



## A Year and Decade in Review

2009 was one of the most volatile years in recent stock market history. The stock market these past few years was like a ship caught in a storm and about to capsize. Those passengers who resisted the temptation to jump off found themselves still on board after the ship righted itself. On the other hand, those passengers who panicked and jumped off are now out at sea, swimming after the ship and trying to get back aboard.

The year ended nicely for U.S. and international securities. Following a difficult 2008 and a weak start to 2009, markets began to rally in March amid optimism that the worst of the financial and economic crises had passed. The government stepped up already strong stimulus efforts, major banks stabilized and economic indicators pointed to recovery. Markets remained on an upward path through the rest of the year; gross domestic product turned positive and companies reported better-than-expected earnings, although cost-cutting largely drove results and unemployment rose.

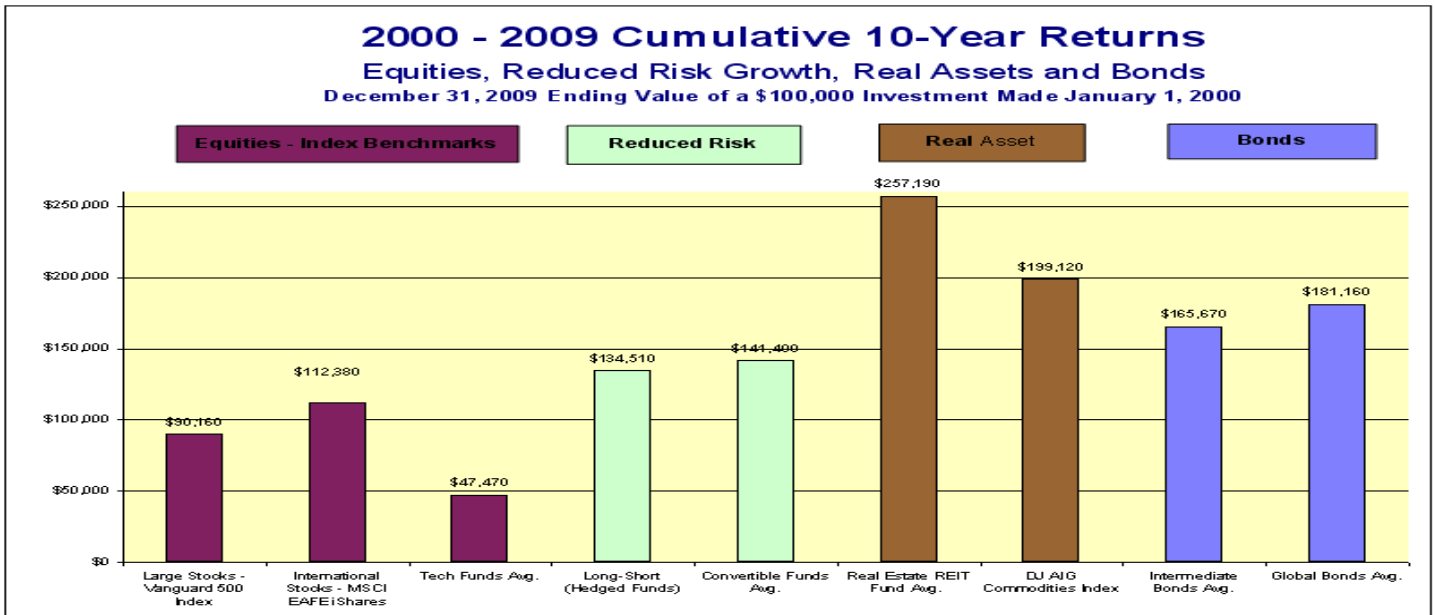
Looking further back, the decade and indeed millennium launched with great hopes abounding for the “new economy” and the seemingly unlimited potential provided by technology and the Internet revolution. And now, according to Pimco’s “new normal” paradigm, we are to expect lower, slower growth, higher taxes, costly regulation and higher unemployment. Still, the decade turned out quite well for some (including *HAS* clients). Our clients held a variety of investments that performed well including bonds, convertible bonds, numerous reduced risk growth investments (Gateway, Merger, Pimco All Asset), publicly traded real estate or REIT stocks, international and small company stocks. On the other hand, the average technology fund investor who started the decade with \$100,000 would have only \$47,470 fully ten years later, a loss of more than 50%. And, due to the cruel math of market declines, the investor who loses 50% must then gain 100% to break even again.

