

Capital Market Perspectives

OCTOBER 2011

Capital Market Activity

Bond Markets

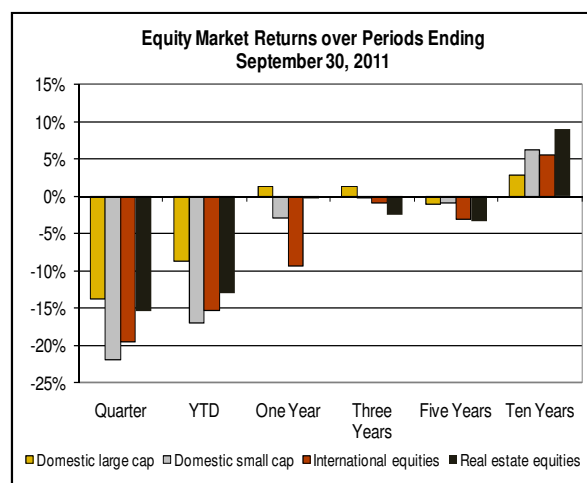
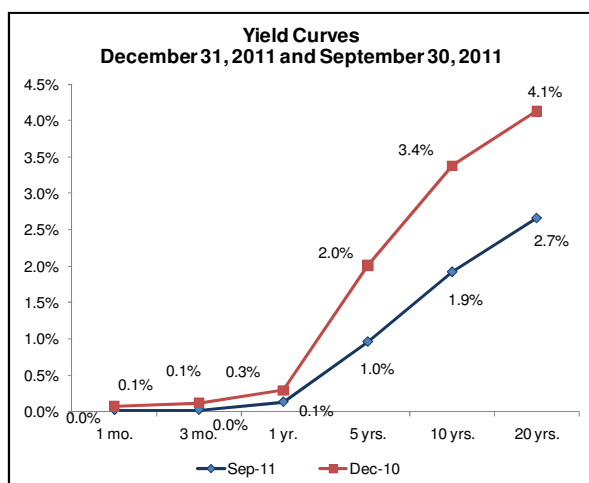
The Federal Reserve System (FED) continues to be the major player in today's bond markets. Its efforts to spur economic growth continue to drive interest rates lower. The curves on the graph below show how yields on U.S. Treasury securities have fallen since the beginning of the year. Look at the declines in the longer maturities. These declines have a significant impact on returns.

After driving interest rates down with its recent programs dubbed "QE1" and "QE2," for quantitative easing 1 and 2, the FED has now embarked on "Operation Twist" under which they will buy longer-term Treasury securities and sell shorter-term securities. The expected effect is to reduce long-term rates and thus increase business investment. While the FED's impact on economic growth has yet to be demonstrated, its activities have distorted bond prices, driving real interest rates (after inflation) to essentially zero. This can't go on forever – capital will not continue to be made available without the expectation of a positive return.

Equity Markets

Equity market returns are shown in the chart below. While the ten-year returns are positive, although generally below long-term averages, short-term returns are not only lackluster but significantly negative. It has been a difficult decade during which investors have endured the bust side of the dot.com boom, the "irrational exuberance" of the domestic real estate market and the resulting meltdown of our banking institutions. Now they face the potential default of several European countries as well as the ongoing wrangling of our political leaders. Past returns reflect this uncertainty.

The precipitous fall-off in the past quarter rekindles memories of the 2008 financial meltdown. While it may seem that uncertainty is unique to today's world, it is not. Markets have dealt with economic uncertainty before. While the issues may vary over time, how this uncertainty is reflected in the market remains constant. ♦



Financial Media - News or Noise?

With more outlets for so-called news than ever before, investors need to distinguish between two kinds of information: news and noise. There have been multiple studies conducted to show the relationship between the media, market prices and trading volume. One entitled, "Is All That Talk Just Noise?" (The Journal of Finance, Volume 59, 2004) concludes that the correlation between the media and market prices is relatively low, yet the correlation between the media and trading volume is high. This correlation suggests that introducing information to a well-functioning market will cause prices to fluctuate. The market has a history of self correction, but it takes time.

News is previously unknown information. This information comes with a reasonable expectation of accuracy, or at least good intentions. Using this previously unknown information, all investors will buy at levels that other investors are willing to sell, and vice versa. Because of this equilibrium, markets will ultimately reflect real values. However, introducing irrelevant news can influence investors' behavior and cause volatility. Irrelevant news is simply noise.

