

Market Perspectives

Zemenick & Walker, Inc.

An Independent Investment Advisory Firm, Established 1987

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Less Risky Returns: A Case for Alternatives

In life, it is natural to avoid unnecessary risks and to reduce those risks that are unavoidable. To take a contrary approach would be foolish or potentially dangerous. So why would investing be any different? The problem with risk, in financial terms, is that it is often difficult to comprehend. Short of the obvious and measurable risks of losing a lifelong savings, or losing a property to foreclosure, the concept of risk is a bit foreign, and to the average investor, almost always takes a backseat to performance during portfolio evaluation.

Measuring a portfolio in performance terms warrants little explanation. It is easy to recognize that given two portfolios, if portfolio A is expected to provide an annualized return of 8% over the next ten years and portfolio B is expected to provide an annualized return of 6% over the same period, portfolio A would be the more desirable choice. However, the choice may not be so clear when risk is added to the equation. One of the simpler statistical measurements used by analysts when evaluating portfolio risk is standard deviation - a measure of the variation from the mean of a data set. In this case, standard deviation simply indicates the historical volatility of a portfolio, with a lower value indicative of lower volatility. Going back to the original example, what if portfolio A (with an 8% expected return) also had a 7% standard deviation and portfolio B (with a 6% expected return) carried a 5% standard deviation? The desired portfolio is now not as easily identified - and to a great extent depends on a particular investor's risk tolerance.

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Avoid the Interest Rate Guessing Game

To the dismay of bond investors, interest rates on high quality bonds have dropped sharply over the past couple of years. Demoralized by low yields, many have concluded that rates must inevitably rise and that they should therefore hold short-term securities in anticipation of a future rate increase. This reasoning is problematic for several reasons, not least of which being that sensible arguments can be made that rates will rise, fall, or stay the same in the short to intermediate term. Though in the financial world it is often true that what goes down will eventually come up, the time frame is both essential and impossible to determine with any degree of certainty.

There is no better example than Japan to demonstrate the danger of assuming that rates must rise simply because they are low. The yield on 10-Year Japanese Government Notes first fell below 3% in June 1995 and by 2000 had fallen to under 2%, where it continues to languish today.

Moreover, regardless of the low rate environment, the current yield curve is actually very steep, thus the reward for extending investments beyond a year or two is relatively attractive. This is illustrated by the chart on the next page depicting the yield spread between two and ten year U.S. Treasury Notes, a popular measure of the steepness of the yield curve. A larger spread (ten-year yield less two-year yield) indicates a steeper curve. As of September 17th the spread was 224 basis points (a basis point is 1/100 of a percent) and since June 1976 the spread has been higher on only a few occasions.

With this steep of a yield curve, an investor who shortens the maturity for a bond purchase needs yields to rise sharply for the combination of the short initial purchase and a subsequent reinvestment to produce a return superior to a longer initial purchase. As an example, assume an investor wants to purchase \$100,000 of a zero-coupon, AA-rated, tax-free municipal bond and is trying to decide whether to target an eight-year bond or a two-year bond - hoping that in the interim yields rise and a subsequent purchase of a six-year bond can be made at a higher rate.

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Market and Economic Focus

After a nearly 65% rebound in the broad U.S. equity market off the March 2009 low and despite the National Bureau of Economic Research declaring an official end to the recession as of June 2009, investors are now faced with the threat of a possible double dip recession. Recently released data indicate that the pace of the economic recovery has slowed due to continued high unemployment, a softened housing market with the end of homebuyer tax credits, and the looming threat of deflation.

In the latter half of the 2nd quarter, equity markets gave up gains from the early part of 2010 as investors pulled their money out of equities and fled to safety in investment grade bonds causing an already low interest rate environment to retrench further. In the 3rd quarter markets rallied sharply and recovered to positive territory for the year, as S&P 500 earnings-per-share improved 45.7% year-over-year and the U.S. job market showed early signs of improvement. This change of events leaves investors pondering how the remainder of 2010 and the early part of 2011 will look.

Weighing on the markets is the continued high level of unemployment facing the nation. Uncertainty about the strength of the economic expansion, the future of tax rates, regulation and health care costs are the likely causes of reluctance among employers to begin hiring again. While most economists agree that unemployment is a lagging economic indicator, it is difficult to conceive how a consumer driven economy, such as the U.S., can strengthen to normal levels without significant improvement in the job market.

