bring this much needed job growth.

**The Housing Market:** After showing some strength in late 2009 and early 2010 largely due to the home-buyer tax credit, the market is weakening again. In recent months home prices have slid backwards again and the declines are spreading to more markets. Looking ahead, despite hugely improved affordability, there are several reasons to expect some further declines in home prices.

First, according to industry data provider CoreLogic, as of the end of September, 23% of all homes with mortgages had negative equity—in other words they owed more than the house was worth. This amounts to 10.8 million homes. Of these, more than 40% (over four million) had negative equity of at least 25%. Another 2.4 million homeowners had equity of 5% or less (meaning a 5% price drop would put them in a negative equity position). Negative equity correlates strongly with defaults and foreclosures so this data suggests that foreclosures will remain high for some time.

On the supply side the story is actually much worse than the recent spike in home sales numbers suggest.

Millions of houses are either in foreclosure or likely to be foreclosed. This number is likely to increase by 20% in 2011, according to recent forecasts. Based on CoreLogic's numbers, the total inventory-to-sales measures, including "shadow" inventory, is at an alarming 23 months. These numbers suggest that house prices have further to fall.

**Consumer Spending Headwinds:** Each of the above factors is a problem for consumer spending. Consumption usually hovers around 70% of the economy. It is likely to grow at a subpar level given the need to reduce debt. In the past, debt growth fueled spending but now deleveraging is a headwind. According to Gary Shilling, "the reality is that deleveraging doesn't occur in a straight line, but is highlighted by a series of seemingly isolated events. After each, the feeling is that it's over, but then follows the next crisis event." Not sure what the next event will be, but there is a negative feedback loop happening: Weak spending is a drag on the overall economy, which impacts the labor market, which is a driver of income growth, which in turn is a key driver of consumption growth, completing the loop. Over the last year (through 9/30) consumer spending has rebounded and is up 2%. However, this is not an exciting level of growth, and in total, quarterly spending has barely regained the level of three years ago. We continue to believe spending growth over the next few years is likely to be below average, consistent with a subpar recovery.

**2010 Election:** The theme of the midterm elections seemed to be that American's have become more concerned about the level of public debt in the US. No surprise, as we are witnessing the long term impact of fiscal irresponsibility in Europe.

*(Reuters) - The U.S. debt will top \$13.6 trillion this*

*year and climb to an estimated \$19.6 trillion by 2015, according to a Treasury Department report to Congress.*

Public sentiment is and will become a larger concern of politicians, as evidenced by even notorious spenders (in congress) talking about austerity. But for now, and according to the Congressional Budget Office (CBO), the estimate for the federal budget deficit will still be massive for 2011 (although slightly lower than the \$1.3 trillion in 2010). Relative to the size of the economy, this year's deficit is expected to be the third largest shortfall in the past 65 years: At just under 9.1 percent of gross domestic product (GDP), it is exceeded only by the previous 2 years. Politicians are walking a tightrope between allowing for tax and other incentives to stimulate job growth, and increasing the deficit and debt numbers, which end up being reported to the public. Unfortunately, we are experiencing the result of many years of poor leadership and the proverbial kicking the financial can down the road. The situation is certainly painful; and the solutions are potentially even more painful in the short term.

**Tax Changes:**<sup>1</sup> After a 277-148 passage in the House and an 81-19 approval in the Senate, President Obama signed the 2010 Tax Relief Act into law on December 17, extending the Bush-era tax cuts. The impact?

Current federal income tax rates are preserved for everyone. The federal income tax brackets will remain at 10%, 15%, 25%, 28%, 33% and 35% for 2011 and 2012. Unemployment insurance extends for 13 more months. This is retroactive, so the federal extension of long-term jobless benefits applies from December 2010 through December 2011. For investments, taxes on capital gains and dividends top out at 15% through 2012.

A payroll tax holiday occurs in 2011. The payroll taxes that employees pay will drop from 6.2% to 4.2% next year. (There will be no payroll tax cut for employers in 2011, only employees.) As envisioned, this will result in a savings of about \$1,000 next year for a wage earner bringing home \$50,000. This replaces the Making Work Pay credit.

For 2011, the federal estate tax drops to 35%. The estate tax exemption rises all the way to \$5 million. Also, the IRA charitable rollover, as it was informally called, went away in 2010. It allowed someone 70½ or older to donate up to \$100,000 in IRA assets annually to one or more qualified charities. This opportunity is back for 2011.

Tax breaks for middle-class and working-class families won't sunset. As a result of the new law, the child credit, the child and dependent-care credit, the EITC, and a \$2,500 tax credit for higher education expenses will all be around in 2011. Another middle class issue, AMT (Alternative Minimum Tax) has been patched as part of the 2010 Tax Relief Act, thereby exempting about 20 million middle-income households from a potential \$3,900 average leap in federal income taxes.