News and noise come from various media outlets. We have legitimate financial news

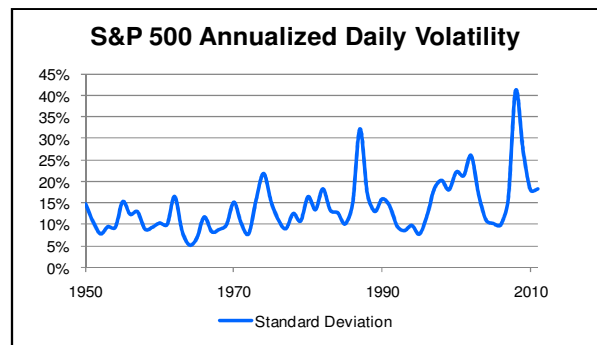


resources that provide information, but we also have an increasing number of financial media sources that simply provide entertainment . . . and investors need to tell one from the other. Some media sources are merely opinion or second-hand information. Investors may want to believe this noise if they feel it will benefit them. Unfortunately, the evidence shows the negative impact noise can have on the market. Noise creates uncertainty and uncertainty creates volatility. This volatility will have an impact on an investor's portfolio return in the short run and will rarely bring long-term value. We can't prevent these short-term fluctuations, but we can plan for them by keeping a well-diversified portfolio that is based on the level of risk an investor is willing to accept. ♦

Volatility & Perseverance

We are about to examine how the strategy of staying the course through discouraging markets has worked for investors over time. One sure way is demonstrated by the gentleman in the cartoon above wearing headphones. The chart at the right illustrates "market turbulence," or the annualized daily volatility of the S&P 500 from 1950 to present. As can be observed, current volatility measures are high, but we are not in uncharted territory. Note that we have experienced choppy markets in the 1970s, 1980s, 1990s, and 2000s.

To demonstrate how perseverance has worked as a strategy, we collected rolling returns of the S&P 500 over several time periods from 1950 through YTD 2011. The S&P is a good proxy for illustrating the value of staying the course. We examined how the holding period has



influenced the overall return to an investor in the table on Page 4. To help explain our findings, we examined different holding periods to track the performance. For example, of the 620 ten-year rolling periods since 1950, the total return of the S&P 500 was negative 3.9% of the time. Put more simply, if performance matched that of the index over ten years, you ended with less than you started in only 1 out

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We are launching a new section of our newsletter as a platform for my perspective on the current investment scene. The rest of our newsletter will include facts and analyses developed by my colleagues; my goal is to provide some longer-term context.

Over the quarter we have been treated to another bout of daily volatility and falling stock values. While it seems too soon to have to go through this again, these short-term ups and downs come with well-functioning markets in uncertain times. Oftentimes short-term traders are not buying a security because they think it's a good investment, they are buying with the hope that someone else will think it's a good investment. British economist John Maynard Keynes described investing as a beauty contest in which you select not who you think is the prettiest, but who you think someone else will think is the prettiest.

Regardless of the fact that the media treats it like a spectator sport, investing is not a game. Its goal is to allocate capital to productive activities and to establish value. A well-functioning market is a necessary ingredient of an economically developed society. There must be a risk-adjusted return to capital over the long run; otherwise, no one would provide

capital. Short-term volatility is the risk investors must endure.

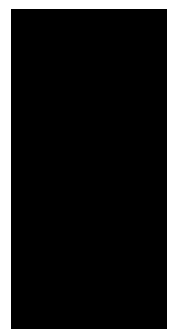
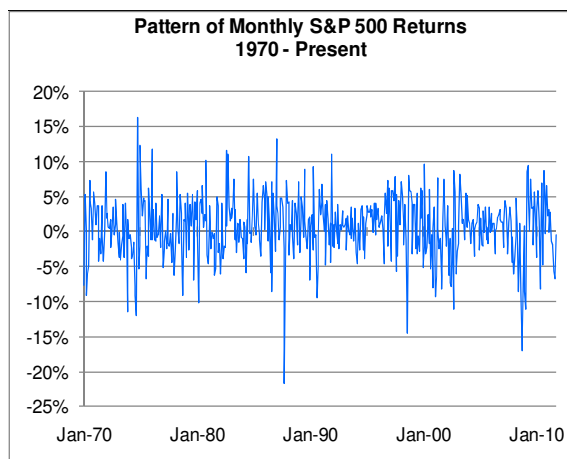
Of course volatile markets are not fun. Yet, I think over the long run our capital markets do a reasonable job of allocating capital and establishing value. There are two important requirements for investors to successfully participate in this process and deal with the daily ups and downs that are part of it – simplicity and perseverance.

