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Quarterly Investment Commentary | May 2010

The Real Economy

Finally! Although “sputtering,” nearly everything is starting to sputter in the right direction.

Productivity, income, and most business cycle indicators, both economic and psychological, are pointing towards continued and improved economic recovery.

There are even a few hopeful signs that the employment picture is starting to move in the right direction. (Employment is always a lagging indicator, meaning it follows the economic trend).

The failure of this economy to recover without restoring the jobs that were eliminated is, however, our achilles heal. There is no question that from

The Financial Markets

The poor health of the labor market, continues to give us pause about the financial markets. We are particularly concerned that rates of return over the next five years will be in the single digit's while risk remains high. This means that on a risk-adjusted basis, bond returns might be similar to equities.

This may seem counter intuitive, especially since it seems everyone with whom we talk is worried about the two factors that would mean lower bond returns and higher equity returns: inflation and higher interest rates.

We believe that the focus on the rising federal debt, which underscores the political debate has been over amplified in the financial press.

10,000 feet up the view of our economy is looking better, but the view on the ground is less encouraging.

Those with jobs are working harder and adding to the positive productivity numbers. But these workers, are scared to seek other opportunities. They are grateful to have a job; and while this is good for holding down inflation, it is not healthy for longer-term economic growth. Even more concerning are the relatively large proportion of workers who have given up looking for work. **These facets of the labor market are disconcerting and are not a healthy sign for the economic growth that affects everyone.**

We do not share the conventionally common view. We anticipate that the lack of robust demand in the real markets, the excess capacity, particularly in the labor market, and the fettered job mobility will temper inflationary trends for at least two and perhaps three years.

Nor do we proscribe to the notion that the Federal Deficit will crowd out private credit. **We think that job anxiety, individual investor caution, and even institutional investor caution, has resulted in a lot of cash growing outside of the financial markets; and this caution (along with Federal Reserve Open Market Operations) will help keep interest rates relatively low for another year or so.**

If we are correct, then the economy will continue to sputter along, primarily in an upward direction, for the next 2-3 years. We are less worried about another economic decline during this period, but if the employment situation does not improve then we could see another downturn within the next five years. We anticipate that this will mean slow growth in the financial markets, but perhaps much more volatility on a day to day basis or month to month basis.

Volatility is the dominant theme for the first quarter of this year.

Stocks started the new year on a sour note and foreign stocks fared even worse. And while domestic fixed-income did better; foreign developed and emerging-markets bonds were barely in the black by the end of January. But everything started to take off in February; and then came March madness!

By the end of the first quarter, the January downturn was ancient history. All domestic equity asset classes are now well into positive territory (year-to-date). The large-cap Vanguard 500 Index was up 5.4%, the iShares Russell Midcap benchmark gained 8.6% and the small-cap iShares Russell 2000 gained 8.8%. Foreign stocks also posted strong gains in March and are now (barely) in the black for the year.

The domestic intermediate-term, investment-grade Vanguard Total Bond Market Index has now posted

A “New” Investment Strategy for our Tactical Asset Allocations

We have been looking into a “new” investment strategy now available as a mutual fund and even as an Exchange Traded Fund. Some call these “absolute-return” (AR) strategies.

Absolute-Return Funds are funds that enable their fund managers to go short and long, hedge, and even leverage. In addition, they often can hold any type of financial asset class on the planet including derivatives.

We have started encouraging investors to move some of their tactical assets into these funds. However, we urge investors to view these funds with extreme caution. They should not be thought of or compared as like funds; even if they are listed in a magazine under the same category. Each fund has it’s own limits and approaches. While the

