

## Newsletter December 2009 – January 2010

### Fog on the Crystal Ball

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It's a good thing that financial planners and advisors aren't paid to predict the future because, well, nobody seems to be doing a very good job of it lately. I hope you'll remember this as all the major financial magazines come out with their yearly "Here's what will happen in 2010" cover stories.

Reading through some back issues, we find that at this time two years ago, nobody, anywhere, was predicting a 4th quarter meltdown in the investment markets, or the global economy tottering on the edge of disaster. In fact, not a one of the prognosticators seems to have realized that the U.S. economy had already fallen into a recession.

If you read the magazine issues in early September, right before the markets suddenly went into a 400-point free-fall in two trading days (triggered, you probably remember, by the collapse of Lehman Brothers, the AIG bailout and the federal rescue of Fannie Mae and Freddie Mac), you realize that nobody had a clue that a storm was brewing on the horizon. The Wall Street Journal talked confidently about Lehman's efforts to secure a line of credit or divest some assets, and the consensus seemed to be that the damage from the burst housing bubble had been safely contained. Postmortem articles about the crisis show that the Federal Reserve Chairman Ben Bernanke and Treasury Secretary Hank Paulson, who both watch the economic numbers DAILY, were caught totally flat-footed.

Closer to home, in January of 2009, economists and pundits were talking about the possibility of a sustained market drop similar to the slow investment torture the Japanese have experienced since 1989. Kiplinger's magazine identified the people who had been most right in their 2008 predictions and asked them what they thought was going to happen in 2009. Not a one of them predicted what actually happened: a dramatic rise in stock prices (the S&P 500 touched bottom on March 6 with an intraday

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price of 666.79 and rose to over 1,100 currently), a sharply rising dollar and an end to the economic recession--what economists are now describing as a jobless recovery.

Here's what they actually said. David Tice, chief equity strategist for Federated Investors, told the magazine's readers that "The dollar will decline, and it's very possible that inflation will pick up. The S&P 500 index could easily fall to 450 or so. This will be a longer-term decline," he added, and gave the worst advice possible for investors over the next three quarters, saying that "Investors should be selling equities and conserving cash."

Bob Rodriguez and Tom Atteberry, of First Pacific Advisors, confidently predicted that: "The upturn won't come until 2010, and when it does, it will look very sluggish and lethargic."

Economist Nouriel Roubini told Kiplinger readers: "I expect that the recession will be very severe and that it won't be over before the end of 2009. I think there is a further 15% to 20% downside risk for global and U.S. stocks, and a further 15% to 20% downside risk for commodity prices. So 2009 will be a year of recession and deflation."

Peter Schiff, president of Euro Pacific Capital, missed the appreciation of the dollar, the dramatically low interest rates and the economic recovery--all in a couple of sentences. "The dollar is going to resume its fall," he said, "leading to a resurgence in the bull market in commodities. That will pierce the bubble in the bond market, causing interest rates to go up. So we're going to be in a depressionary environment, but with rising prices and rising interest rates. Our economy will be a mess for years and years to come."

The worst advice was being given right at the bottom in March, when global stock prices were about to reward patient investors with an amazing rally. Consider this evaluation from the March 5 issue of Business Week magazine:

All told, more than \$10 trillion of stock market wealth has vanished, and with it the confidence that springs from financial security. "We are looking at a 60% to 70%

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chance that this bear market is not over," says Robert D. Arnott, chairman of Research Affiliates, a Pasadena (Calif.) firm that manages \$25 billion.

The article went on to predict "more debt busts and government trial and error until things get set right again. That could mean two more years of bouncing around and then another six or so before the Dow is back above 14,000. Not long ago, such an outcome would have seemed unimaginably bleak. Given the other possibilities, it doesn't seem so bad now."

The hardest part about investing is controlling the natural urge to sell when the market has cratered, or to buy when the market is euphoric. But that's like going to the mall and waiting to buy until all the sales are over and prices have gone up, and then, as soon as the store has its next 25% off sale, going back and selling whatever you bought. Nobody would even think of doing that with their holiday gift purchases, but it's normal behavior in the investment markets.

The unhappy truth is that nobody can foresee the future, and the investment markets tend to be far less predictable than other areas of our lives. Like it or not, we venture blindly forth every day, control what we can control (investment costs, taxes and savings rates), and generally make more money in the upturns than we do in the downturns. Years ago, a pundit threw up his hands and said: "I don't know what the markets will do tomorrow, or next week, or next month. But I do know, with certainty, which direction the next 100% movement in the markets will be."

There, finally, is a prediction I can endorse.

