

Capital Market Perspectives

OCTOBER 2009

Current Investment Environment

by Bob Ryan

Equity Markets Continue to Provide Robust Returns

As shown in the chart below, equity markets earned extraordinary returns over the past quarter and year-to-date periods. Yet, even with these results, all but international equities are still in negative territory for the trailing twelve months.

Over the three, five and ten year periods, equity market returns are well below long-term averages. Even so, it is still reasonable to expect that future market returns will reflect risk, regardless of what we have experienced in the recent past. If this were not the case no one would participate. Also, it is reasonable to conclude that in the long-run investors realize what they expect. This conclusion is why historical averages are oftentimes used to indicate market expectations. The average return of the S&P 500, after subtracting inflation, is something in the neighborhood of 7%, which is a reasonable expectation for future returns for bearing this

level of equity risk. That market returns were under this average for the past ten years does not alter this expectation. Equity market results over the past few months demonstrate just how quickly and significantly markets can move – both down and up. Once again, the only way to ensure participating in the upsides and realize the long-term returns from bearing risk is to endure the downsides.

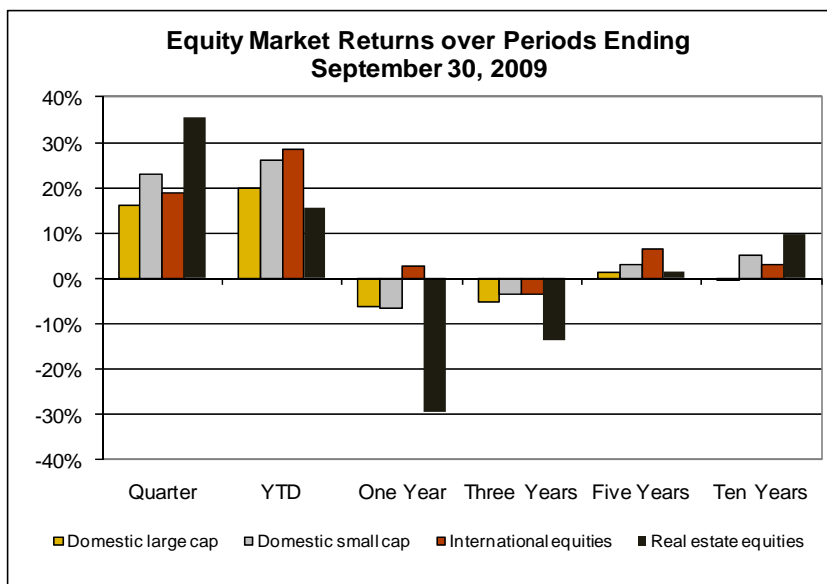
Fixed-income Returns Reflect Changes in Yields and Credit Spreads in the Short-run, and Risk in the Long-run

Look at the significant differences among returns of various fixed-income indices in recent periods as shown in the chart on Page 2. These short-term results reflect the twin impact of increasing yields and narrowing credit spreads, as well as the equity-like characteristics of high-yield bonds (credit spreads are the difference between yields on U.S. Treasury securities and corporate fixed-income securities.) In these periods an allocation to fixed-income markets could have dramatically different results depend-

ing upon the particular strategy employed. Yet, over longer periods fixed income results fairly consistently reflect the level of risk assumed. The results shown in the chart demonstrate that fixed-income returns can be volatile in the short-run due to changing yields and credit spreads, but generally reflect risk over longer periods.

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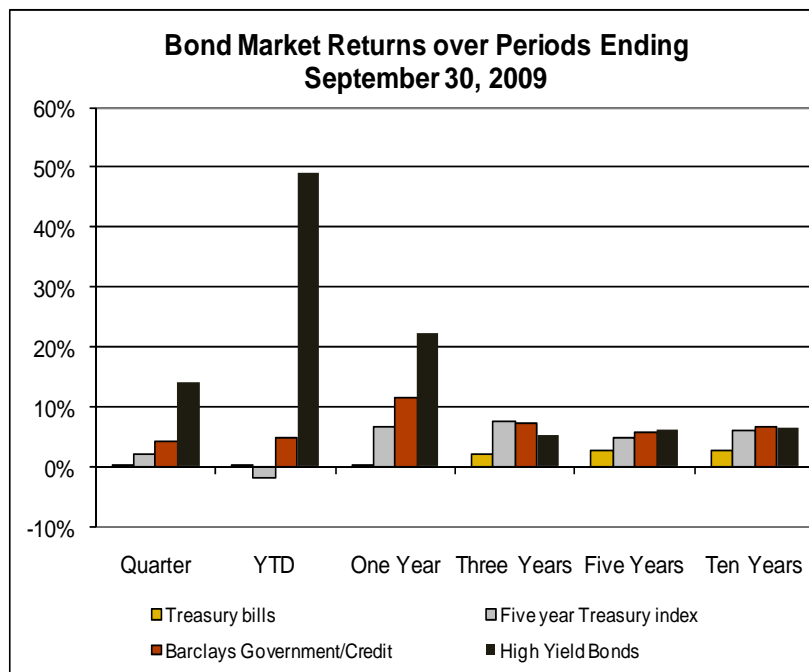
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Current Investment Environment

