

# Market Perspectives

## Zemenick & Walker, Inc.

An Independent Investment Advisory Firm, Established 1987

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## In Defense of the Long-Term

In the wake of a historic equity market collapse, which included a peak to trough (so far) decline in the S&P 500 of 56.78%, it has become fashionable to mock the strategy of long-term investing as out of date. Instead, many assert that the only way to make money in this market is to be a short-term trader. Not surprisingly, we emphatically reject this claim.

Those most loudly trumpeting the death of long-term investing appear to be reacting emotionally to the losses they suffered in 2008, as if screaming in frustration, "Something else must be better!" In a bit of faulty logic, they cite items like the S&P 500's annualized loss of 3.42% over the ten years ending February 2009 as irrefutable evidence that returns over the next ten years will also be poor. Admittedly, the return over the past ten years has been disappointing, but anyone who has read a prospectus and seen the familiar, "past results do not guarantee future performance" should realize this argument has little merit. Extrapolation of the recent past into the future is a dangerous practice.

In addition to faulty logic, many newly minted short-term traders often fail to distinguish between high-turnover quantitative approaches, a variety of technical-based strategies, and pure market timing. They seem to imply that they would have been able to side-step the carnage in global equity markets during 2008 if only they had followed a short-term strategy. In reality, countless quantitative and technical traders took their lumps alongside their long-term counterparts. Only *Continued on Page 2*

## Investing in a Challenging Muni Market

Zemenick & Walker has always maintained that a high-quality bond portfolio is a critical component of a well-diversified investment mix. Offering income, liquidity, and safety of principal, a bond portfolio provides the foundation from which all other investment decisions can be made. For many investors, tax-free municipal bonds, often overlooked and taken for granted, have long been this foundation. With the recent economic downturn however, many bond investors are re-examining the municipal bond market and questioning some long held paradigms.

Most importantly, investors are rethinking the convention that municipal bonds do not default. While such an absolute tenet might sound extreme, Standard & Poor's reports that between 1970 and 2006 not a single triple-A or double-A rated municipal bond defaulted. Even the default rate on single-A rated municipal debt over the same period was a miniscule 0.23%. Yet such low historical default rates offer little consolation with state and local officials struggling to balance their budgets in an environment of falling tax revenues and growing demand for services. Indeed, the National Conference of State Legislatures estimates that in aggregate the states will face a \$121 billion budget gap in the coming fiscal year *after* the receipt of federal stimulus money. California's budget gap alone is expected to approach \$24 billion. Obviously, closing these gaps will require tough decisions. In California for example, proposals have been made to release thousands of prisoners early, close state parks, and commandeer the share of state fuel-tax revenue allocated to local governments for road maintenance.

To make matters worse, state and local municipal issuers have all but lost the crutch of bond insurance. For years, bond insurance allowed municipalities to lower their borrowing costs by paying an insurance premium. The insurance protected the owner of the debt in the event of the municipality's default, allowing below-average issuers to take their bonds to market at lower rates. This was a win-win for bondholders, municipalities, and taxpayers alike. The industry was so *Continued on Page 3*

## *In Defense of the Long-Term* *Continued from Page 1*

by making a market call and shorting or completely liquidating equities would they have avoided the downturn.

While it is occasionally possible to anticipate a turn in the market, it is unlikely an investor will consistently be correct over time, as the market is extremely unpredictable over the short and intermediate term. One must not only get the sell decision right but also determine when to re-enter the market. Because equity markets move so quickly, mistiming one part of the decision can be catastrophic to long-term returns. As the market bounces around, emotion invariably enters into any timing decision and investors risk becoming reactive.

This leads to the situation described by Warren Buffett in an October 2008 *New York Times* editorial, where he noted that many investors managed to lose money in the twentieth century, despite prodigious growth in the benchmark indexes. “The hapless ones bought stocks only when they felt comfort in doing so and then proceeded to sell when the headlines made them queasy”. Anyone who sold stocks near the October 2008 or March 2009 lows only to watch the market stage a rapid rally can attest to this.