Clearly, investments that worked fabulously during the late 90s fell off the cliff during the next decade. Among even the mighty S&P 500 U.S. Large Company stocks, an initial investment of \$100,000 made on 1/1/2000 had declined to just over \$90,000 a full decade later. However, some other investments

## EXECUTIVE SUMMARY

- The stock market over the past two years was like a ship caught in a storm about to capsize, and then finally managed to right itself.
- Emotions caused many investors to make poorly timed investment decisions.
- Our disciplined investment process helps our clients avoid these mistakes.
- Many traditionally non-correlated asset classes fell alongside equities in 2008 and in early 2009. Most types of investments suffered.
- Our portfolios contain hedged, lower volatility and fixed income investments that held up well.
- There are times when more stable investments outperform their more risky counterparts. This was clearly the case during the past ten years.
- By strategically rebalancing client portfolios we are able to buy at lower prices and sell at higher ones.
- Valuation measures indicate that equity markets are not cheap, especially if the subpar growth we expect becomes reality.
- We are not concerned with inflation in the near term, but we are about the long-term.
- We think the long-term trend for the value of the dollar is continuing weakness relative to faster growing economies.
- We consider both inflation risk and dollar weakness in the design of our portfolios.
- Our ongoing research scrutinizes new investment opportunities to improve our investment strategies.
- Our primary objective is to help clients achieve their lifetime goals.

performed much better as the Cumulative 10-Year Return graph illustrates. Over longer periods of time, diversification is absolutely essential to investment success. Gains in one area often offset losses in other areas and make for a much smoother, more comfortable journey along the way. Multi-asset class



diversification paid off handsomely, providing superior risk-adjusted returns.

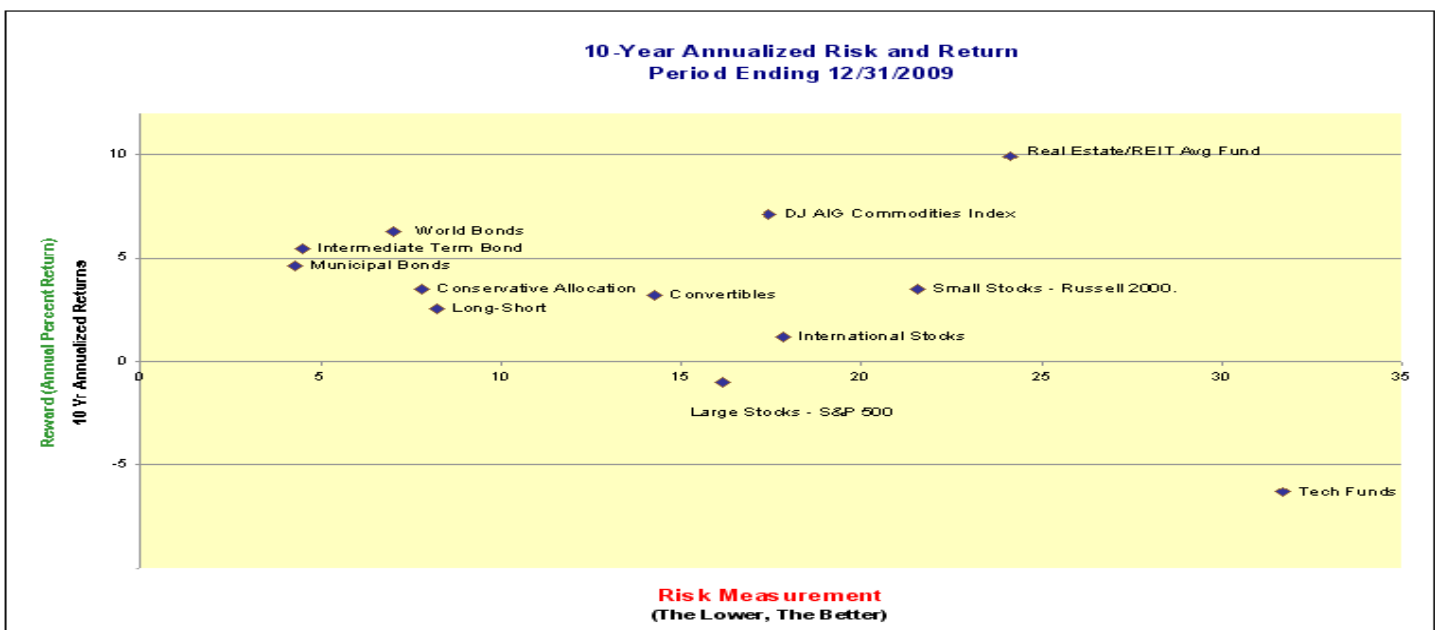
A vital ongoing component in our portfolio design process is assessing trade-offs between risk and reward. *HAS* portfolios include a variety of investments that span the entire risk-reward spectrum. During bear markets, lower risk investments provide a welcome cushion and peace-of-mind to persevere through stormy waters.

