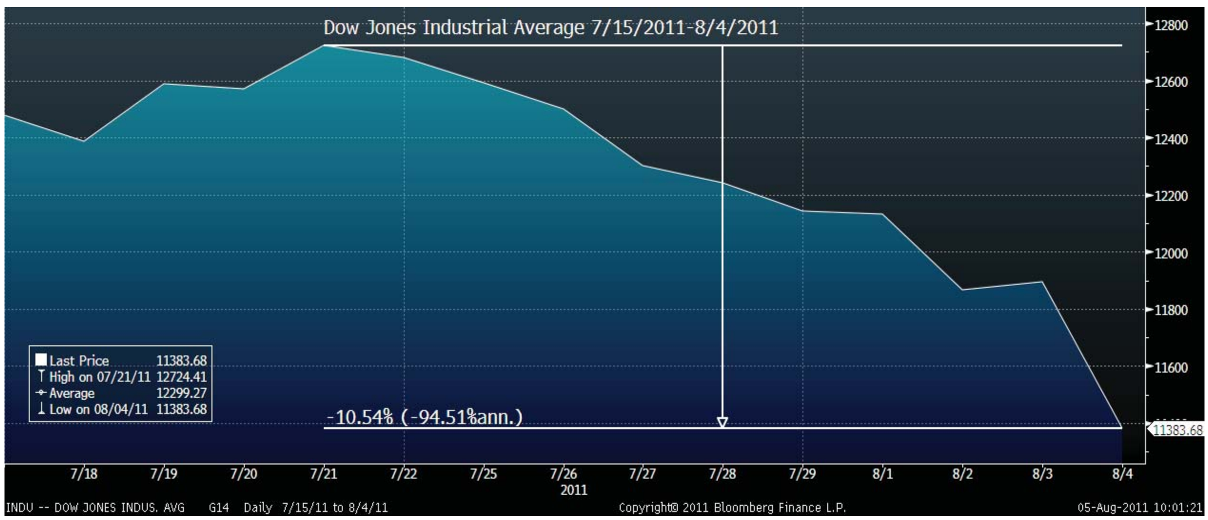
Market Alert

Be Careful What You Ask For

As indicated in our July Market Update, the market adjustment has unfortunately arrived. The debt ceiling debate is resolved, though Democrats and Republicans are both far from satisfied with the end result. The Democrats failed to get the tax increases they were hoping for and Republicans did not get the significant spending cuts they were angling for in the deal. However, a deal was ultimately struck and now that the debt ceiling issue is out of the way, the focus has turned back to incredibly disappointing economic data. In essence, the debt ceiling debate distracted us from the much deeper issues that have since reared their ugly heads.



Recent GDP downward revisions have shown us that the recession was far worse than we initially thought and our recovery is slowing down to a snail's pace. Instead of a 4.1% decline in real GDP as previously thought; we experienced a 5.1% decline. Moreover, though GDP growth was far from spectacular in 2010 (estimated at 3.0%), growth is downright dismal in 2011. First quarter GDP growth was revised down from an original estimate of 1.9% to a miniscule 0.4% and second quarter GDP growth has been estimated at 1.3% but could just as easily be revised downward once more accurate data is collected. Moreover, Monday's disappointing news on the manufacturing front didn't help matters. Hit by weakness in new orders, the Institute for Supply Management's manufacturing index for July came in at 50.9 vs. a 55.3 reading for June. This is the slowest rate so far of the recovery.

Thoughts of a double dip recession had fled our minds in 2010, as the stock market surged, consumer spending was ticking up, unemployment numbers dropped into single digits and corporate earnings were back on track. Unfortunately, not even a year later, thoughts of a double dip recession are resurfacing and appear to be more real this time around. The stock market turned negative, consumer spending has slowed, the job market has stalled and corporate earnings, despite being strong for the time being, may begin to face stiff headwinds.

As indicated above, consumer spending has slowed significantly amidst rising oil and gas prices. The commute to work, for those fortunate enough to have a job, is more expensive now. Add in the fact that food prices have been creeping up at a steady pace, and its no wonder that consumer discretionary income is shrinking. This is bad news for an economy that relies on the consumer, which accounts for over 70% of our nation's GDP. Add in the fact that the job market is limping along badly (data released this morning indicated 117,000 jobs were created and although this was above economists' forecasts, the absolute number is inadequate), and the housing market barely has a pulse, and all that is left to give us a glimmer of hope is corporate earnings. However, if consumer spending continues to slow, corporate profits that have been driven more so by bottom-line cost cutting than top-line sales growth, will begin to contract and that glimmer of hope will begin to dim.