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“...That the managers of our Wall Street institutions failed miserably . . . is a testament to their incompetence and not some sort of market failure.”
- Bob Ryan



Developing Allocations to Various Markets

A well-diversified portfolio designed to capture global equity market returns includes commitments to markets/asset classes that contribute to producing the best risk/return tradeoff of the portfolio. Developing the right commitment depends not only on the expected returns and variability of returns of each market, but also on how the returns are correlated with one another. To develop our commitments we use a quantitative process that is based on historical data. As we update our models and assumptions as to how past results translate to expected results as well as add new data we will alter our established commitments from time to time. Throughout our process the fundamental concept that underlies our approach is that over time the prices and returns established by markets are the best indicator of expected results and “expert” predictions are just not useful. This idea is generally consistent with the so-called “efficient market hypothesis.” As a result of the recent activity of many in the financial industry and the resulting impact on market prices, some have questioned the validity of the role of markets and the efficient market hypothesis.

Are Market Prices Valid?

Essentially, the efficient market hypothesis says that the observed market price reflects all available information. It neither says that the

observed price is the correct price, nor rationally determined, but, without saying how market prices are determined, hypothesizes that they reflect what information is available. Keep in mind that what we have here is a hypothesis – not a law. This hypothesis has been studied exhaustively since first put forth around the turn of the twentieth century and, as far as I know, still stands as the best explanation of market behavior. Those taking recent market activity as evidence to reject the efficient

hypothesis, to my knowledge, have yet to propose something better.

One problem with trying to explain market behavior is that there is a lot of short-term random noise in returns. By definition, a random event cannot be predicted. The efficient market hypothesis does not say market “bubbles” cannot happen – it does say that they cannot be predicted consistently. The efficient market hypothesis does not say that mispricing of assets can’t happen – it says that any mispricing is unbiased and can neither be predicted nor produce abnormal long-term returns. There is simply too much empirical evidence that capital markets are reasonably efficient for it to be rejected cavalierly based on what has gone on in the recent past.

In my view, the recent financial disaster was due simply to our financial institutions taking excessive risk with someone else’s money. There is a great deal of volatility in well-functioning markets and that volatility is not always on the upside. Financial intermediaries must be managed in a way that they not only participate in the volatility on the upside, but also survive the volatility on the downside. That the managers of our Wall Street institutions failed miserably in this regard is a testament to their incompetence and not some sort of market failure. ♦

Inflation Concerns

by Tom Benner

The amount of money recently pumped into the economy by the Federal Reserve is prompting many investors to consider how a possible surge in consumer prices would affect the value of their portfolio. An overcautious investment strategy earning 1-2% could leave one's purchasing power significantly eroded.

Even if inflation is held in check to 3% a year, it will make what today costs \$100,000 rise in 30 years to \$235,000. Should inflation be higher, say 4%, that amount would grow to \$312,000 or three times the current cost.

Historical Perspective

Inflation is often described as "too much money chasing too few goods" which causes an upward price movement of products and services. The inflation rate, or annualized percentage change in prices, is frequently measured by the Consumer Price Index, or CPI. The CPI tracks prices of a selection of goods and services purchased by a so-called "typical consumer."

Since 1929 the CPI has averaged 3.2% a year, ranging from a high of 18.2% (1946) to a low of -10.3% (1932). Of the dozen highest inflationary years since 1929 more than half were in the 1970s, which experienced sharply higher oil prices due to the Arab embargo. Below are the average inflation rates for the last eight decades. Note the annualized S&P 500 results compared to the real returns generated after adjusting for inflation.

Year Begin	Year End	Inflation Rate	S&P 500 Nominal	Growth Real
1929	- 1938	-2.0%	-0.9%	1.1%
1939	- 1948	5.6%	7.3%	1.7%
1949	- 1958	1.9%	20.1%	18.2%
1959	- 1968	2.1%	10.0%	7.9%
1969	- 1978	6.7%	3.2%	-3.5%
1979	- 1988	5.9%	16.3%	10.4%
1989	- 1998	3.2%	19.2%	16.0%
1999	- 2008	2.5%	-1.4%	-3.9%
1929	- 2008	3.2%	8.9%	5.7%

Inflation Expectations

Investors are concerned about unexpected developments, since markets have already reacted to known information. Although a spike in consumer prices is surely possible there are ample reasons why runaway inflation is not imminent. It was little more than a year ago when many economists were worried about deflation, or a downward spiral in prices. And over the past 12 months consumer prices, as measured by the CPI, have actually dropped 2.1%.

