

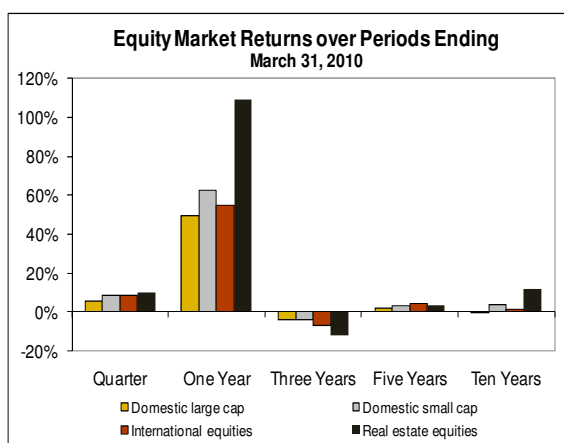
Capital Market Perspectives

APRIL 2010

Equity Markets - Past 12 Months

At about this time twelve months ago equity markets had fallen to their lowest point since their October 2007 peak. The chart below shows how these markets have rebounded over the past twelve months - all equity markets are up more than 50%. Note the dramatic increase in real estate markets. These results demonstrate again how important it is to long-term success to maintain established commitments to these risky markets. It is human nature to want to get out when the pain becomes intolerable, which is usually at the bottom. Doing so this time would have resulted in missing one of the best twelve months of equity returns in recent history.

Of course everyone wants to know about the future for equity markets, not the past. Unfortunately, the future depends on what surprises are in store. If the surprises are positive, the market goes up - if negative, the market goes down. If there are no surprises, but of course there will be some, market returns will generally reflect long-term averages.



Bond Markets - Past 12 Months

Bond market returns over recent periods ending March 31, 2010 are shown here:

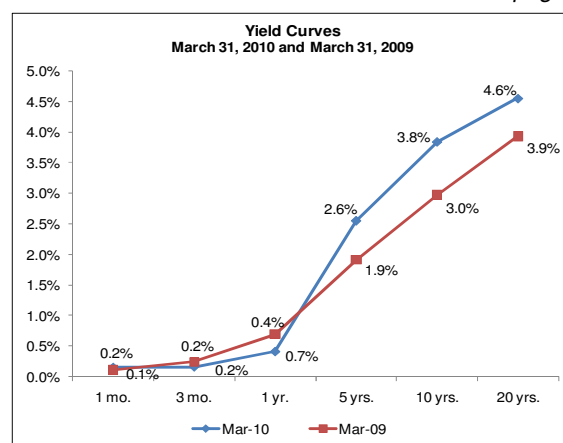
	Qtr	1 year	3 years	5 years	10 years
Citigroup 5-Year Treas. Index	1.7%	-0.1%	7.1%	5.5%	6.0%
Barclays Govt./Credit Index	1.6%	7.5%	7.0%	5.9%	6.6%

Note the significant difference over the past year between the returns of the Treasury index, which reflects only U.S. Treasury securities, and the Government/Credit index, which includes U.S. Treasury and corporate bonds. Also note the consistency in returns over longer periods.

Generally two factors affect bond market returns: 1) changes in interest rates, and 2) changes in credit spreads (difference between yields on U.S. Treasury securities and corporate bonds). As interest rates increase, bond returns fall off; as credit spreads narrow, returns go up.

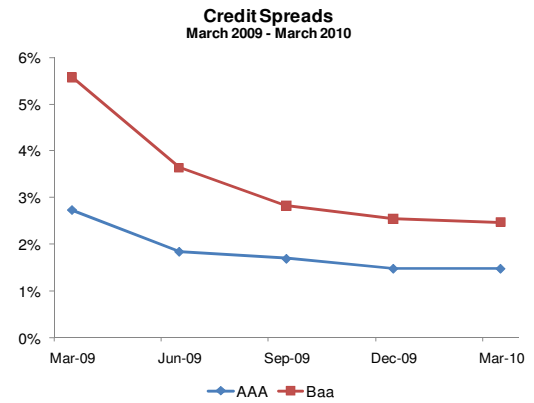
If neither interest rates nor credit spreads change, a bond will earn its stated yield. The charts below and at the top of the next page show how these two factors have changed over the past twelve months and help to explain