All this data currently leads to pessimistic headlines which, in turn, is driving fear into the markets. Driven by this fear and uncertainty about future prospects, many investors are considering selling their investments.

As investors, we tend to have the news and markets drive our emotions and, subsequently, have our emotions drive our investment decisions. Our emotions overtake rational behavior. As such, we are generally making reactive investment decisions rather than proactive investment decisions. For instance, during boom times, investors tend to be overly optimistic and during bust times investors become overly pessimistic. The result is that the financial markets seem to be the only market where buyers (investors) are running away from discounts.

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Therefore, how can we better manage our behavior or manage our participant's behavior? How can we ensure prudent investment decisions?

The first step is to acknowledge that we are making our investment decisions based on emotions. Once this is realized, we need to step back, breathe deep and think about our investment decisions on a rational basis.

For our Defined Benefits Plans:

Investment decisions should be based on the Investment Policy Statement. The policy statement is the stabilizer in these uncertain times that helps us prevent emotional decisions and stay within our guidelines. The policy statement defines target portfolio allocations and allowable ranges around this target portfolio. These portfolios are based on the plan's objectives (return and risk) and constraints (liquidity, legal, time horizon, tax, unique circumstances). Bull and bear market are part of the economic cycle and are all considered in the asset allocation guidelines for the DB plan. Actuarial reports utilize Monte Carlo simulations which include the possibility of significant market downturns. Drastically changing the asset allocation and/or converting a significant portion of the portfolio to cash will change the expected return/risk assumptions of the portfolio and will significantly alter the probability of success for the plan.

This can work for you and it can work against you. The probability of making good market timing decisions are no higher than that of a coin toss and its success can only be evaluated on an ex-post basis. Therefore, the questions that committees should ask themselves are as follows: Are the current issues longer term in nature so that it would make sense to rebalance the portfolio towards the more conservative allocation that is within the allowable ranges of the Investment Policy Statement? Or are these issues shorter term in nature and does rebalancing towards the more aggressive allocation make sense?

Only time will tell as to which strategy would have been more successful, but committees should follow their asset allocation to ensure that the current market volatility does not drive the portfolio outside of the allowable ranges.

For our Defined Contribution Plans:

We are fully expecting higher call volume in the coming days and weeks as the double dip story works its way through the news. Investors that have been hit with two bear markets in just one decade may feel as though they need to abandon riskier asset classes, as they cannot afford to lose principal for the third time.

However, investors who do abandon riskier asset classes during market downturns must eventually make the decision as to when to come back into the market. Exiting the markets right now will only be profitable if you re-enter the market at a lower point. That lower point would likely be characterized by even worse news and an even worse outlook. Our experience shows that individual participants rarely move back into riskier asset classes at an opportune time.
Asset allocation should be based on the investor's return objectives, the ability and willingness to take risk, the individual time horizon, liquidity and spending needs and unique circumstances. These variables will vary widely depending on individual participants' needs. As such, USI Advisors cannot make blanket statements about how to allocate assets, but volatile markets are always a good time to revisit these variables to ensure adequate allocation.

In Summary:

The markets are currently giving us lots of questions. There is no way to tell when the correction will end or if it has already ended. Further, there is no doubt that the economy is on shaky ground but what we don't know is whether and when things will start to turn around.

As indicated above, market timing is a very risky proposition and a long-term view of the markets and investing is what investors should focus on.

The Dow Jones Industrial Average is a price weighted index comprised of 30 actively traded blue chip stocks; primarily industrial companies, but including some service oriented firms.

Gross Domestic Product (GDP) is the market value of the goods and services produced by labor and property in the U.S. It is comprised of consumer and government purchases, net exports of goods and services, and private domestic investments. The Commerce Department releases figures for GDP on a quarterly basis. Inflation adjusted GDP (or real GDP) is used to measure growth of the U.S. economy.

Monte Carlo simulations are a problem solving technique used to approximate the probability of certain outcomes by running multiple trial runs, called simulations, using random variables.