- Two global disinflationary forces should continue to help contain inflation:
 - The opening up of labor markets around the world
 - The spread of technology such as personal computers and cell phones
- An increase in the money supply does not necessarily lead to higher demand for goods and services – consumers may lack the desire to purchase them.
- If job losses continue to rise and manufacturing capacity remains underutilized, pressure to increase wages and prices should stay light.
- Consumer demand will be restrained as long as banks continue to hold on to excessive reserves and rein in lending.

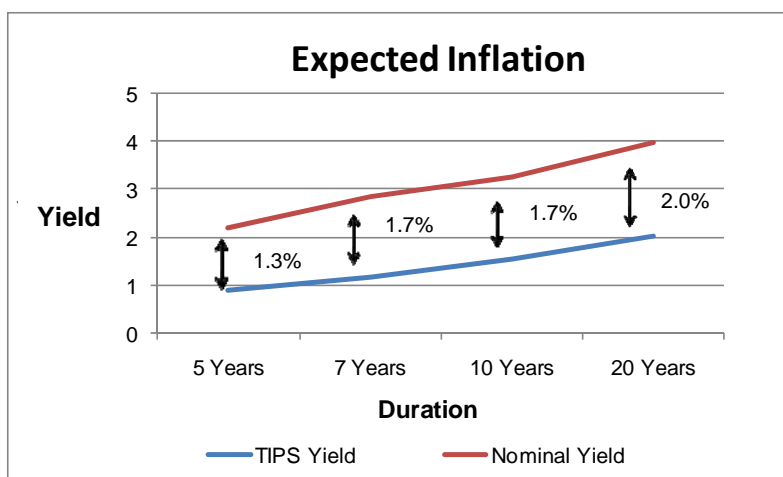
There is little sign market participants are worried about increased prices. As evident on the graph on the next page, the yield on inflation-indexed bonds (or TIPS, which capture real yield) compared to the nominal yield of Treasury notes suggests inflation will be less than 2%. And if people really thought runaway prices were likely, the government would not be able to borrow money, as it does now, at such low interest rates.

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Form ADV Notification

Form ADV (Uniform Application for Investment Adviser Registration) for RJR Associates Inc. has been filed as appropriate with the Securities and Exchange Commission, and may be reviewed at the offices of RJR Associates Inc., 101 S. Salina St., Suite 750, Syracuse, NY 13202, or may be obtained by mail by requesting same at this address or by phone at 315-476-8200. ♦

Inflation Concerns ...continued from page 3



◆ Prices rose 8% annually between 1971-1980, with five-year T-Notes gaining just 6% and one-month T-Bills gaining 7% compared to +14% for international stocks and +15% for U.S. small cap stocks.

◆ During the 20 years from 1970-1990, when 6% inflation was twice the historical average, a portfolio comprised half each of globally diversified equities and intermediate-length U.S. bonds earned 12% a year – exceeding annual inflation by 6%.

Keeping Pace

The impact rapidly rising prices have on an investment portfolio depends on the types of securities held. Equities have historically provided an effective hedge:

- ◆ During the 1940s U.S. small cap stocks exceeded inflation by 9% a year, compared to one-month T-Bills (-1%) and five-year T-Notes (-4%).

Maintaining a broadly diversified portfolio of equities and fixed income has been a sound strategy for out-pacing inflation and should continue to be so, even if prices rise faster than expected. Shorter-term bond prices are less sensitive to changes in interest rates than long-term fixed income securities and when faced with rising costs many companies, in addition to paying dividends, can increase prices to sustain profitability. ◆

Rockbridge Investment Management to be Independent of RJR Associates

Craig Buckhout and Tony Farella, the principals of Rockbridge Investment Management, have decided to become independent of RJR Associates. While RJR Associates will continue to concentrate on applying well-established principles of capital market behavior to constructing financial asset portfolios for both individuals and institutions, Craig and Tony are seeking to establish their own identity to concentrate on bringing a more comprehensive wealth management solution to individuals. We will continue to work with Rockbridge Investment Management in bringing 401K plan programs to plan sponsors.

Craig and I started the firm over 18 years ago when we had essentially no clients but shared a passion

for what was at the time a unique investment philosophy. While over the years our investment philosophy has remained consistent, we have grown to where it is appropriate for Craig to establish an independent firm with its own value proposition. This is an exciting time for both Craig and Tony. I wish them every success.

There is no change in what we are doing at RJR Associates and Disciplined Capital Management, however this change will allow us to begin to streamline our activities. We will continue to work with both individual and institutional clients in efficiently constructing financial asset portfolios to achieve established long-term goals. ◆

Serving the investment needs of individuals and institutions, foundations and endowments

RJR Associates Inc.
AN INVESTMENT MANAGEMENT FIRM

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