There have been lengthy periods when more stable investments outperform their more risky counterparts. This was the case during the past ten years (see the 10-Year Annualized Risk and Return Chart). The chart clearly shows that the lower risk

investments (on the left side) performed quite well and with a fraction of the risk compared to the investments on the right half of the chart. Both small stocks and the average conservative allocation fund returned 3.5%, however small stocks had almost three times the risk.

### How Did We Execute in 2008 & 2009?

In answering this question one must always keep in mind that hindsight is 20/20. It is easy to look back and see what you should have or could have done, once you know how things turned out. However, not even the foremost experts in the Treasury Department, Federal Reserve, the leading economists,



popular news talking heads, or vaunted Wall Street investment banks could predict the severity and depths of the crisis to come as it unfolded. For an insider's view, one can read Andrew Ross Sorkin's book, *Too Big To Fail*, which documents in fascinating detail insiders dialogue and accounts of what really happened on Wall Street and in Washington during the crisis. Sorkin notes, "in the span of just a few months, the shape of Wall Street and the global financial system changed almost beyond recognition. Each of the former Big Five investment banks failed, was sold, or was converted into a bank holding company." We were on the brink of the abyss; we were that close to falling into another Great Depression. Time magazine named Fed Chairman Bernanke *Person of the Year* stating "how the mild-mannered man who runs the Federal Reserve prevented an economic catastrophe." Likewise, Sorkin makes a compelling case that both Bernanke and Paulson deserve ample credit for saving us from disaster. Sorkin includes some graphic accounts of the normally unflappable Treasury Secretary Paulson exhausted and distraught enough to vomit on a couple occasions. The book is long but provides fascinating insight into Wall Street's vanity, hubris and insatiable, addictive appetites for money and power.

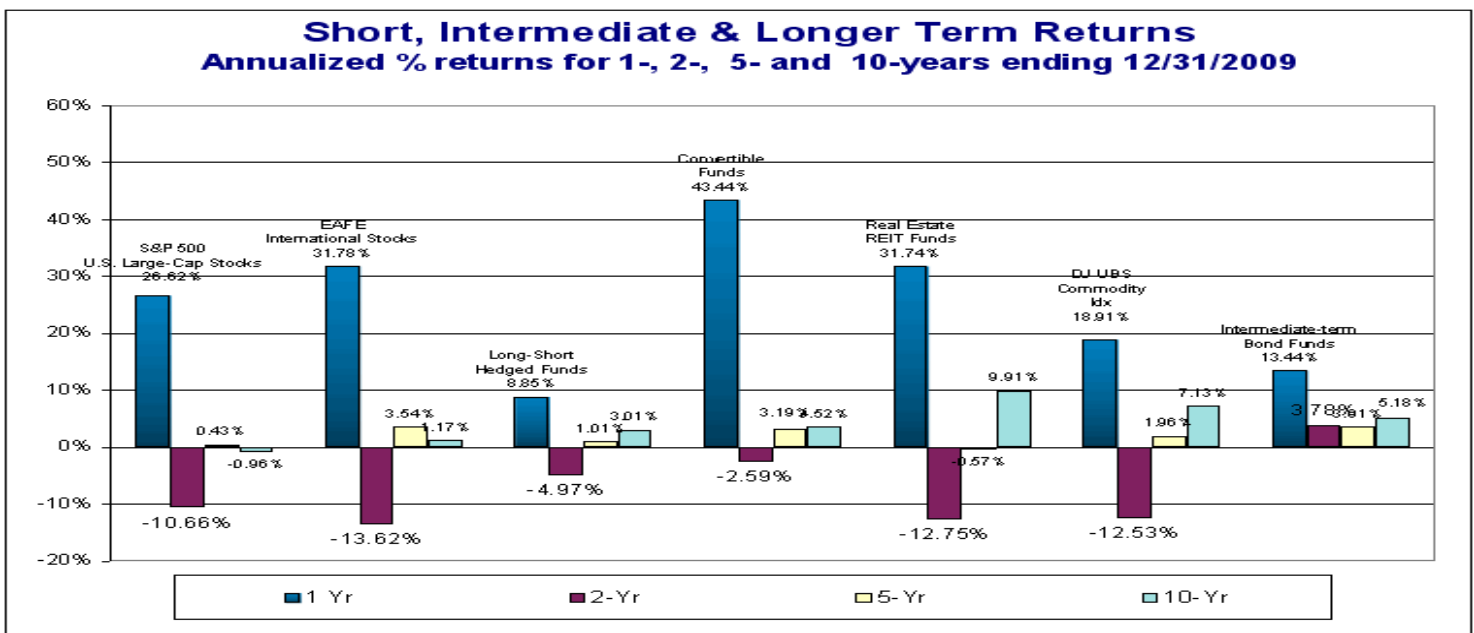
How did large institutional investors react during the crisis? For an insiders view, last fall I met with Paul Quinsee, a Managing Director and Chief Investment Officer at JP Morgan. He shared an interesting story from a February 2009 conference when the stock market was hitting 12 year lows. The conference participants were large institutional investors, including many massive multi-billion dollar pension funds. With stocks down over 50%, the big