## Who Works for Whom?

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It's hard to be a financial consumer these days, especially when it comes to knowing who you can trust. The Bernie Madoff scandal was a textbook case of how really smart, sophisticated investors can find themselves in the clutches of a scam artist. Meanwhile, millions of investors hire salespeople to give them investment

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advice--which is a little bit like hiring a used-car salesman to give you advice on which car to buy and how much to pay. In both cases, the result can be less than ideal for your financial health.

How do you know who to trust? You might be interested to know that professional financial planners have been debating this question among themselves. An ongoing topic at conferences attended by advisors who are NOT salespeople is trying to find better ways to give investors and clients better information about who you're working with and how much you can trust them. It's a never-ending process, because on the sales side, highly-skilled professionals are working overtime to make these distinctions as fuzzy as possible.

In the case of an outright scam, this isn't as challenging as you might think. One huge protection is the presence of an independent custodian--that is, you receive advice from an advisor, but your money is held at an institutional firm whose internal processes are closely regulated by the authorities. You get statements from the advisor, and also from the independent custodian, so there is a check and balance in place that tells you that your money is.

The trust issue becomes a little bit harder when you're deciding whose advice to take. There may be as many as 500,000 insurance and annuity salespeople who call themselves "financial advisors" or "financial planners," but once they've collected a lot of personal information, their recommendation is always the same: buy a lot of life insurance and (often) equity-indexed annuities that their company is offering. If the person sitting across from you is skilled at overcoming what seem to you to be valid objections, and if the recommendations tend to involve products rather than ongoing advice, and if you are never quite sure how this person is getting paid for the time he/she spends with you, then you should be very careful about giving your trust.

Most salespeople are pretty easy to spot. Representatives of Wall Street firms (the companies that recently took our global economy to the brink of collapse) can be far more difficult to evaluate. Many of them are now, on their business cards, referring to themselves not as a broker or securities salesperson, but as "vice president of investments" and/or "financial advisor." Many of them now say they charge fees for

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their services, except that the fees are paid not by you to the broker, but collected by the brokerage firm and then paid back to the broker as an employee of the firm.

So is there any real difference between an independent advisor--who works for you--or a broker who works for the brokerage firm?

Yes, but you have to know where to look. The independent advisor offers one important service that the broker does not: we, as a routine part of our work for you, try to protect you from excessive costs in your investment portfolio. The brokerage firm representative, meanwhile, needs to recommend products which will be highly-profitable to their employers--which is how money finds its way to those billion-dollar employee bonus pools that you've probably read about.

So where do you find these expenses? At a recent financial planning conference, an advisor who had worked with two brokerage firms talked about the difference in costs to his clients now that he works as an independent advisor. When he became independent, his clients saved, in the first year, an aggregate of just under \$2 million in mutual fund expenses, account and brokerage fees.

Later, he analyzed the portfolio of somebody who had been working with a broker, and compared the costs with the portfolio that he would propose. The investment mix was essentially the same. But on a \$1.107 million investment account, when all the various fees and costs had been accounted for by the advisor and the brokerage account, even though the advisor's planning fees were higher than the broker's, the savings by working with the advisor came to \$6,648 a year--or, put another way, about the cost of a nice 10-day trip to Europe. Every year.

All of these numbers are disclosed, if you know where to look for them, but generally they're buried deep in hundreds of pages of legalese. Every situation will differ, of course, but the consensus in the professional financial planning community is that this example probably understates the average difference in costs.

If you know somebody who is currently receiving investment advice from a brokerage firm, you might offer this information, and invite them to compare the costs of their

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investments with what else is out there. (If asked, we will perform this analysis as well.) The question that people might ask themselves is: how much of your money would you want to contribute to those Wall Street bonus pools?

## What's Going On

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One of the most important jobs tax and financial planners do (that you never see) is reading. As you know, our lives are awash in a constant flood of information, and even professionals sometimes struggle to make sense out of it. To make matters worse, the headlines often don't help us figure out what's going on.

For instance, is there still a threat of deflation, which was in the headlines at this time last year? Since May, the CPI has been +.1% (May), +.7% (June), flat (July), +.4% (August) +.2% (September), +.3% (October) and +.4% (November, the most recent statistic we have). For the most recent 12 months, consumer prices have risen 1.8%. This is in contrast to the 1.4% drop in consumer prices reported by the Bureau of Labor Statistics over the second half of 2008, when a lot of economists were talking nervously about a deflationary spiral. No headlines have declared this, but the deflation threat appears to be over; the question now is whether inflation will remain as mild as it has been or, as the economy recovers, will it take off?

Since you always hope to get more return on your investments than the inflation rate, are there any investments that look especially weak if, indeed, the threat of deflation is over? In an effort to avoid any losses, a lot of investors and institutions have parked their money in short-term investments; by one estimate, there is now about 90% as much money (\$11.7 trillion) in money market accounts and short-term Treasuries, as in the Wilshire 5000 stocks (\$13.1 trillion) currently.

