

# Capital Market Perspectives

JANUARY 2010

## Equity Markets Rebound in 2009

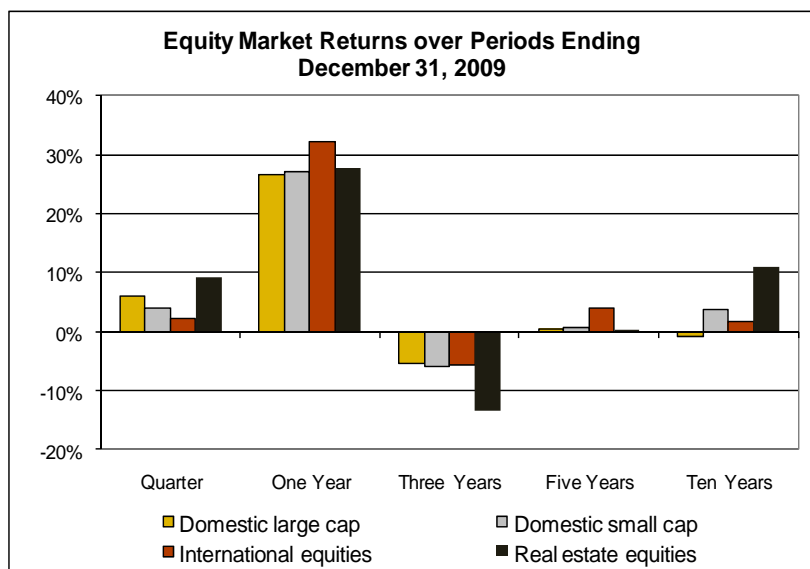
All equity indices reported returns in excess of 25% in 2009 as shown in the chart below. Yet, even with these results equity market returns remained in negative territory for the three-year period. Looking closely at the bar graphs for each period shows that it's generally a different asset class that is best. It will no doubt be this way in the future. Nobody can predict the market that will be best in any future period, which is why a well-managed portfolio is diversified among all asset classes.

Look at the ten-year results. Except for real estate markets, the decade was not good for equity markets. Keep in mind, however, investment decisions are about the future. Be careful not to expect future decades to look like this one. If markets are to exist, participants will value today's investments based on expecting a return for bearing risk; otherwise there would be no trading. Also, equity investments are not simply pieces of paper, but



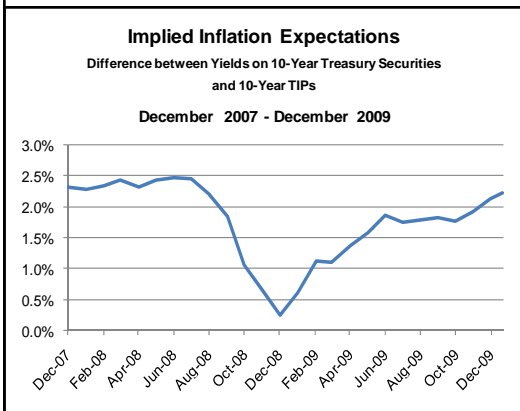
Clinton Square decked out for Christmas as viewed from the 7th floor offices of RJR Associates

are claims on the cash flows of real companies. For these companies to have access to capital they must produce a return for their claimholders. ♦



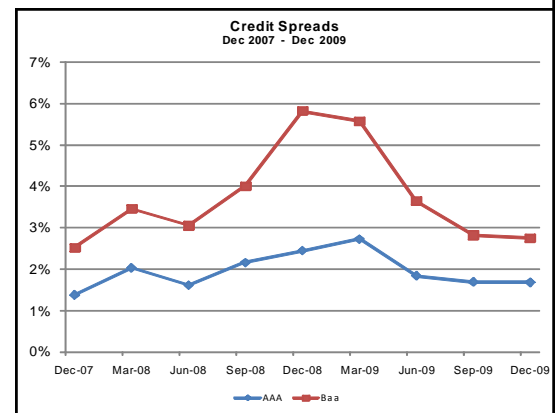
## Bond Markets Seem More Settled

Inflation expectations continued to be reasonably subdued and today's credit spreads have returned to more typical levels. Inflation expectations, which we measure by the difference in yields on nominal ten-year treasury securities and ten-year inflation protected securities (TIPS), are shown in the following graph:



While increasing since the extraordinary lows during the financial meltdown, inflation expectations remain at reasonable levels of

something in the neighborhood of 2%. The next chart shows that credit spreads (the difference between corporate bonds and U.S. Treasury securities), after increasing dramatically during last year's period of economic uncertainty, have come back to more typical levels. As credit spreads narrow, returns on corporate bonds will be greater than those from U.S. Treasury securities. ♦



## Risk, Return & the Rollercoaster of the Past Two Years

The following table shows what we have endured over the past two years, broken down in terms of risk profiles by using widely followed market benchmarks. Note

Risk Profile	2009	2008	Ann. Return 2008-2009
Aggressive (70% Equities)	21.3%	-25.8%	-5.2%
Moderate (50% Equities)	16.6%	-17.5%	-1.9%
Conserv. (30% Equities)	11.0%	-9.4%	0.2%

that the extent of the rollercoaster ride, as well as the two-year annualized returns, depend on risk – the greater the risk, the greater the fall-off in 2008 and the subsequent rise in 2009. The greater the risk,

the worse were the two-year returns.