question was whether to rebalance and add to stock holdings. He said that only one quarter of institutions stuck to their written mandates and added to equities. Most of the remaining three quarters made deliberate policy exceptions and did not add to equities. Thus, in the depths of the crisis, even the large institutional pension investors (upon whom millions of retirees rely) were spooked and did not follow mandates to rebalance and make incremental purchases.

Buy high, sell low behavior is well-documented by mutual fund flows which measure investors timing decisions (see the Mutual Fund Flows Exhibit on Page 8). During 2009 domestic equity funds experienced \$30 billion in net withdrawals thru November. Consider that mutual funds (and especially tech stocks) received record inflows of \$260 billion in 2000 while the market peaked. Humans are naturally conditioned to run with the herd, hating the loneliness of buying low and instead opting to 'buy high' with the crowd.

During lonely 2009 we added value at *HAS* by making incremental purchases in international investments including Matthews Asian Growth & Income, Aim Energy, convertible bonds, and Cohen and Steers Closed-end Opportunity Fund which posted substantial gains.

Keeping all of this in mind and being the perfectionists that we are, we give ourselves a grade of B to B+ for how we executed our investment strategy in 2008 and 2009. It was, after all, the worst financial crises since the Great Depression.



Considering the more relevant long term, only a handful of investments did well during the past decade. At *HLAS*, we are very pleased to not only have owned most of these successful investments, but to have sold positions and taken profits when they became overvalued. We are especially gratified that our retired clients, who rely on their portfolios to make ends meet, have successfully navigated this stormy decade. To better serve retirees, we developed specific strategies so that they may be much more assured of generating sufficient “Portfolio Paychecks” to meet their lifetime spending goals.

## Current Outlook

In our valuation research, we analyze a variety of quantitative information, publications, review institutional sources, and consult with colleagues. One of our resources, Jeremy Grantham, has proven accurate over many extended time periods. In his October 2009 quarterly letter he estimates the fair value on the S&P 500 Index at 860; this is lower than the 950 to 975 estimate that he made during the crisis. He explains that fair value has declined steadily since the crisis began due to the destruction in the financial sector. With the S&P currently trading at approximately 1,140 Grantham makes a case that the market is about 20% overvalued.

An objective quantitative measurement is offered by the 10-Year Normalized Price/Earnings (P/E) Ratios for the S&P 500 Index (see the graph below). This ratio has surged to 20.79 in January after being as low as 12 in March of last year. As we discussed in some detail in our July 2009 newsletter, higher PE