September, a historically negative month for the equity markets, was bolstered early on by “less bad” employment data. While overall nonfarm payrolls declined for the 3rd straight month, there were moderate gains in the private sector. Private sector payrolls increased by 67,000 in August, coming in better than expected versus the consensus estimate, and the unemployment rate increased by 0.1% versus the prior month coming in at 9.6%, in-line with market expectations.

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Avoid the Interest Rate Guessing Game *Continued from Page 1*

In this case, the 8-year bond currently pays 2.70% and would be worth \$123,931 at maturity, while the two-year bond currently pays 0.70% and would be worth \$101,407 at maturity. The six-year bond purchased after the initial two-year bond matures would have to yield 3.37% for the two-year/six-year combination to produce the same \$123,931 as the eight-year bond. Currently the six-year bond has a rate of 1.90%, thus for shortening to work, two years from now the six-year rate must increase by at least 1.47%. A rate increase of this magnitude in the next two years is certainly within the realm of possibility, but it is by no means guaranteed.

We believe the above analysis is most appropriately used on the intermediate part of the yield curve (for our purposes this portion of the curve extends from two to ten years). We hesitate to move substantially beyond that point because the yield curve is less steep after ten years, meaning investors receive less compensation for incrementally extending the years to maturity on bond purchases.

Additionally, as a bond’s maturity is extended, all else equal, its duration increases as well. Duration is a measure of a bond’s price sensitivity to changes in its yield. A bond with a 20 year maturity and 3.50% coupon that is priced at par would have a duration of roughly 14.5, which means that if its yield rises by just 1%, the bond’s price would be expected to decline by roughly 14.5%! Given the widely-held expectations for substantial interest rate increases, it is prudent to avoid purchasing bonds with excessive duration - even for those investors who plan to hold the bonds until they mature.

Taking Advantage of Yield Curve **AA-Rated Zero Coupon Muni Bond**

Option A: 8-Yr Bond

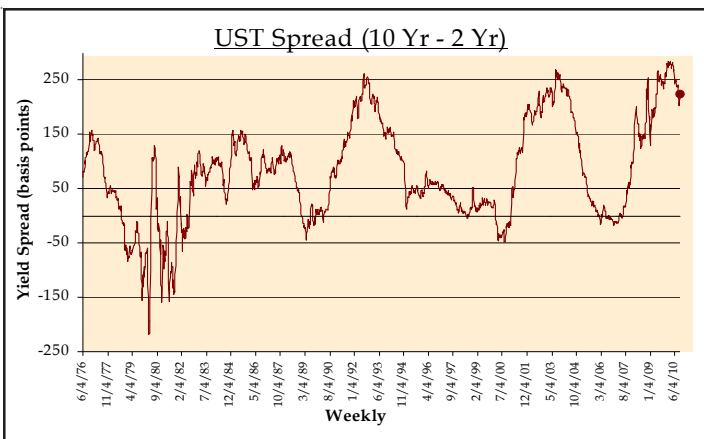
\$100,000 @ 2.70% for 8 Yrs = \$123,931

Option B: 2-Yr Bond Followed by 6-Yr Bond

\$100,000 @ 0.70% for 2 Yrs = \$101,407

\$101,407 6-Yr Investment Must be at 3.37% for Option B to Equal Option A.

6-Yr Rate Currently = 1.90%. Option B Requires 1.47% Rate Increase in 2 Yrs.



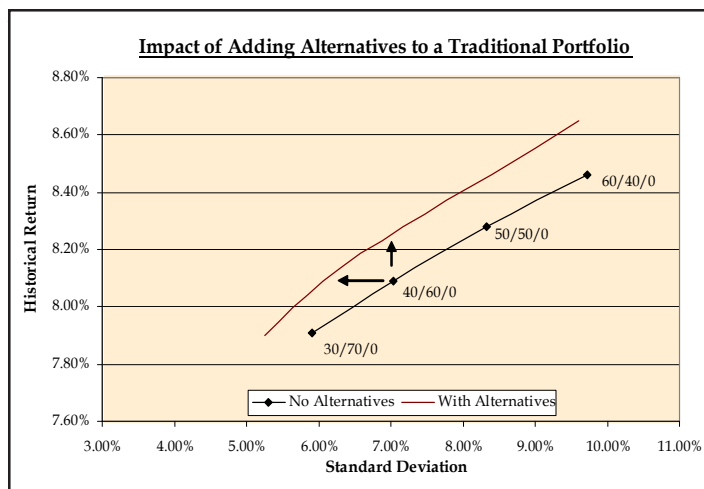
It is a dangerous game to bet on the timing and direction of interest rate moves; accordingly, we would be unlikely to advocate investing an entire bond portfolio in either short, intermediate, or long-term bonds. Instead, we favor structuring bond portfolios with maturities staggered throughout the short and intermediate term parts of the curve, an approach also known as a maturity ladder. It is important for investors to maintain a suitable portion of their portfolios in one and two year bonds to cover short-term liquidity needs and provide a source of cash for opportunistic investments. Once this is established, given the current low-rate environment and steepness of the yield curve, it makes sense for any further purchases to be made towards the back end of bond maturity ladders. ■

