March 2012

INVESTMENT UPDATE

INSIDE THIS ISSUE:

The brokerage industry's main regulator warns investors against chasing yield. 2

Bonds have trounced stocks for years, but a shift is coming. 3

Americans don't see economic improvement, older workers are struggling, and more. 3

Overly cautious investors may be missing a big opportunity. 4

Points of interest:

- Interest rates do not keep up with inflation over time, especially after taxes are levied on the interest.
- Gold is a non-productive asset whose price is determined by the whims of the market.
- Stocks of companies are safer investments because they increase in value faster than inflation.

USE STOCKS, NOT BONDS OR GOLD, TO PRESERVE PURCHASING POWER

Legendary investor Warren Buffett is a lot like Karl Marx: as did Marx, Buffett delights in standing orthodoxy on its head.

Marx did this with the philosophy of Hegel, and now Buffett has attacked the orthodox definition of investment "safety" as low fluctuation of principal.

As usual, Buffett nails the problem quite succinctly: rather than measuring risk by how much a potential investment might fluctuate in value, investors should concentrate on whether an investment has a "reasoned probability" that it will not cause a loss of purchasing power over time.

Buffett says stocks are the best way to preserve and increase purchasing power over time, while fixed income investments are not. "A non-fluctuating asset can be laden with risk," he writes.

Warren Buffett says low-interest-rate bonds and non-productive gold will not keep up with inflation, while stocks of productive companies will.

Value destroyers

In an article in Fortune magazine adapted from Buffett's upcoming shareholder letter, he laid out the argument against bonds and for stocks.

Investments denominated in currency—bank deposits, bonds, money market funds—are usually thought to be safe. "In truth they are among the most dangerous of assets," Buffett writes. "Over the past century these instruments have destroyed the purchasing power of investors in many countries, even as these holders continued to receive timely payments of interest and principal."

How does this happen? It is the twin effects of inflation (in essence, government devaluation of its currency, he says) and income taxes on interest.

Buffett notes that it takes $7 today to buy the same goods and services that could be purchased for $1 in 1965.

Currency-based investments pay interest rates that do not keep up with inflation, once taxes are taken out of the interest. Thus purchasing power falls.

Occasionally interest rates will be high enough to compensate for inflation, as they were in the early 1980s. But today's rates are very low and "bonds should come with a warning label," Buffett says.

Forget about gold

He also dismisses gold as a store of value. "Gold, however, has two significant shortcomings, being neither of much use nor procreative," Buffett writes.

Gold prices go up due to fear and enthusiasm. "As 'bandwagon' investors join any party, they create their own truth—*for a while*," he

(Continued on page 2)

Companies that increase their output will prove the safest

(Continued from page 1)

writes.

Eventually gold prices will form a bubble, and they will pop just as home prices did in 2008 and internet stocks did in 2000, he said

Compound growth

Those who want their capital to grow should invest in productive assets like businesses, farms, or real estate. "Ideally, these assets should have the ability in inflationary times to deliver output that will retain its purchasing power value while requiring a minimum of new capital equipment," Buffett says.

Consumer products companies, he says, will do just that, while others, such as regulated electric and gas utilities, won't because they have heavy capital requirements.

Productive businesses, however, are like cash cows, delivering greater quantities of "milk" over the years. "Proceeds from the sale of the milk will compound" just as the Dow Jones Industrial Average went from 66 to 11,497 during the 20th century, he adds. He says stocks will be the runaway winners in the future, and "*by far* the safest."

Productive companies increase profits.

Chasing yields can get you in trouble

The brokerage industry's top regulator is worried that consumers looking to increase their investment yields are being sold risky and complicated products that could backfire on them.

The continuing near-zero interest rate environment is creating an opening for unscrupulous salespeople, says FINRA, the self-regulatory authority for the brokerage industry.

"The challenging economic environment can lead individual retail investors to be susceptible to recommendations to chase yields without necessarily understanding the risk-versus-reward tradeoffs, particularly as more esoteric or complex products find their way into retail portfolios," FINRA said.

Hints for buyers

FINRA's concerns were included in a letter to its members that warned them of its priorities for investigations in 2012. The letter also offers clues to consumers about sales practices and products to avoid.

First, FINRA warns against chasing high yields. "We are concerned that investors may be inadvertently taking risks that they do not understand or that are inadequately disclosed as they chase yields," it said.

It also warns that investors should be wary of liquidity issues: some high yield investments may lack a trading market, making it hard to cash out.

Consumers who have been stung by low interest rates on bank deposits and U.S. bonds may be at risk when using exotic high yield investments.

Potential investors should also be cautious about future cash flows of products they are considering: for instance, will they be getting repaid from their own principal or from capital raised from later investors?

Mortgage-backed securities also worry FINRA, it said. Because mortgage borrowers are allowed to pre-pay on their loans, investors may have "significant reinvestment risk," meaning they will not be able to reinvest their earnings at the same yield as their original investments.

Complex exchange-traded funds, also known as ETFs, may expose investors to the risks that they won't track the index to which the ETF is tied.

Finally, FINRA warned against variable annuities, which "have certain risk characteristics that make them unsuitable for some investors." it said. "These products often have long holding periods and significant surrender fees, making them unsuitable for investors who have a need for liquidity."

"We are concerned that investors may be inadvertently taking risks that they do not understand."

Stocks will likely beat bonds over the next twenty years

Twelve years of low stock returns, high volatility, and bear markets have driven a lot of stock investors into the relative safety of bonds.