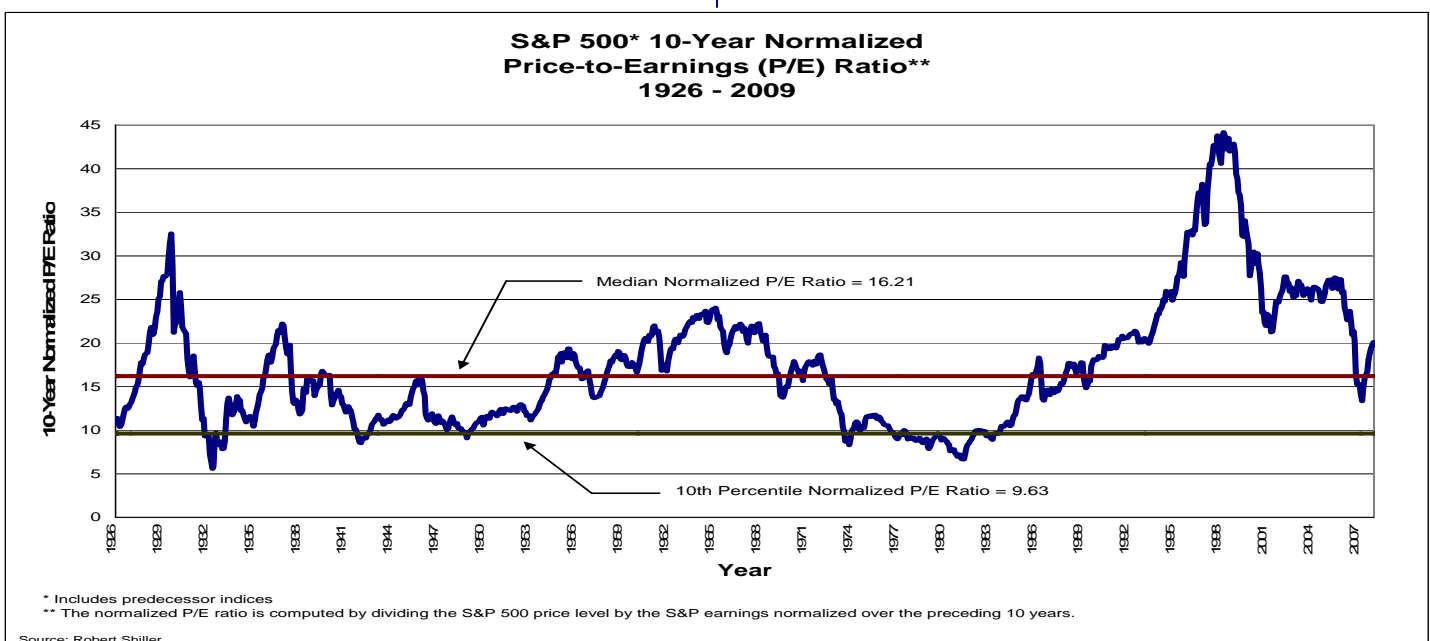
ratios normally lead to lower future stock returns and vice versa. Performance based on PE valuations fluctuates widely and wildly over the short-term. However, long-term data is much more predictable, consistent and compelling; it's best to overweight stocks when PEs are low and underweight when they are high. Likewise, trimming equities when price-to-earnings ratios are higher and adding to equities when they are lower has increased returns and helped investors avoid emotional decisions to sell low and buy high.

Although we would not be surprised to see the market climb higher as the economy slowly recovers, we consider significant increases in stock prices as another opportunity to take profits, investing proceeds in moderate and lower risk investments.

With bond yields at very low levels and stock market P/E ratios once again at the top quartile, we anticipate less total return potential for the near term.

## Emotions and Investing

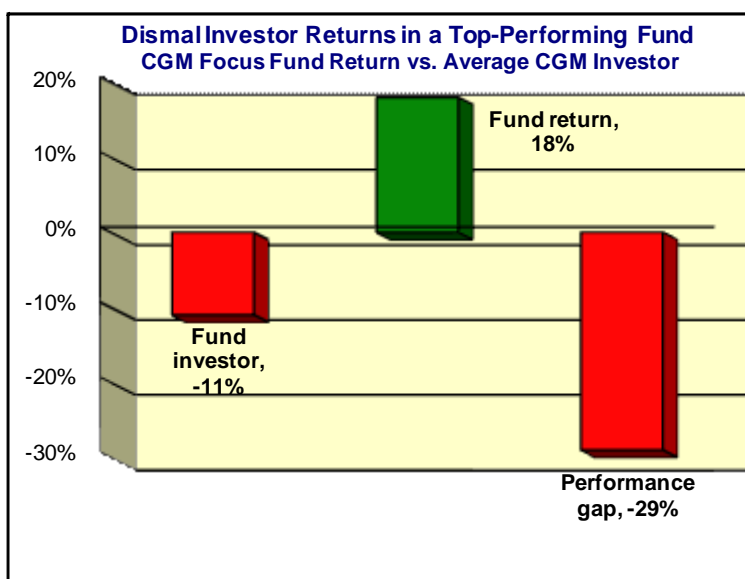
In our July 2006 newsletter segment, “Investments and Psychology: The Emotional Factors,” we noted this research article quote, “Most investors and investment advisors agree that the hardest work in successful investing is not intellectual, it's emotional. It's important to remain level-headed during turbulent, uncertain times and stick to one's long-term plan when outside influences and emotions are suggesting otherwise. Actions stemming from emotional reactions are perhaps the greatest risk that most investors face.”