Finally, businesses gained some tax incentives, one of which allows expensing 100% of their investments in 2011. Qualified investments made after September 8, 2010 and before January 1, 2012 are eligible for this bonus depreciation.

What's the price tag of all this short-term tax relief? It is sizable. The federal deficit is projected to increase by about \$858 billion over the next two years as a consequence, without increased economic output. Hence the reason job creation has to be the focus of actions taken in Washington DC.

## Investment Outlook

Risk assets such as stocks, higher income bonds and commodities will likely ride the wave of stimulus for the time being. As liquidity floods into the economy, the flows will likely drive growth in risk assets simply because money will not stay in money market funds paying zero. What is the reason for the Federal Reserve to drive this easy money/zero rate policy through 2011? In past recessions, recovery typically moves from the slow down phase fairly quickly into the expansion phase. This time, this transition from recovery to economic expansion is taking substantially longer. As mentioned before, the risks are substantial with this approach.

In light of the stimulus, we believe the opportunity will continue to exist for adding quality risk asset positions at a short term market pull-backs, whether it be stocks, or other risk assets. There could be any number of market “shock events” that allow for this opportunity.

## Asset Classes

**Stocks:** Overall, we remain underweighted to equities but overweighted to more aggressive fixed income positions because even with a greater earnings boost from emerging markets, stocks are selling above our fair-value range. This results in five-year return expectations, under most scenarios, that are too low to justify a normal equity weighting given the elevated risks we see.

A new concern is the economic strength in many emerging markets. The problem is not that the economies are strong, but rather that in a number of cases, policies to prevent their currencies from ap-

preciating (and hurting their exports) necessitate low interest rates that can ignite inflation and asset bubbles. Inflation in China is the most visible problem and it is already driving a tightening of monetary policy, the fear is this will cause growth to slow too much. We will continue to hold assets in these areas. The risks of sudden reversals remain.

**Commodities:** Our position has been to add or remove commodities based on risk measurement analysis, as we did remove them from portfolio models in early 2008, before the all time high. Since we do not believe inflation in the U.S. is a near-term risk, we will consider adding commodities to our portfolios in a meaningful way at some point. Currently, there are a number of asset classes we currently own that act as inflation protection without the volatility of commodities.

**Bonds:** There is growing debate about whether bonds are a bubble. Technically, we don't view them as a bubble from the standpoint of having the downside risk that stocks do when they are in bubble territory. At this time, our position is that we don't view most of the investment-grade bonds, especially governments, as offering attractive long-term returns from current price levels. Moreover, it is too simplistic to generalize about the bond market. There are sectors of the bond market that offer reasonable value—the potential to earn mid-to upper-single-digit returns over the next few years. Given macro uncertainty we are comfortable holding assets we think offer a high probability of allowing us to stay ahead of inflation. Some of these are clearly a lower-risk parking place for our portfolios as we wait for higher return opportunities to appear—and



we are certain they will. As has been the case for quite a while, our positioning does not emphasize traditional investment-grade bond funds. Our bond holdings are much more focused in investing globally to take advantage of currency differences, investing across bond sectors, and to adjust maturities. The result: We are significantly underweighted to traditional investment-grade bonds. This should alleviate some concerns as to potential exposure to the bond crash that the media and various newsletters have been writing about.

**Tax Exempt (Municipal) Bonds:** Currently, tax-exempt yields are very attractive relative to equivalent quality taxable investment-grade bonds. Unless we see a material increase in defaults in the tax-exempt bond universe, investors should do quite well over time. Though we believe defaults are likely to be much more common than in past cycles, we don't expect them to be so widespread that well-managed municipal bond funds will be hit with meaningful performance impact from defaults. A previous version of the commentary was devoted to this issue, the same circumstances remain and the same diligence of research is in place.

## Opportunities

### *Pending Asset Class Research*

**Leveraged Loans:** Bonds have ridden a tailwind of falling interest rates for close to 30 years.

With little room for rates to fall further, and massive stimulus and deficits likely to push rates higher at some point down the road, we have been researching options to minimize our portfolios' sensitivity to rising rates while still getting attractive returns. One option we are looking at is leveraged loans—

also referred to as bank loans, floating-rate loans, or senior loans. As you probably know, in a rising-rate environment, traditional bonds will see the value of their bonds drop as rates rise. If rates rise substantially, this could lead to a meaningful loss of principal. Floating-rate loans on the other hand are largely unaffected by rising rates as they have variable interest rates that “float” regularly to reflect changes in current market rates, and to maintain a fixed spread over a “reference rate” such as LIBOR (London Interbank Offered Rate). Because loan rates reset at specified (short) intervals, the prices of leveraged loans are less affected by rising interest rates, and can be more attractive to investors when rates are rising. Something to keep in mind, risk management is key. Some methods to accommodate this desire for risk management are: Leveraged loans are considered senior and secured, meaning the loan has priority over unsecured bondholders, preferred stock holders, and common stock holders. Also, governing covenants are present in virtually all cases; these senior and secured loans have strict covenants, which are intended to protect the lender. The maturities are typically shorter (5-8 years), which reduces default risk, interest rate risk and allows for the portfolios to benefit from rising rates more quickly. Finally, the most notable distinction between leveraged loans and bonds is that leveraged loans are floating-rate securities. The rate of interest is tied to the above mentioned rate, such as LIBOR, that “floats” during a rising rate environment.

