

Capital Market Perspectives

JULY 2009

Current Investment Environment

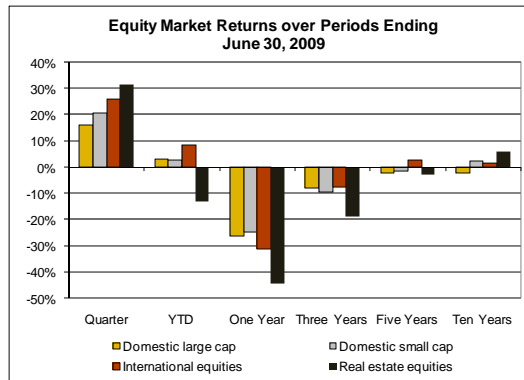
by Bob Ryan

The current investment environment can be characterized by:

- A nice bounce in equity markets in the second quarter
- Especially robust results in emerging markets
- A steepening yield curve
- A welcomed reduction in the daily volatility of the S&P 500 Index

A Nice Bounce in Equity Markets in the Second Quarter

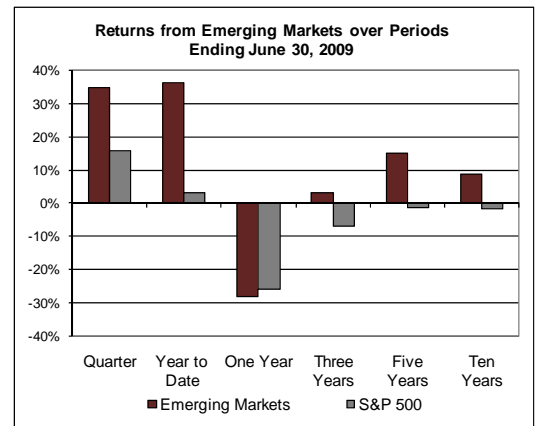
Equity markets bounced back nicely in the quarter, bringing all but real estate markets into positive territory for the year-to-date period. However, equity returns over the trailing twelve-month and three-year periods are still distinctly negative. These results, as well as results over the five- and ten-year periods from several equity markets, are shown in the following chart.



In my view, the recent results reflect not only some increased confidence in the future global economic environment, but also a lack of selling pressure from panic investors, especially in hedge funds. No one, of course, knows what the economic future holds, but the behavior of equity markets over recent periods sure feels better and, once again, points to the validity of remaining committed to establishing long-term policies and guidelines.

Robust Results in Emerging Markets

Emerging equity markets have been performing especially well in recent periods. As the chart below shows, except for the one-year period when all equity markets were off dramatically, emerging markets have provided



reasonable returns to investors. In this chart, I compare these results to the S&P 500 Index. Note the extent to which emerging markets have done better. However, to have realized these better returns, significantly greater variability in monthly returns had to be endured. While this greater variability seems benign with hindsight – it is not. The common urge is to alter commitments to risky markets at just the wrong time. To have realized the better returns of emerging markets over these periods requires a long-term discipline that many investors do not have.

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“...recent results reflect...some increased confidence in the future global economic environment.”
- Bob Ryan

Time Horizon - How Long is Long?

by Craig Buckhout

As humans we crave instant gratification, which perhaps helps explain our reluctance to take a long view when investing.

Behavioral economists refer to this phenomenon as “*time inconsistency*,” when the value of something tomorrow is discounted irrationally in favor of today’s gratification. Evidence of time inconsistency helps explain behaviors like procrastination and addiction, and failed efforts at weight loss or saving for retirement.

“*Barn door closing*” is another potentially harmful behavior documented by behavioral finance economists. This is the concept of taking actions that would have been profitable if taken yesterday.

Together these concepts help explain why it is so difficult for investors to remain focused on the long term and avoid reaction to current circumstances.

Why is the Long-term View Important?

It is only over the long term that we observe the realization of expected returns. In the short run we are often surprised by new information and see security prices rise and fall randomly.