In the same newsletter, under the heading “Brain-Damaged Investors,” we went on to remark the following: “researchers at Carnegie Mellon, Stanford, and the University of Iowa tested a number of people with an investment game. They found that the people who did best had brain damage to the emotional areas of their brains as a result of strokes or diseases. Unlike people with undamaged brains, the people with the damaged brains were not hampered by emotions when it came to making rational investment decisions.”

The fact that average investors are adversely affected by poorly timed emotional investment decisions is well-documented. Simply look at fund flows into and out of mutual funds during bull and bear markets to confirm this “buy high, sell low” behavior. (see appendix exhibit “Mutual Fund Flows”). At the peak of the Internet and tech bubble, funds investing in tech stocks received their largest inflows during the first quarter of 2000, just before the bubble burst (e.g., Janus Funds). The average technology stock fund plummeted 82.7% from 3/1/2000 to 9/30/2002 (Morningstar) which would require a subsequent 578% return to recoup losses! Sadly, “buy high and sell low” behavior has been well-documented in quantitative, behavioral studies including those by JP Morgan and Dalbar. Dalbar studies over multiyear periods illustrate that the average equity fund investor only captures a fraction of investment returns.

Recent activity in the CGM Focus fund illustrates this pattern. The fund surged 80% in 2007 and investors poured \$2.6 billion into it the following year – only to see the fund sink 48% in 2008. Investors then pulled out more than \$750 million from the fund



in the first eleven months of 2009. They bought in after the fund had risen, then did not have the patience to ride out a rough period. The fund ended 2009 up over 10%. Mr. Heebner, the fund’s manager since its 1997 launch said, “A huge amount of money came in right when the performance of the fund was at a peak. I don’t know what to say about that. We don’t have any control over what investors do.”

An antidote to being harmed by emotional investment decisions is to establish and stick to a disciplined investment process; and working with a firm like ours can serve as a firewall to help prevent poor timing decisions.

## Is Inflation a Risk for the Near Future?

Our outlook for inflation has not changed much since we wrote about it in our July 2009 newsletter. At that time we stated that there has been growing press coverage recently regarding the risk of rising inflation. Most coverage paints a negative or even dire inflation portrait, with many pundits focused on the near-term inflationary implications of government spending and the resulting deficit surge.

However, other objective analysis and research builds a strong case that resurgent inflation is likely further off, perhaps two to four years, due to a variety of factors that alleviate inflationary pressures. These factors include the weak economy, high unemployment and underemployment, shorter work weeks with reduced wages, unused industrial capacity and a surging savings rate that also reduces consumption. With greatly reduced demand for many goods and services, most businesses are unable to pass on increased prices, thereby containing inflation.

While inflation may stay in check in the short-term we do feel it is a serious intermediate to long-term risk, and we absolutely consider this risk in our portfolio design. Client investments that we expect to do better longer-term in inflationary environments are U.S. and foreign stocks, real estate stocks, commodities, natural resource stocks, short- to intermediate-term domestic and foreign bonds and of course TIPS (Treasury Inflation-Protected Securities).

## The Dollar

For some time we have been concerned about the decline of the dollar. We feel the downward trend is likely to continue over the long-term although it may not be as abrupt as many in the media predict. As a result of this belief, we include in client portfolios

large multinational equities, foreign stocks, global natural resources, commodity-related investments and international bonds. These investments have often performed well when the dollar has exhibited weakness or price shocks.

The dollar has declined in six out of the last 10 years; and in each of those years, international developed-country stocks outperformed U.S. stocks. The magnitude of the out performance by international stocks can be attributed to high foreign currency returns versus the U.S. dollar. Once again, it pays to diversify.

Some other major currencies face challenges as well, including the Euro, British Pound and Japanese Yen due in large part to massive structural deficits. We'll see dire financial headlines about the PIGS (Portugal, Italy, Greece and Spain) this coming year. On a positive note, the dollar continues to benefit from it's status as the world's reserve currency. Longer term, the faster-growing developing markets look attractive along with select developed countries like Australia.

## **OUR DISCIPLINED INVESTMENT PROCESS**

In this segment we deliberately over-simplify the description of our disciplined investment process. This newsletter is a bit long and we want this section to be short and concise. Our intention is to offer a basic understanding of how we design, research, implement and monitor our investment strategies.