They have profited from that move, as bond interest rates dropped sharply since 2000, pushing up bond prices so that they outperformed stocks.

Investment experts warn that this trend may not go on much longer. They say that over the next 10 to 20 years it is more likely that stocks will be the winning asset class. At best, bonds might offer a return of zero after inflation. At worst, they will be losers.

No room to move

Yes, the stock market continues to look risky, they say, but the bond market's prospects look downright dismal.

"The bond outlook is extraordinarily bad," said Jeremy Siegel, finance professor at the Wharton School and author of *Stocks for the Long Run.*

Siegel and others say that bonds are overvalued in a similar fashion to the way stocks were overvalued in 1999, before the first of two major bear markets pummeled stock prices.

About the only way bond prices can continue to rise would be during a panic even worse than in 2008, when government bonds were snapped up by professional and amateur investors alike.

With bond interest rates near zero, stocks offer better prospects going forward.

It is more likely that interest rates eventually will begin rising again as the economy recovers. When that happens, bond prices will fall.

"We are in the very mature stages of the secular bull market in bonds," David Rosenberg, chief economist at Gluskin Sheff + Associates told Marketwatch.com, a financial website operated by the publisher of *The Wall Street Journal.*

Roger Ibbotson of Yale University says stocks don't have to jump a big hurdle to beat bond returns.

A risk premium

Historically, stocks have returned about four percentage points over U.S. Treasury yields. A 10-year Treasury today yields about 2 percent, which suggests stock returns at 6 percent going forward. "Long term, it's a fine time to buy stocks," he says.

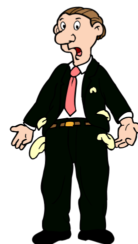
John Bogle, founder of the Vanguard Group of mutual funds, believes stocks will offer average returns of 7 percent per year.

"It is more likely that interest rates eventually will begin rising again as the economy recovers."

Feeling poorer, older workers, & more

The average American doesn't see the recovery that recent economic reports indicate is here, found a nationwide survey by the website Bankrate.com

In a poll conducted late last year, only 17 percent of respondents said their financial situations were improving. A third said their finances had declined over the previous 12 months.



What's more, one-half said they felt less comfortable about their savings than they did a year earlier. One in five had tapped their retirement accounts for emergencies, the survey found.

Income insecurity

Older workers who lose their jobs are less likely to find new jobs, says the Government Accountability Office.

It also said that unemployment rates for workers over age 55 have doubled since 2007. The median time of unemployment for workers between ages 55 and 64 was 31 weeks in 2010, up from 11 weeks in 2007. The GAO said more older workers decided to take Social Security early at age 62 during the 2008 recession.

Plastic abuse

Households with credit card debt have average balances of $14,687, says the website Creditcards.com

It also says the average interest rate on cards with balances was 13.1 percent last year.

Americans collectively hold some $793.1 billion in revolving debt, with 98 percent of that debt on credit cards, it adds.

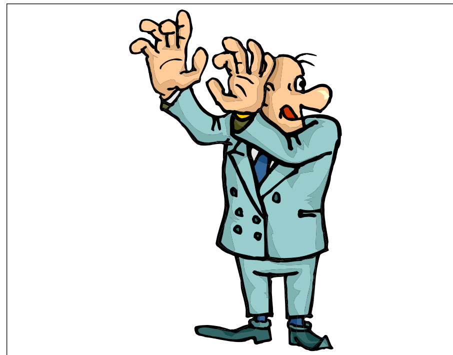
Investment Update is published monthly by OBS Financial Services, Inc. © 2012 All rights reserved. Information has been obtained from sources believed to be reliable, but its accuracy and completeness, and the opinions based thereon, are not guaranteed and no responsibility is assumed for errors and omissions. Nothing in this publication should be deemed as individual investment advice. Consult your personal financial adviser and investment prospectus before making an investment decision. Any performance data published herein are not predictive of future performance. Investors should always be aware that past performance has not been shown to predict the future. If in doubt about the tax or legal consequences of an investment decision it is best to consult a qualified expert. OBS Financial Services, Inc. is a Registered Investment Advisor.

Investors are making the mistake of being too cautious

Individual investors are making a typical mistake today: they are overreacting to the negative sentiment that has built up over the last 10 years and "taking too cautious a position with regard to investments," says finance professor and author Jeremy Siegel.

"This is something that has occurred throughout history, where stocks don't do well and people are down on stocks," said Siegel, who teaches at The Wharton School and who wrote *Stocks for the Long Run.* "Then when stocks *do* perform well, they get up—in fact too far up—on stocks."

Some investors are reacting very badly by avoiding stocks and locking in "yields on bonds that, to me, are extremely poor compared to any historical calculation of stock returns," Siegel told the *Journal of Indexes,* a publication for professional investors.



Nervous investors are looking over their shoulders at the volatile stock market of recent years.

He also noted that the poor performance of U.S. stocks over the last decade was partly due to the bust in technology stocks at the beginning of the decade.

Although some professionals talk about a "lost decade" due to minimal returns on the Standard & Poor's 500 Stocks Index, Siegel says a more diversified investor who held value and small stocks had much better performance over the period.

Investors today may also be reacting to the sharp stock market volatility that occurred in 2008 and again last summer when debt rating agencies downgraded U.S. bond ratings.

Yet investors should be happy about the volatility—during quick down markets long-term investors can pick up bargains.

"I would advocate that investors use these opportunities to accumulate equities and actually thank program traders for giving them bargains in the market," he said.

Siegel predicted that investors who diversify internationally will be very pleased "with their returns over the next five to 10 years."