“Closing the barn door” *after* these surprises can be extremely costly, as experienced by those who bailed out during the market’s darkest days this past February or March. Only

over long time periods does the market adjust to provide returns demanded by investors – the investors who set prices for investments.

So How Long is Long Term?

One could argue that a true investor has an *infinite* time horizon. Saving to buy a car next year is not long term. Saving does not equal investing. On the other hand, most university endowments anticipate surviving forever. Infinity is forever and that is a long investment horizon. Investors in retirement live from income and appreciation, preserving principal for an indefinite period of time – not exactly infinity but similar in an investment sense.

The Behavioral Finance Lesson?

If we agree that investors by definition have an infinite time horizon, then we can point to these principals of behavioral finance and take a long-term view. This realization can also help us ignore the noise from Wall Street and the financial press that focuses almost entirely on the short-term issues that affect traders and speculators trying to profit from surprises in the market. The long view will help us avoid the pitfalls of investing in what would have been profitable yesterday or reacting to the current situation or short-term predictions of the future. ♦

Equity Diversification - Does it Still Matter? by Tony Farella

The case for diversification across global stock markets was tested in 2008. Domestic stocks, international stocks, and real estate were all down between 34% and 49%. These results not only test our will to persevere with our investment plan, but cause us to question the value of equity diversification.

Diversification dampens volatility in a portfolio by adding uncorrelated asset classes. This lack of correlation means that when one asset class is doing very well others may not, and vice versa. By sticking with a diversified portfolio we capture the returns of equity markets and reduce the risk of the overall portfolio by grouping uncorrelated asset classes together. The global financial catastrophe in 2008 caused all the equity markets to move together in a stunningly negative way at the worst possible time. Current conventional wisdom suggests that the global economy is making the world flatter and the value of diversification across equity markets is illusive as Thomas Freidman discusses in his book, *The World is Flat*.

Returns for the first six months of 2009 tell a different story from what was observed in 2008:

2009 YTD Returns Compared to Calendar 2008

Returns	First 6 Months 2009	2008
Total U.S. Stock Market	5.0%	-37.3%
Int'l. Stock Market	8.4%	-43.1%
Int'l. Emerging Mkts.	36.2%	-53.2%
Real Estate (REIT Index)	-12.4%	-38.3%

When world events conspire they sometimes affect all markets in a similar manner, as in 2008, causing us to question the benefits of equity diversification. In the chart above we observed the benefits of a diversified portfolio during the first six months of 2009. In a crisis, the urge to make emotional decisions is quite natural. However, rational analysis should provide investors with confidence to ignore short-term phenomenon in favor of a well thought out long-term investment plan that includes the benefits of equity diversification. ♦

Expanding into Emerging Markets

by Tom Benner

An efficiently diversified portfolio would include exposure to international stocks as well as emerging equity markets because:

- ◆ The expanded diversity contributes to smoother and higher expected returns.
- ◆ Emerging equity markets make up over 11% of the world's total stock market capitalization.
- ◆ Over 80% of the global population lives in these countries.

However, there are additional risks associated with emerging markets and investors should proceed carefully.

What are Emerging Markets?

Emerging markets consist of lesser-developed countries which are beginning to develop rapid economic growth, experience a rising population with a substantial increase in living standards, and have a relatively stable currency. Prominent countries include China, India, Brazil, South Africa, Israel, Mexico, Poland, Egypt and South Korea.

Recent Returns

Over the past 20 years emerging markets have generated an annualized return of 10.7% versus 4.2% for internationally developed countries and 7.8% for U.S. equities, as measured by standard indices.

Returns 6/30/09	S&P 500	MSCI EAFE	Emerging Markets
1 Year	-26.2%	-30.9%	-26.2%
5 Years*	-2.2%	2.8%	15.1%
10 Years*	-2.2%	1.6%	9.0%
20 Years*	7.8%	4.2%	10.7%

* Annualized

However, emerging market returns were considerably more volatile on significant price drops. Staying the course during these periodic negative periods was essential to capturing the higher returns.