Less Risky Returns: A Case for Alternatives Continued from Page 1

Over the past several years, Zemenick & Walker, Inc. has embraced the idea that adding new asset classes to a traditional portfolio can enhance its risk/return attributes. Indeed, as the Nobel-winning economist Harry Markowitz theorized with his “efficient frontier” model in 1952, the primary reason to consider adding a new investment to a portfolio is its impact on the existing portfolio’s risk/return characteristics. For example, adding an asset class with a low correlation to the existing asset classes could either increase the expected return of the portfolio, decrease the risk, or both. Correlation is a statistical measurement of the relationship between the price movements of two different asset classes. A positive correlation indicates that the two securities’ prices tend to move in the same direction and a negative correlation implies that their prices tend to move in opposite directions. In essence, the new asset would be expected to provide a balancing effect, by moving in directions independent of the underlying portfolio.

The chart in the adjacent column displays how the previous concept is intended to work. The black dots represent the historical risk/return characteristics of various “traditional” portfolios (i.e. portfolios with only equity and fixed income components). For example, the lowermost dot represents a portfolio with 30% equities, 70% fixed income, and 0% alternatives. Using historical data from 1986 to present for the S&P 500 and the Barclay’s U.S. Treasury Index to reflect equity and fixed income returns, such a portfolio produced a historical return of ~ 7.9% annually with a standard deviation of ~ 6%. As an investor increases equities at the expense of fixed income (moving upward along the black line), the portfolio’s return and standard deviation increase. For many years, this black line represented the investment universe to which many investors were limited. However, with the tactical addition of new asset classes, investors can now shift the entire frontier upwards and to the left to provide higher returns and/or lower risk. The maroon line assumes three new asset classes (*commodities*, *real-estate*, and *distressed debt*) are added to portfolios in allocations consistent with our methodology. The line illustrates that by adding the new components, an investor wanting to hold risk constant could increase anticipated return. Similarly, an alternate investor satisfied with his anticipated return could decrease his risk.

Since 2000, we have strategically added the three new asset classes listed above in italics to many client portfolios. Diversifying away from the traditional components of a portfolio (equities, fixed income, and cash) is not unique to Zemenick & Walker however.



New investment products are surfacing constantly with a focus on the most popular alternatives, such as hedge-funds, private equity, commodities, etc... These “non-traditional” asset classes have come to be collectively known as “alternative investments”.

Certainly many of these “alternative” asset classes have existed for some time. Commodities are a prime example – their market has been around for many years. However, short of actively buying and selling futures contracts or taking long positions in the physical commodity itself, few alternatives were available to the average investor until a few years ago. We have elected not to engage in such trading strategies or invest in other alternatives like hedge funds and private equity. Such investments would have violated three of our long-held investing tenets: liquidity, transparency, and reasonable cost - all of which were pivotal to our entry into the alternative assets currently approved.

The recent development of Exchange-Traded Funds (ETFs) has changed the dynamics of alternative investing, and in our case, provided the avenue for our entry into commodities. ETFs now offer easy access to many different kinds of alternative investments at reasonable costs; and given their structure, offer liquidity and transparency as well. Yet such easy access to alternatives may generate an unwelcome side-effect. As more investors embrace alternatives, trading patterns may force correlations more in line with equities - reducing their benefit as a diversifier. Indeed, such an event was witnessed in 2008 and early 2009 when nearly all alternative assets dropped in tandem with equities. While many view the phenomenon as an abstraction resulting from the global financial crisis, only time will tell if the increased use of alternatives will alter how they have historically impacted investment portfolios. ■

Zemenick & Walker Welcomes Michael Hill

Michael Hill is the newest member of the Zemenick & Walker team. Prior to joining Z&W in March 2010, Michael worked as a financial consultant at AG Edwards before transitioning to a business analyst role for Wachovia / Wells Fargo. His primary responsibilities at Z&W include equity & fixed income research and trading, portfolio management, and due diligence. Michael received his Bachelor of Science in Business Administration with an emphasis in International Business and a minor in Spanish from Saint Louis University in 2003 and earned a Master of Science in Finance degree graduating with honors in 2009 from Webster University in St. Louis. He is currently a CFA Level II candidate. In his spare time, Michael enjoys camping and fly fishing, teaching taekwondo, and spending time with his wife, Courtney and newborn baby girl, Camila. ■

