

## **Recent Thoughts**

### **July 2009**

The three months ending June 30<sup>th</sup> marked the first time since the third quarter of 2007 that the S&P 500 registered a positive quarterly return. The stock market rally that started in early March continued through the second quarter, pushing the index into positive territory for the year. The move higher was led by economically sensitive sectors such as Financials, Technology and Industrials while defensive sectors, including Consumer Staples and Health Care, lagged the overall market. The tremendous amount of risk aversion that developed in the market over the last year was pushed aside as investors looked ahead to better economic times and propelled the market higher. A slower rate of contraction in many economic indicators, rather than tangible signs of renewed growth, has been the catalyst for the recent advance.

The headline unemployment rate currently stands at 9.5% and is expected to peak in the double digits sometime next year. An alternative measure of unemployment, which includes those who want a job but have given up looking and those forced to work part-time for economic reasons, reached 16.5% in June. In addition, the duration of unemployment has reached unprecedented levels. The raw numbers are staggering as over 7 million jobs have been lost since the recession began in December 2007. It should be noted that unemployment statistics are generally viewed as a lagging economic indicator, meaning that it will continue to deteriorate even after an economic recovery has taken hold, and thus has little predictive power. However, when one considers that the current downturn was fueled by bad debts and that the ability to service debt is directly tied to employment, it becomes apparent that dismissing employment statistics as insignificant would be a mistake.

Anxiety over job security has produced significant changes in individual behavior. For example, the personal savings rate, as reported by the Bureau of Economic Analysis, reached 7% in May. The recent uptrend reverses a 25 year period of declining savings that saw a negative savings rate earlier this decade. The higher savings rate will temporarily hinder economic growth by reducing consumption, but should build a more solid foundation for future growth.

Ten banks repaid the government funds they received last fall as part of the Troubled Asset Relief Program (TARP). The participants were eager to return the money in order to demonstrate their financial strength as well as rid themselves of the extra government oversight they have endured. The imminent danger of a financial system collapse, or at least perception thereof, seems to have been removed from the table. It remains to be seen, however, how financial institutions will progress as additional Federal assistance programs expire, or are exhausted, and the mortgage refinance boom that was fueled by ultra-low interest rates subsides.

Financial regulation and health care reform are atop the agenda in Washington. Following the recent crisis in financial markets, public sentiment is conducive to some sort of regulatory

overhaul in the financial sector. Increased transparency, sensible limits on risk taking, as well as some of the other stated objectives could be beneficial if done in a reasonable manner. The fear, however, is that any new regulations could be overly burdensome and costly to the financial industry. Questions over how to pay for health care reform combined with a ballooning budget deficit have slowed the effort to expedite legislation through Congress. Reimbursement concessions, a surtax on high-income earners, levies on employers not providing health insurance and taxes on employer-provided health insurance are a few of the options that have been put forward to finance the plan. Bitter partisan battles will likely be waged on both fronts before any final legislation emerges.

A lot of ink and pixels have been spilled writing the obituary for long-term, buy-and-hold investing. Market timing, rapid trading and other exotic strategies have been offered up as attractive alternatives to long-term investing. Many of these strategies and instruments are touted as giving individuals greater flexibility in managing their investments. However, before embracing the virtues of greater flexibility and market timing it is worth reviewing the findings of a recent DALBAR study.

DALBAR's research showed that for the 20-year period ending December 31, 2008, the average equity mutual fund investor realized annual returns of 1.9% versus 8.4% for the S&P 500. In addition, the study found the average holding period for equity funds was 3.1 years. In other words, the average equity investor underperformed the S&P 500 by 6.5% per year as they impatiently jumped from one fund to another every 3 years. The temptation to constantly chase the hot investment of the day too often leads investors down the road to sub-par performance. On the other hand, history has shown that the patient investor who buys high-quality securities and lets time and earnings growth work in their favor is ultimately rewarded with attractive long-term results.

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