



Back to School



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Flying in the face of warnings about how “September is the worst month for stocks!”; most major stock indexes continued their advances from the second quarter, rising ~4% in September and finishing the third quarter up over 15%. Large Cap U.S. Stocks, as measured by the S&P500 index, are up 19.3% for the year through September 30th.

A chart of the index’s price throughout the year, including the 11% drop in the first quarter, illustrates what a ride it’s been.



Small Cap and International stock indices have performed even better, with the stocks of emerging market countries leading the global equity mar-

kets. The rally has been as relentless as the correction was, with gains in six consecutive months for most stock market averages. Risk, as measured by daily volatility, is thankfully back to normal historical levels after reaching stratospheric, unprecedented levels last fall.

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We warned earlier in the year that the U.S. Treasury market was not attractive, and suggested that there were tremendous opportunities in many parts of the bond market. That has indeed played out, as year to date, the returns of Treasuries have been mostly flat, and in many cases down, while corporate, high yield, municipal and global bond averages have all produced returns over 6%, with the returns of many bond categories exceeding 10% or even 15%.

The bounce in the capital markets is largely a reflection of a consensus that the worst is behind us. That we have avoided economic Armageddon, a financial meltdown, and the Great Depression II, and that we are on the footsteps of a recovery, if it hasn’t started already. Naturally, there is still great debate and uncertainty as to how and when we will exit “The Great Recession”, as it has aptly been labeled. With the little (and not so little) ones returning to classes recently, let’s review these issues in a familiar context:



Core Studies – English and Math.

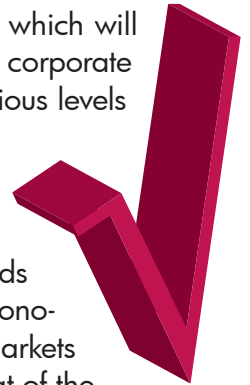
The trajectory of the recovery has been projected by various analysts as taking a wide variety of shapes. An “L” shape would obviously result in no real recovery, but things not getting any worse. A “V” shaped recovery describes a scenario with a sharp and dramatic rebound to recent historical growth rates, while a “W” shaped recovery envisions a brief, modest recovery, followed by another albeit small recession, before we can ultimately enjoy a robust recovery. Finally, a forecast for a recovery in the shape of a “Square root” envisions a quick, robust recovery followed by years of economic malaise. While we think that the recession is likely over by most measures, due in large part to a virtually unavoidable bounce in cyclical activity, we are inclined to think that what has transpired and where we are going cannot be conveniently summed up by a letter or a symbol, so we turn our attention to:

Economics. You’ve no doubt at one point in your life heard someone use the term “New Math.” Well, there’s a similar phrase being used by one of our most respected bond managers (PIMCO) to describe their view of the current and future state of the global economy. They call it the “New Normal.” This new world is one of significant change, leaving behind the hyper consumption, overleveraged global economy led by the U.S. consumer and heading toward a new environment with less leverage, less globalization,

and more regulation – all of which will keep U.S. growth rates and corporate profits from returning to previous levels anytime soon.

It’s hard to argue against the theory that we have gone through a crossroads and that the future of our economy and the global capital markets will be very different from that of the past few decades. After all, as a whole, we who make up the good ole’ USA have for a long time collectively consumed too much, saved too little and taken on too much debt. What can not just lead us out of this Great Recession, but help our economy continue thriving in the future? It’s not going to be debt financed consumption. It’s not going to be domestic housing. No, there are two possibilities. The growing middle class in the rest of the world (which we helped create by buying their stuff and outsourcing our jobs to them) will likely hunger for our quality of life and maybe even adopt some of our consumerism. This can potentially fuel worldwide economic growth, including our exports to them. This may very well help, but there is much uncertainty about whether this growth will be big enough, fast enough and of the kind that will help developed economies like ours. Our best chance to preserve our economic leadership rests with... well, we’ll have to walk down the hall to History class.

History. In world history, economic leadership has rotated across countries and regions for a variety of reasons. While

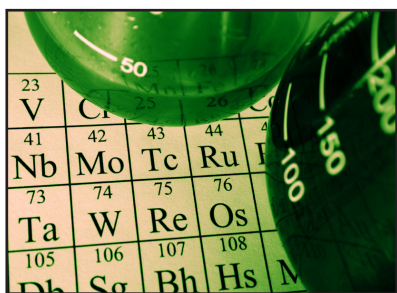


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our country is unequivocally the dominant economic force in the world today, that is changing. Over the next two decades, China's economy is likely to grow to be larger than ours (although on a per capita basis we will remain a wealthier nation.) Massive deficits, entitlement spending, a weakening currency, increased taxes and regulation are unlikely to help us in the long run. But we can do better than simply survive. We can thrive. Maybe the emerging consumers in South America and Asia will buy enough Ipods, Coca Cola and Levi's, but it's unlikely to be enough to preserve our economic status. We need "the Next Big Thing." Whether it was Railroads, Automobiles, Housing, PC's, or the Internet, over time our economy has flourished when dynamic and creative capitalism has led innovation and investment. Alternative and clean energy are the most obvious candidates, but their contribution is neither certain nor imminent, which leads us to the subject of Science.



to change." Clearly, our country must change to continue thriving. But we're also at the point now where investors must consider what change is necessary for them to continue to succeed. In a nutshell, it strikes us as very unlikely that many investing strategies that worked in the "old normal" will work over the next few decades.

"It is not the strongest of the species that survive, nor the most intelligent, but the one most responsive to change."

— Charles Darwin

Science.

Charles Darwin said, "It is not the strongest of the species that survive, nor the most intelligent, but the one most responsive

So, after completing this curriculum do we know what the future holds? Of course not. But practically speaking, all of these crosscurrents and disruptions in the world economic order are likely to have surprisingly clear implications:

- Risk should neither be avoided completely nor embraced vigorously.
- The U.S. Dollar is at serious risk of long-term erosion.
- From current levels, broad U.S. stock and bond averages are likely to produce very unexciting returns over the next 5-7 years – perhaps 6-10% for stocks and only 2%-4% for most bonds. Cash yields, of course, are near zero today.
- Commodity prices are at serious risk of long-term inflation.
- Investing strategies should be global, balanced, active and opportunistic.
- Portfolios, and their performance, should thus be very different from well known U.S. benchmarks. This will work both ways (+/-) over any given time period. Patience will be required during the inevitable periods of underperformance.

Looking back at recent returns across most markets, we are quite pleased with the results this year. I should remind you however, not to get too excited, just as it was important not to get too fearful or despondent last winter. While broadly speaking, return opportunities are somewhat muted and risk somewhat elevated over the intermediate horizon, we remain cautiously optimistic. As these scenarios unfold, we will continue to work hard and "hit the books" on our client's behalf to identify the investment solutions with the best chance of success in this ever changing world. ■