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Bond Markets . . . continued from page 1

bond returns over the period. We can observe interest rate changes by shifts in the yield curve. Note that interest rates have remained stable for short maturities and increased for longer maturities. These changes mean that for a U.S. Treasury portfolio, returns will have been adversely impacted. Credit spreads have also narrowed, having a positive impact on corporate bonds. ♦



Risk in the Long-Run – The Fallacy of Time Diversification

Risk can be thought of as the chance that things can turn out differently from what is expected. If uncertainty about the future can be expressed as a series of random outcomes, then we can use an average of these random outcomes as what we expect, and standard deviation as a measure of the range over which the actual result might occur (i.e. risk).

In the investment world, we tend to view outcomes in terms of annualized return on investment.

Contrary to what is often implied by conventional wisdom, risk does not go away with a long time horizon.

To get some sense of the uncertainty associated with investment returns we can use historical returns from the S&P 500 Index. Looking back over the period beginning in 1926 we observe the average annual return of the S&P 500 was 11.8% and the range of possible annual returns, as measured by standard deviation, was 20.5%. It is important to grasp that over this same period inflation, as measured by change in the CPI index, averaged 3.1%. Thus, the actual

increase in purchasing power over this period was 8.7%. Many investors are comforted by the fact that as the time horizon becomes longer than one year the range of possible returns is reduced, but the average annual

return stays approximately the same. This reduction in risk is shown in the following table:

	1 year	5 years	10 years	15 years	20 years
Annualized average return	11.8%	10.1%	10.7%	11.0%	11.2%
Standard deviation	20.5%	8.6%	5.6%	4.5%	3.4%

As comforting as the data in this table is for long-term investors, it is not helpful. It is dollars that are relevant and should be used to measure outcomes. And, as the time horizon increases the variability of possible outcomes in dollars (risk) increases. This increase in the range of dollar outcomes (vs. returns) as the time horizon increases is what is called the “fallacy of time diversification.” In other words, risk is not reduced as the investment horizon increases. The next table that shows the expected dollar value of an initial \$100,000 investment and variability (standard deviation) as the time horizon increases:

	1 year	5 years	10 years	15 years	20 years
Average outcome	\$111,000	\$173,000	\$309,000	\$539,000	\$986,000
Standard deviation	\$21,000	\$71,000	\$150,000	\$382,000	\$656,000

Risk is serious business. Contrary to what is often implied by conventional wisdom, risk does not go away with a long time horizon. It is important to long-term investment success to understand risk and the level of risk required to achieve long-term investment goals. ♦

The Lesson of Three Year Periods

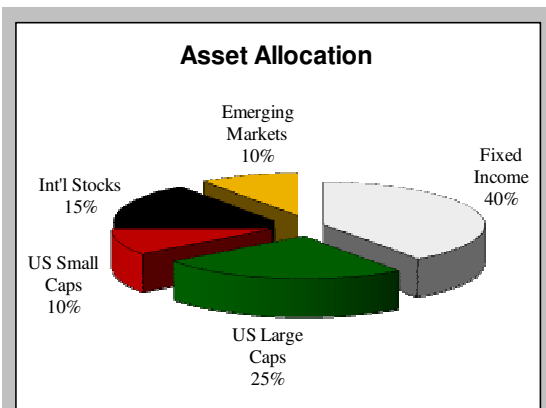
by Tom Benner

During the last three years ending 12/31/2009, investors weathered the second worst financial crisis in over a century (the first being the Great Depression of the 1930s). The U.S. stock market, as measured by the S&P 500, lost over half its value (-50.2%) in just 17 months (10/07-02/09). Two questions:

1. How much damage did a well-diversified portfolio experience?
2. Did maintaining an intelligent long-term strategic allocation hold up?