The recent decade begs the question – why bear risk? The answer is that as risk increases we expect to earn a greater return. The table below shows the value of this higher return at the end of a twenty-five year period, based on starting with \$100,000. This analysis is based on actual returns of market benchmarks since 1970. The recent past demonstrates some of the downside of risk; the table below shows some of the upside. ♦

Risk Level	Expected value of an Initial Investment of \$100,000 at the end of a 25-year period	Percent increase from assuming incremental level of risk
Aggressive (70% Equities)	\$400,000	13%
Moderate (50% Equities)	\$355,000	27%
Conservative (30% Equities)	\$280,000	-----

## Enough by Mark Armbruster

*We asked Mark Armbruster to write an article for this newsletter. Mark is affiliated with RJR Associates and is President of Armbruster Capital Management in Rochester, NY.*

A few years ago, I had the privilege of spending a day with John Bogle, the founder of the Vanguard Group. He told me a story, the accuracy of which is dubious at best, but it is insightful nonetheless. In the story, the author Kurt Vonnegut is at a party with his friend and colleague, Joseph Heller. The party is hosted by a billionaire who made his fortune in the hedge fund industry. Vonnegut informs Heller that the host made more money in a single day than Heller did over the previous many years on his popular novel, *Catch 22*. Heller quips “Yes, but I have something he’ll never have...enough.”

Mr. Bogle has told that story during his many speeches and lectures and it has been the catalyst for his latest book, *Enough*. One of the many reasons that I admire him is that in his own career he has resisted the temptation to pursue the most lucrative options, in order to do what is right by his clients. I’ve been thinking about my meeting with him and the philosophy that he follows, as I encounter story after story of those who have been ruined by fortune.

The most recent story about the adverse impact of money, and consequently power, involves Tiger Woods. Clearly Tiger had it all: a career that was unbeatable, a net worth in the neighborhood of \$1 billion, a wife almost as good looking as mine, and a growing family. What drives someone like this to throw it all away with reckless behavior? Interestingly, Tiger is not unique. Our former governor, Eliot Spitzer, was in a similarly

envious position before he brought about his own downfall. These are just two of a myriad of examples.

There’s an old saying that “it takes three generations to go from overalls to overalls.” The first generation starts out poor, but sacrifices everything to provide opportunity for its children. The children, armed with strong educations and work ethics, rise to the top and build significant wealth.

The third generation, who are given too much too easily, never appreciates the value of anything and squanders the family fortune. That third generation often does far worse than just squander money.

On the other hand, money is a really good thing. It can solve all manner of problems, affords us the opportunity to help others, instills peace of mind, and provides the freedom to try new opportunities. I would never argue that anyone should stop working productively because they have earned more money than they will need. Indeed, economic growth depends to a large degree on wealthy people working and creating jobs. Nor does the idea of having enough imply that you should stop trying to grow your assets and build additional wealth. It simply means that you should not let money rule your life or impact your moral code.

Money is simply a tool to achieve and enjoy the truly important aspects of being alive. Psychologists have published volumes that conclude that human beings derive the most utility out of spending time with friends and family, intellectual challenges, physical exercise, and enjoying nature. All of these are obtainable without significant financial resources. Perhaps “enough” is not such a big number after all. ♦



Mark Armbruster

## About Wall Street's Pay Levels & Bonuses

by Bob Ryan

What is most discouraging to this writer is that today's Wall Street activities neither require any special skill, nor add to our economic growth. What these institutions are doing and have been doing in the past is simply borrowing short-term at essentially a zero cost and lending long-term. Leveraged 10:1 (borrowing \$100 for every \$10 of capital) banks can earn a 41% return on capital by just investing in long-term U.S. Treasury securities.

Earning these kinds of returns can go on as long as the bank can continue to refinance its short-term debt. Of course, the short-term environment has a way of changing, oftentimes resulting in banks having difficulty rolling over its short-term debt. This inability for Wall Street firms to refinance their short-term debt is basically what precipitated the financial panic of a little more than a year ago. It will happen again as these firms seek to increase the risk of their investments and add to their leverage

to earn more for their bonus pool. The management simply can't help it! And, as long as they have this easy way to make returns by trading, they will not engage in the hard work of making loans to businesses seeking to grow and add jobs.

Because earning today's profits from this activity takes no special talent and adds nothing to the economy it consequently deserves no special remuneration. The pay for those on Wall Street is a gross misallocation of society's resources. It takes a breathtaking level of hubris by the management of these institutions to believe they deserve bonuses at today's levels. I don't know what it takes for our large financial institutions to go back to simply taking deposits, making loans and helping companies raise capital in financial markets, but with so many earning so much trading financial assets, I don't see that happening any time soon. ♦

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