We look forward to a good year regardless of what the economy and markets will bring. Thank you for the trust you have placed in us.

#### *Footnotes:*

1. Peter Montoya, assembled from various sources



## 2011 – Our Core Beliefs

The beginning of a year is a good time for businesses to plan strategy, and it is useful to start with a strong foundation. For us, it is investment process and our defining beliefs. These beliefs are the foundation supporting our investment process and approach. They are also an important source of our confidence in what we do, hence the reason to share them now.

**Needed Context:** We are living in a time where economic macro environments are shifting. Therefore, it stands to reason that the historical frame of reference investors have built from the last 30 years may not offer the most useful guide going forward. It is important to recognize the fundamental changes happening in the economic environment in which we live. Almost 30 years ago when Financial Architects was being formed, interest rates were in the teens and investors didn't believe the days of double-digit inflation were over. It turned out that interest rates were at the beginning of a 30-year decline. Not only did it drive financial market returns, it contributed to growing debt levels as credit became more available and affordable.

So here we are today, this long trend is over. It likely cannot be repeated. Back then a lot was different. Baby boomers were young, some just entering the workforce. Now they are beginning to retire. Japan was on its way to global economic domination—now they struggle with deflation and 19 consecutive years of property price declines. China seems now on its way to global economic domination. Globalization has taken hold to a much greater extent than back then. The Internet has expanded beyond our imagination. In the early 1980s PCs were showing up in offices for the first time and cell phones were yet

to come. Now we each have more power in our phones than a mainframe computer did back then. We had a society focused on expansion, high savings rates and growing wealth through the longest secular bull market we have seen. Today, we live in a society dominated by thoughts of entitlement, many people refusing to live below their means, and an ever increasing need of people to look for someone else to blame for their problems. We only need to watch Europe as a preview of our potential future. So, having a process that is forward looking is very important. Staying disciplined and staying true to that process will continue to be critical to future success.

- Investment fundamentals matter—things like earnings levels and growth, debt levels, valuations, competitive advantage, inflation, interest rates, etc. They matter most of the time, but not all the time. ie: late 2008.
- We believe we must be patient and be willing to wait to be right. Sometimes fundamentals suggest securities should be priced lower yet they go higher. Sometimes securities can be priced at bargain levels yet they keep declining. Junk bonds in late 2008 were a great example, but eventually investors realized that they were selling at prices far below their value. Their market surged in 2009 and we captured a lot of return when that happened.
- We believe we must not be victims of greed and fear. There are many times when compelling investments simply are not available and we must accept this and avoid being convinced otherwise. Opportunities will come. But when we do get a fat pitch we should swing, and typically swing hard.



# January 2011

- We believe that we increase our opportunities by being highly flexible and willing to look around the world for opportunities.
- We believe strongly in the value of being contrarian. Common sense tells us that when an investment is hugely popular it is probably overpriced. When an investment is hated, relentless selling probably means the asset is a bargain. Research is key, not just being contrarian, and we rely on the thinking of other smart investors to build our own independent analysis using common sense.
- We generally distrust much of what comes from our own industry. The investment community exhibits herd-like behavior, which can cause independent thinking to stop and group behavior becomes automatic.
- We must obsess about what could make us wrong because it is too easy to fall back on past analysis, accept our assumptions, and find support for our views. This drives us to test and retest our thinking. It is important to frequently challenge our assumptions, and to stay humble.
- We don't believe consistently accurate forecasting is something that can be counted on so we never bet on any one forecast. We work to understand the range of potential outcomes so we can invest with an understanding of the opportunity and the risk. This is why we use 12 different research resources, ½ of which are outside our industry.
- We believe in honestly communicating our views and expectations. It's common in our industry for advisors to want to tell a positive story. We believe our long-term credibility is dependent on telling it like it is, whether positive or not.
- Finally, at the core of everything we do is intellectual honesty. For us this concept means always searching for the truth; understanding what we can really know and what we can't, being realistic about our circle of competence. It is critical to be able to recognize when we are wrong and move on.

FAI Advisors, Inc.

Portfolio Sterling Committee December 2010

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