March Benchmark Returns (Preliminary)			
Large-Cap Benchmarks	Mar	1Q	YTD
Vanguard 500 Index	6.0%	5.4%	5.4%
Russell 1000 iShares	6.1%	5.6%	5.6%
Russell 1000 Growth iShares	5.8%	4.6%	4.6%
Russell 1000 Value iShares	6.5%	6.7%	6.7%
Mid-Cap Benchmarks			
Russell Midcap iShares	7.0%	8.6%	8.6%
Russell Midcap Growth iShares	6.8%	7.6%	7.6%
Russell Midcap Value iShares	7.3%	9.5%	9.5%
Small-Cap Benchmarks			
Russell 2000 iShares	8.1%	8.8%	8.8%
Russell 2000 Growth iShares	7.9%	7.6%	7.6%
Russell 2000 Value iShares	8.3%	10.0%	10.0%
Other Benchmarks			
Vanguard Total Int'l Stock Index	6.7%	1.5%	1.5%
Vanguard Emerging Mkt Stock Index	8.2%	2.5%	2.5%
Vanguard REIT Index	10.1%	10.0%	10.0%
Vanguard Total Bond Mkt Index	-0.1%	1.7%	1.7%
Merrill U.S. High Yield Cash Pay	3.1%	4.8%	4.8%
Citigroup World Govt. Bond Index	-1.7%	-1.3%	-1.3%
JPMorgan GBI-EM Global Div. Index	4.0%	5.4%	5.4%
DJ-UBSCI (Commodity Futures)	-1.2%	-5.0%	-5.0%

a positive 1.7% return year-to-date. Developed foreign bonds (as represented by the Citigroup World Government Bond Index) are down 1.3% for the year so far. But emerging-markets bonds roared in March, ending the quarter with a 5.4% return (as measured by the JPMorgan GBI-EM Global Diversified Index). High-yield bonds are now up 4.8% for the quarter.

investment strategies used are not new, they are not strategies most mutual fund managers are allowed to use. Moreover, they are not the type of strategies that most long-term investors utilize.

Advertising that these funds are intended to generate consistent, albeit modest single-digit returns, in almost any market environment does not make it true. And since the strategies employed by these funds can vary considerably, they should not be considered a “class of funds” in the way we consider other mutual fund types. Since, manager skill, strategy, and judgment are not equal each funds approach to research and the manner and consistency in which they implement their strategies will be even more critical than it is when comparing “conventional” mutual funds.

Therefore, it is logical to ask, on what basis can we reach an objective perspective on assessing these funds and their fund managers? The strategies are complex, some of the instruments used are esoteric, and nearly all of these funds are too new to have a meaningful track record. We find some of them compelling and have found a team that has a proven track record using some aspects of their current approach and so, given the prospects in other asset classes, have moved a small portion of tactical assets into one of these funds.

While we remind ourselves that past performance is not predictive in and of itself, a track record is useful to help evaluate the approach and discipline of a particular fund team and to get a better sense of correlations of that fund to other asset classes. And these funds do not have much of a track record.

Moreover, with so many different approaches at hand, how does one determine an appropriate benchmark against which to evaluate relative performance?

The benchmark used by most managers of AR strategies is a short-term risk-free return such as T-bills or LIBOR. We have decided to use T-bills as one of our benchmarks, but we are likely to also

A New Year Resolution Resolved

In our last investment commentary we wrote that we plan on expanding our capacity. We are pleased to welcome Elizabeth Kenney. Elizabeth is a Registered Paraplanner with more than 20 years of experience in the financial and insurance field. Elizabeth is here to help our clients and so if you

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compare the funds' performance relative to the core Barclays Aggregate Bond Index, as well.

Assessing Risks, Correlations, and Performance in Different Scenarios:

AR funds seek low correlations with traditional asset classes; however, our research partners have found that the beta between merger arbitrage returns and equities has tended to increase during periods of sharp equity-market declines, just when you'd most like to have no correlation. On the other hand, other AR strategies might be expected to have little equity correlation (or beta) in that circumstance.

Recognizing this means we have much to watch and learn. We will of course be watching closely how adding this exposure (and reducing our exposure somewhat to traditional bond funds) fits within our overall recommend asset allocations in terms of risk and return. Further research may yield other recommendations and with time a better sense of which approaches and how much exposure to these approaches to include in our portfolios.

We want you to know that we think there are possibilities within in this approach but we also want to caution you not to jump on any band wagons on your own too quickly.

are a client, please feel free to introduce yourself to Elizabeth. If you would like to be one of our clients, you too can call Elizabeth. She would be delighted to set up a convenient time for you to get to know us. There is no charge for this initial consultation.