Diversified Portfolio

Let's review the results of a typical investment portfolio divided between global equities (60%) and fixed income (40%). The diversified allocation consisted of:



- 25% - U.S. Large Cap Stocks (S&P 500 Index)
- 10% - U.S. Small Cap Stocks (Russell 2000)
- 15% - International Stocks (MSCI EAFE Index)
- 10% - Emerging Markets Stocks (MSCI Emerging Markets Index)
- 40% - Fixed Income (5-Year U.S. Treasuries)

For the three year period (2007-2009), including the steep 17-month drop, results for each market are below:

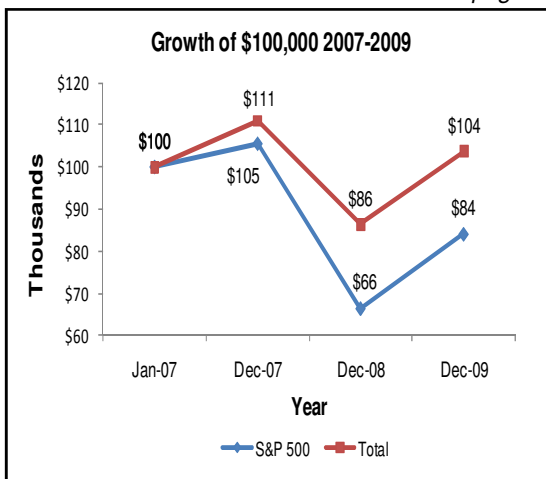
Market / Asset Class	Total Returns	
	Worst Period 10/07-02/09	Three Years 2007-2009
U.S. Large Caps	-50.2%	-15.9%
U.S. Small Caps	-50.7%	-17.1%
International Stocks	-54.7%	-15.8%
Emerging Markets	-57.1%	17.2%
Fixed Income	15.1%	21.5%
Total Portfolio	-31.0%	3.7%

Observations

1. All equity markets dropped during the panic as investors fled to the safety of U.S. Treasuries.
2. The allocation to "risk-free" fixed income investments significantly buffered the steep fall-off in equities, helping investors weather the painful period and enabling them to participate in the market rebound.
3. The rebound did occur (beginning March 2009), and over the entire three year period the total diversified portfolio generated a positive return (+3.7%).
4. Broad diversification paid off, with both fixed income and emerging markets generating strong results.
5. To achieve the positive total returns, enduring the relentless drop in stock prices was essential since it was entirely unpredictable when demand for equities would begin pushing values up again.

A Rough Ride in the Short-Run

The chart below shows the years 2007-2009, comparing results of the S&P 500 to the total diversified portfolio. Starting with \$100,000, after three years of significant market turmoil the total portfolio had a . . . *continued on next page*



The Lesson of Three Year Periods

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balance of \$103,666 compared to the S&P 500's \$84,054 (a difference of \$19,612, or 23.3%). The total portfolio's lowest value was \$76,091, a -23.9% fall-off from its original \$100,000 balance.

How About Other Three Year Periods?

Looking further back over the last 40 years of S&P 500 annual results (1970-2009), the worst one year return was -37.0% and the worst three year annual return was -14.6% (for a -37.6% total drop). However, these losses were significantly lessened using a simple 60% equity portfolio. The worst one year return for this portfolio was -21.3% (compared to the S&P 500's -37.0%) and the worst three year annual return was just -4.1% (for an -11.9% total drop). Also, during these 40 years the diversified portfolio experienced a total loss only twice in any three year period

(with annual drops of -2.9% and -1.2%). Of course, this has no bearing on the performance of any future period and it is quite possible for any portfolio to drop in value much more than what has been recently experienced.

Looking Ahead

Staying dedicated to a well-designed investment strategy throughout the three year period of 2007-2009 took quite a bit of grit and discipline. And the fact that it has passed has no bearing on how soon a similarly dramatic fall-off in prices might be repeated. But what is clear from this experience is that maintaining a low cost, broadly diversified portfolio through the short-term market ups and downs has historically shown to be the most intelligent strategy for achieving long-term investment success. ♦

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