But is this really avoiding losses? 3-month Treasuries are paying about 0.3%; 6-month issues now pay .16% and 12-month T-bonds are yielding .37%, which is well

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below the inflation rate. Every rise in the CPI means the value of their money is going down--which is something else we aren't reading about in the headlines. Money market funds, meanwhile, are at record lows.

Meanwhile, we've all been reading screaming headlines about debt problems in Dubai, one of the oil-rich countries on the Persian Gulf. But Dubai makes up just 0.1% of the global economy. What hasn't been reported is that, very quietly, the sovereign wealth funds in Qatar and Kuwait have been selling their stakes in U.S. companies, and raising capital. More recently, Saudi Arabia, Kuwait, Bahrain and Qatar are now creating their own petro-currency (<http://www.ritholtz.com/blog/2009/12/persian-gulf-currency-union-and-the-forex-risk-to-nations-everywhere/>), which will be called the "Gulfo," and are in the process of creating a regional central bank along the lines of Europe's monetary union.

Will the Gulf States Union (or whatever it is called) need to pump more oil in order to balance their fiscal ledgers and support their new currency? Does that mean oil prices will drop further--at least temporarily, as all these issues get sorted out?

There's one more subject that's getting a lot of headlines lately: unemployment. Recently, we've heard some rare good news, that fewer jobs are being lost now than a year or six months ago. What isn't being reported is that every month that jobs are lost puts American deeper into a hole that it will need to climb out of eventually.

How big is this hole? Has anybody tried to calculate it? Economist Paul Krugman recently suggested that with eight million jobs lost since the start of the recession, plus 100,000 new Americans moving into the work force every month, the economy would need to create an average of 300,000 new jobs a month in order to get to something close to full employment five years down the road. So if you see any number lower than 300,000 new jobs created, you'll know that this particular hole is getting deeper.

This makes it easier to interpret some of the forecasts that you may be reading, such as the recent study by the Bureau of Labor Statistics, which estimates that the economy will create 15.3 million new jobs in the next ten years. Do the math, and that comes out to about 125,000 a month.

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None of this helps us predict the future, of course. But it does show that much of the information that we receive, and the way the information is presented, can be disinforming (at worst) or (more often) take our attention off what's really going on in the world. There's a lot more to know than what the headlines are telling us.

Now, if you'll excuse me, I have to get back to reading...

## The Hidden Risk of Online Banking

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We've all heard about how hackers have been able to penetrate the computer systems of large companies that have customer credit card information in their computers. But when we ask our neighborhood bank about such problems, they give positive assurances that their online banking system is highly secure. O.K. Let's accept that your bank is as safe as Fort Knox. But what about your own computer -- which represents at least 50% of each online transaction? How secure is your home or small business computer? Probably not nearly as secure as the bank's computer. And therein is the hazard of online banking. If your computer has picked up a "Trojan" program (also known sometimes as a keystroke logger), that program is capturing all of your keystrokes and transmitting that information to the hacker's computer. Then the hacker uses another program to analyze the sequence of your keystrokes in relation to the website URL (address) to which you are connected. With a small amount of data crunching, the hacker has extracted your bank's login sequence and your password. Some banks are warning their business customers to do their online banking with a stand-alone computer that does not permit any email or web browsing activities other than for the banking connection. Another suggestion is to use a Mac (Apple) computer which is less susceptible to malware. For more see [Tighter Security Urged for Businesses Banking Online](#).

## IRS Publicity Claims to Expand Prosecutions of Tax Protesters

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Every year in the Spring, the IRS issues a steady stream of press releases about prosecutions of tax protesters as part of their propaganda program to encourage

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"voluntary" compliance with the tax laws. But it seems that the number of tax protesters, defiers and scofflaws is growing because of the recession. The [Fair Tax](#) group and the TEA ([Taxed Enough Already](#)) movement are generating a lot of media attention and growing support. The question is whether their efforts will persist and grow after the April 15th income tax filing date.

## **Tax Reform?**

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The White House recently announced the creation of a task force to find ways to simplify the tax code and reduce tax evasion. But you can ignore the talk about simplification. The effort to reduce tax evasion is the key issue rather than real simplification. Nowadays, when the government talks about tax "reform" it's time to get a better grip on your wallet. The politician's idea of tax reform is mostly about eliminating the use of offshore tax havens and raising taxes on the successful members of society. Changes in the tax deferral rules for U.S. owned foreign corporations is on the table but there will be heavy opposition from the U.S. multi-nationals that generate a large part of their earnings from their offshore subsidiaries