Municipal Market Still Holds Many Strong Credits

Municipal debt credit quality, once unassailable, has become a subject of concern for the marketplace. Headlines like “The Muni-Debt Bomb”, “Municipal Bonds: The Next Financial Land Mine”, and “Muni Bond Crisis” are now commonplace in the financial news media. To a casual observer it might appear that the era of the municipal bond safe haven has ended; however, this would be an overreaction. Though the weak economic environment and collapse of the bond insurance industry have made credit issues more visible, strong credits are still available. As always, attention to credit quality remains an essential element of municipal bond investing.

Assured Guaranty is the one surviving bond insurer to maintain a AA or higher rating by both Moody’s and S&P. Assured’s CEO, Dominic Frederico, noted in a recent office visit to Z&W that the industry’s greatest losses have been concentrated in special assessment revenue bonds as well as health care revenue bonds (particularly nursing homes), and non-GNMA guaranteed housing bonds. Moreover, he noted that many of these bonds were either unrated or below investment grade. Frederico suggested that properly supported essential service revenue bonds (i.e. water, sewer, and electric) and investment grade unlimited general obligations are currently the highest quality sectors of the market, a sentiment with which we wholeheartedly agree.

Though the weak economic environment and collapse of the bond insurance industry have made credit issues more visible, strong credits are still available.

For example, the Permanent School Funds of both Texas and Nevada are of the highest quality. The Texas PSF is a \$26.5 billion behemoth consisting of equities, bonds, alternative investments, real estate, and mineral rights. These assets are pledged as collateral for bonds issued by Texas school districts, providing investors with both a general obligation of the district and the PSF collateral in the event the district defaults. As of June 30th the Texas PSF had outstanding guarantees on \$49.5 billion of school debt, meaning it guaranteed less than \$2 for every dollar of collateral - a very conservative position. The Nevada PSF is much smaller than that of Texas, but in some ways may be stronger. As of June 30th it had roughly \$300 million invested primarily in government bonds and cash against guarantees of around \$170 million, thus only about \$0.57 is guaranteed per dollar of collateral.

We also target state general obligations and school bonds backed by state guarantees, which are effectively state general obligations. Apart from the obvious benefits of a large and diversified economic base, widespread taxing authority, and easy access to credit markets enjoyed by most state governments, we are attracted by the fact that states are unable to file for bankruptcy. Ultimately, there are many other credits we believe are very strong and are comfortable buying. Though there is no doubt that weaker credits and sectors in the municipal market are at risk, high quality bonds are still appropriate for conservative investors as long as they understand the credits up front and diligently monitor their portfolios on an ongoing basis ■

Market and Economic Focus *Continued from Page 2*

The threat of deflation is another issue weighing on sustaining the economic recovery. Deflation generally causes consumers to defer purchases and causes the real interest rate to rise, weighing on corporate capital expenditures. The latest figures on inflation provided by core PPI and core CPI (both excluding volatile food and energy prices) show that prices have increased only slightly year-over-year at both the wholesale and retail level. These measures suggest that while overall price movements are currently in check, the threat of deflation in the near term is still very real without a recovery in consumer expenditures or corporate investment.

Consumer confidence continues to decline on the negative assessments of the job and housing markets. The most recent survey of consumer confidence provided by the University of Michigan’s Consumer Sentiment Index for the month of September came in at 66.6, declining more than two points against the prior month and well below the median consensus estimate of 70.0. In general, levels below 90 indicate a negative assessment of the U.S. economy by consumers, which usually translates into weaker consumer spending.

The current economic indicators relating to employment, inflation and consumer sentiment imply that the U.S. economy still has room for improvement. However, early signs of improvement in the job market and better than expected corporate earnings indicate that the probability of a double dip recession could be waning. Recently Warren Buffet spoke at the Montana Economic Development Summit and boldly stated, “*We will not have a double-dip recession at all. I see our business coming back almost across the board.*” On the other hand, economists such as NYU Professor Nouriel Roubini and Harvard University Professor Martin Feldstein have said that the odds of another recession may be one-in-three or higher. These conflicting views and uncertainties among top economists, analysts & other market professionals underscore the importance of diversification, asset allocation, and taking a long term approach to investing ■

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