Simplicity is a well thought out long-term strategy for determining what securities the portfolio will hold and how it will be allocated among various markets. If it's too complex to understand, then don't do it. Once you have a strategy that makes sense – stick to it. Hair-trigger responses to market developments lock investors into an unproductive cycle of chasing yesterday's returns.

While that crank Henry David Thoreau might be an unlikely source for financial perspective, his great theme of "simplicity, simplicity, simplicity" as a principle for living is a principle for investing as well. He noted that you can't outwit the fundamental laws of economy; schemers and con-men end up the victims of their own machinations. His words remain resonant for 21st century readers. ♦

A Historical View of the Pattern of Equity Values

The graph at the right shows the pattern of S&P returns since the beginning of 1970. Note that markets go up and markets go down. We are now going through a down period, which has happened many times before. What we don't know is how much further this down market has to go and how long we have to wait for it to go back up. However, to provide a long-term return to equity capital, markets must go up to a greater extent than they go down. This has in fact happened over this period, as the average monthly return of the S&P 500 since the beginning of 1970 is an annualized 7.5%. ♦



Volatility & Perseverance ... cont.

of every 25 times. What is particularly interesting is the “% of Negative Returns” column. There is a smaller incidence of negative returns in the index as the rolling time periods lengthen. A one-year holding period would have generated a negative result in nearly a quarter of the periods examined, while longer-term investors have much better results. Considering these findings in conjunction with the volatility graph on Page 2,

we can conclude that more often than not, it pays to persevere, despite prevailing market conditions. ♦

S&P 500 Returns from 1/1/1950 - 9/30/2011			
Rolling Period	% of Negative Returns	Minimum Annual Return	Maximum Annual Return
One Year	23.1%	-43.3%	61.2%
Five Year	8.2%	-6.6%	29.6%
Ten Year	3.9%	-3.4%	19.5%
Fifteen Year	0.0%	4.1%	19.7%

Market Returns

We show returns over several periods ending September 30, 2011 from indices typically used as proxies for individual markets as well as from diversified portfolios with different risk profiles. Note that not only have bond markets generally done better than the more risky equity markets, but also that returns have been subdued. However, be careful about extrapolating these past results into the future.

Chart I - Returns from Individual Markets

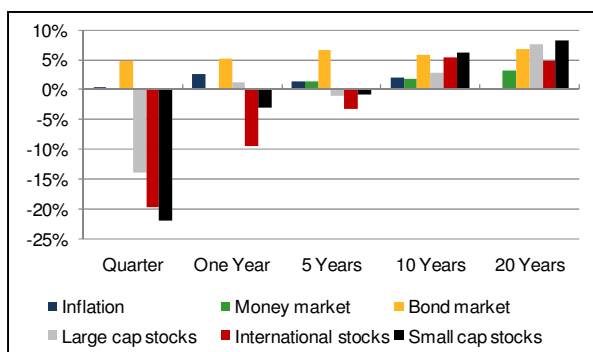
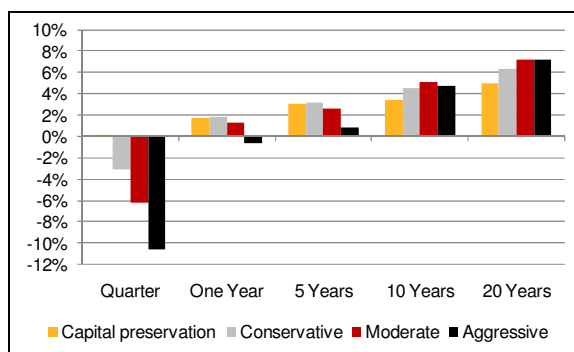


Chart II - Returns from Diversified Portfolios



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