Asset Class Characteristics

Emerging equity markets do not move in tandem with other global stock market

returns, thus reducing overall volatility when added to a well-diversified portfolio. The correlation between emerging markets and equity markets in the rest of the developed world, on average, has been about 0.65 over the last 20 years. A correlation of 1.0 would mean they moved in perfect tandem.

Emerging markets are also home to most of the world's population and natural resources, such as oil, copper and natural gas. The U.S. Department of Commerce estimates that over 75% of the expected growth in world trade over the next two decades will come from developing countries. U.S. investors who overweight domestic and developed country stocks risk missing out on these promising growth opportunities.

Proceed with Caution

The risks of investing in emerging markets can be significant. In the last ten years there have been nine separate corrections of at least 10% and two declines in excess of 45%. Legitimate concerns include political uncertainty, lack of liquidity and reduced transparency. Over the long run, however, investors should be rewarded for maintaining exposure to this asset class, provided funds are low cost and broadly diversified, and problematic countries with unreliable economic infrastructures are avoided. ◆

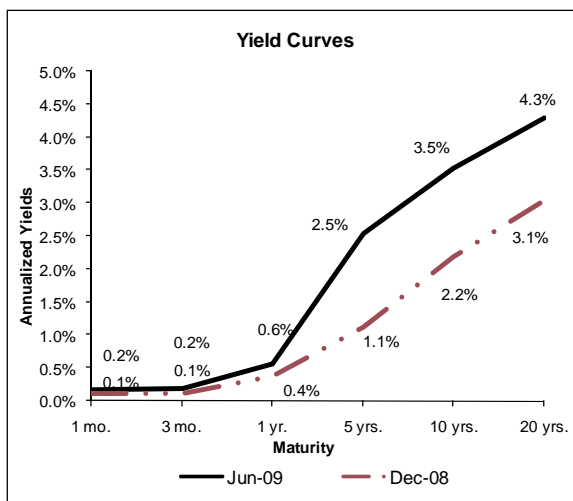
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Current Investment Environment (cont. from page 1)

A Steepening Yield Curve

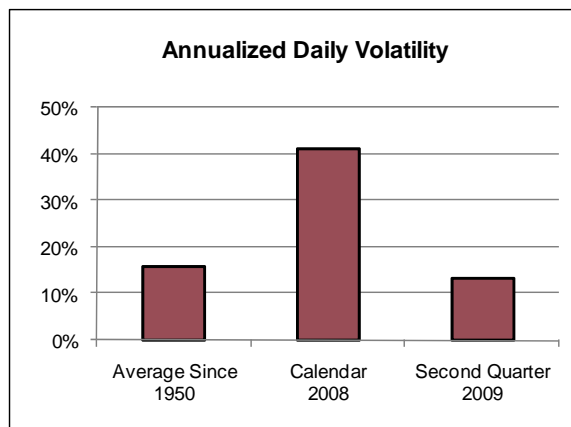
The yield curve below shows how the required yield on U.S. Treasury securities changes as the maturity increases from one month to twenty years. I show the shape of this curve currently and what it was at the beginning of the year. Note



how the yield curve has steepened indicating that investors require a greater yield on longer-term securities today than they did at the beginning of the year. As interest rates increase returns on fixed income investments fall. A steepening of the yield curve oftentimes not only anticipates increasing short-term interest rates, but also an improved economic environment. Of course, there are times when these anticipated results don't always pan out. We'll see.

A Welcomed Reduction in Daily Volatility in Equity Markets

To measure daily volatility I use the S&P 500 Index as a proxy for equity returns and the annualized difference between the actual daily return and the average over a given period (annualized standard deviation). I show the average daily volatility since 1950, over calendar 2008 and the past quarter. The volatility in daily returns reflects the inherent uncertainty of those events that impact equity values, which is the risk we accept for making equity investments. For bearing this risk we expect a higher return. The data in the chart below first demonstrates the dramatic level of uncertainty in calendar year 2008, again showing the extent that 2008 was different from past periods. Secondly, it demonstrates what we hope is a return to more normal levels of volatility of equity returns. ♦



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- Jim Rohn

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