### **I. Know Our Clients/Establish a Client Profile**

Before we can select an investment strategy for a client, we need to first know their financial goals and objectives as well as their risk-profile. We have partnered with FinaMetrica to provide objective, measurable risk profiling to better assess each client's risk-reward comfort level (contact us any time to revisit or update your risk-profile). Once we know a client's objectives, we select a portfolio intended to provide the proper balance of current income, principal protection and future growth.

### **II. Design Client Portfolios Using Multiple Asset Classes**

By combining investments from four different broad investment classes we strive to create portfolios that have reduced risk in down markets yet still have

growth potential in up markets – all in an effort to meet client objectives while taking less risk.

The four broad asset classes we use are:

1. Equities
2. Hybrid and Risk Adjusted
3. Real Assets
4. Fixed Income

Each of these classes can be further divided into categories. For example, Equities are made up of U.S. Large Stocks, International Large Stocks, and other size and style categories.

We research and screen investments in each of the various asset categories. By strategically combining selected investments into a cohesive portfolio, we aim to achieve superior long-term returns on a risk adjusted basis.

### **III. Establish and Review Target Allocations**

Based on our research, each asset class and investment category is assigned a target allocation as a percentage of the portfolio. As market and asset valuations shift, we consider whether target allocations should be modified. When valuation metrics are low (attractive) we may move to overweight the asset category; and when valuation metrics are high (unattractive) we may move to underweight it. We realize that this is actually very difficult to do effectively in the short term and take a judicious approach when deciding on adjustments.

### **IV. Strategically Rebalance and Monitor Portfolios**

Rebalancing is a discipline that forces us to do the opposite of what most emotional investors do. It forces us to buy assets that have fallen and sell assets that have risen or at least fallen less. Making incremental investments over time is another part of our process. On the surface, it may appear easy to follow through with these strategies, but in reality it is extremely difficult to execute in times of high emotion and stress. It requires courage, knowledge, discipline and experience to carry out effectively.

## Summary Observations & Conclusions

The financial crisis of 2008 and 2009 was severe, intense and emotional. Government intervention including massive fiscal and monetary stimulus both at home and abroad has done much to stabilize and restore faith in our global financial system. However, it will take time for the economy to fully recover. We still have major challenges of stubbornly high unemployment, two more years of elevated mortgage defaults and foreclosures, and massive government deficits both in the U.S. and other developed nations, including Japan and much of western Europe.

At some future point we will likely face a battle with higher inflation, and the dollar may continue to weaken. We continue to take both of these possibilities into account in our portfolio strategies.

By sticking to our disciplined investment process, we were able to mitigate much of the damage of the recent financial crisis. We continue to work hard to further improve and enhance our investment strategies. Recently, our research identified the Goldman Sachs Absolute Return fund as a new attractive risk-adjusted return fund while earlier in the year we added Matthews Asian Growth and Income which has delivered excellent risk-adjusted returns. Furthermore, we continue to refine and diversify our income-producing investments, recently adding British Petroleum that provides energy-exposure and sports a current dividend yield over 5%.

We are mindful that for most clients, the objective is to meet their lifetime financial goals and simply put, to not run out of money. To this end, we have developed a Lifetime Income and Portfolio Planning Process so that our retired clients may be much more assured of the success they desire.

Looking ahead, in 2010 we will send clients a personal investment strategy summary (or personal portfolio blueprint). This will help update and confirm our understanding of client investment objectives. In addition clients will receive an important independent survey in the next few weeks. Based upon client feedback and input, we will make appropriate adjustments to our services.

We encourage you to call should you have a question or if you would like to discuss your situation in light of any statements made in this newsletter. As always, please keep us up-to-date with any changes that have occurred in your personal or financial life. All this helps us serve you better.

Thank you for the trust and confidence you have placed in us. And once again, we thank those of you who continue to refer new clients to us.

On behalf of our team, we wish you all the best in 2010.

*Past performance is no guarantee of future results. All content in this newsletter is intended as general information, not specific advice. Performance data listed is for illustrative purposes only. Portfolios are personalized and often consider many variables, including investment objectives, age, time horizon, risk tolerance, client requests and tax variables. Information contained herein has been obtained from sources believed reliable, but not guaranteed.*

## Hillegas Advisory Services

**PO Box 5010, PMB #221  
Rancho Santa Fe, CA 92067-5010**

**Phone**  
858.756.6111 or 858.756.2125

**Facsimile**  
858.759.4316

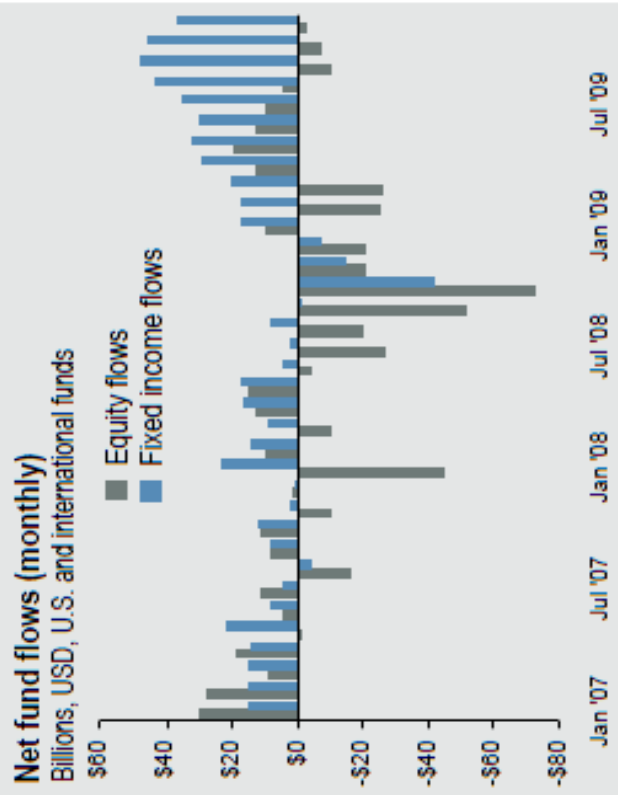
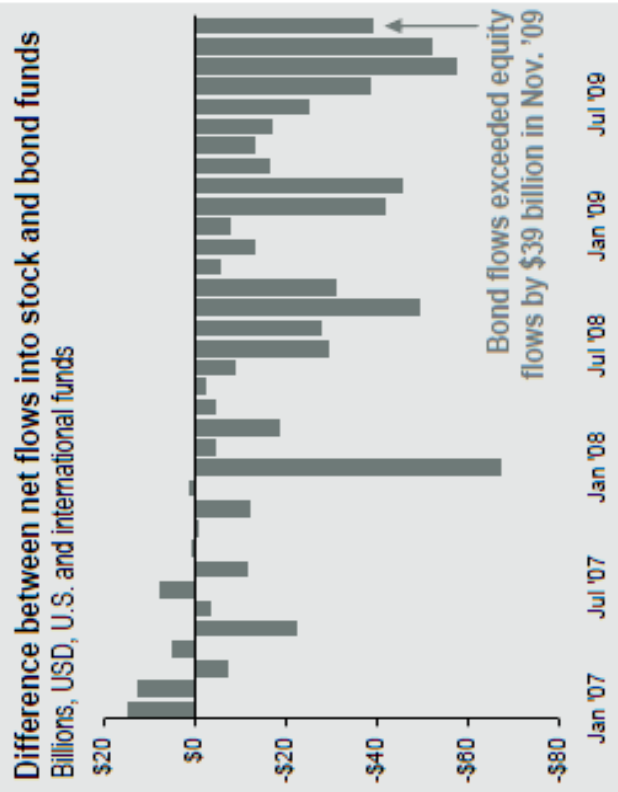
**E-Mail**  
Hillegas@HASwealth.com or Craig@HASwealth.com

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Mutual Fund Flows

Equities

Billions, USD	AUM	Fund Flows											
		2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Domestic Equity	3,580	(30)	(151)	(48)	11	31	111	130	(25)	54	260	176	
International Equity	1,245	26	(82)	139	148	105	67	23	(3)	(22)	50	11	
Taxable Bond	1,736	285	19	98	45	26	3	39	124	76	(36)	8	
Tax-exempt Bond	450	64	8	11	15	5	(14)	(7)	16	12	(14)	(12)	
Hybrid	629	20	(19)	23	7	25	43	32	8	10	(31)	(14)	
Money Market	3,318	(535)	637	654	245	64	(157)	(258)	(46)	375	159	194	



Source: Investment Company Institute, J.P. Morgan Asset Management.

Data include flows through November 2009 and exclude ETFs. International equity flows are inclusive of emerging market, global equity, and regional equity flows. Hybrid flows include asset allocation, balanced fund, flexible portfolio and mixed income flows.