Though pure market timing is not a viable strategy for most investors, we acknowledge that quantitative and technical trading strategies can be successfully employed. Nevertheless, apart from our philosophical objections, there are other reasons to be wary. As succinctly stated by Chris Davis, a renowned money manager, in a *Morningstar* interview, “Turnover has a certain cost and an uncertain benefit”. Trades have a certain cost in terms of commissions and taxes but offer an uncertain expectation of profit. Moreover, short-term gains are taxed as ordinary income while long-term gains receive beneficial capital gains treatment, significantly influencing performance for taxable investors. It must also be noted that many quantitative and technical traders depend on constant innovation to fine-tune their models in a battle to stay ahead of the market. Strategies that worked for years can become obsolete as market trading patterns shift and competitors eliminate arbitrage opportunities.

Perhaps it is an impulsive desire “to take action” after a tough year that caused so many to shift to a short-term focus. It is an ironic motivation, given that a long-term method based on bottom-up fundamental analysis and regular review, is anything but “buy-and-hold”. At Zemenick & Walker the process begins with an investment policy that identifies a suitable equity allocation range

based on a client’s risk tolerance, goals, and current financial condition. Theoretically, this range is appropriate for any market environment, though it is subject to revision if there are material changes to a client’s financial position. The equity range allows us to take action based on a macro market view, but within limits that prevent major market timing calls, which expose the portfolio to all of the previously described risks.

Further, we select a basket of active managers through which to gain equity market exposure, making sure to diversify between large cap and small cap, value and growth, and foreign and domestic. We continuously monitor approved managers and replace them if something changes to invalidate our original investment thesis or if a better alternative comes along. In addition to periodic manager reviews, we modify the investment mix by changing or rebalancing to equity sector targets.

Naturally, the managers themselves are the greatest (and least visible) source of activity in our portfolio.

Again, Chris Davis concisely summarizes their method of portfolio management, “Business value can be independently determined through research and there is usually a difference between value and price. If price exceeds the estimate of value you would be a seller. In general, business prices are more volatile than business values, but usually not so volatile that they swing from below intrinsic value to above intrinsic value in short periods of time.” Thus, a manager’s approach is guided by fundamental assessments of the intrinsic value of individual companies and trading is a result of the long-term realization of this value.

In terms of future results (which, of course, are all that matter), it is impossible to definitively prove that one investment philosophy is superior to another. However, we believe our approach is a sound one: using a diversified group of active managers who trade when market prices depart from and coalesce around company value, combined with periodic rebalancing, and governed by a reasonable investment policy allowing for shifting allocations in response to the economic outlook and market valuations. It has a strong rational foundation and is far more flexible and adaptive to changing market conditions than its critics recognize. Consequently, we are confident that, like Mark Twain, the reports of the death of long-term investing have been greatly exaggerated ■

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## **Z&W Website Update**

**Z**emenick & Walker, Inc. has a new look on the Internet, with a recently redesigned [www.zandw.com](http://www.zandw.com). We hope you will find our new website to be more aesthetically pleasing and user friendly than its former version. The redesign provides a more detailed introduction to our investment team by including short biographies and pictures and, for those who are unfamiliar with our firm, a thorough description of the services that we offer ■

## Roth IRA Conversion Opportunity

**B**eginning in 2010 the \$100,000 AGI limitation for Roth conversions will be eliminated, opening the door to high income investors to access the Roth IRA, a very attractive savings vehicle. A Roth conversion involves transferring funds from a traditional IRA to a Roth, with income tax due on the balance transferred. Unlike a traditional IRA, qualified distributions from the Roth are tax free and there are no required distributions during the owner's lifetime. This allows earnings to compound and to be passed to one's heirs at death. Though non-spousal heirs must take distributions over their life expectancies, they remain tax free.

A Roth conversion loses its appeal if an individual cannot pay the income tax due from a source other than the IRA. In 2010 the tax burden is reduced by a provision allowing taxes to be deferred and split over the next two years. Investors should discuss this opportunity with their accountants and financial advisors to determine if it is something that they should pursue ■

### *Investing in a Challenging Muni Market Continued from Page 1*

successful that by 2006 insurance guaranteed nearly \$3.3 trillion of outstanding debt. However, only \$34 billion of equity capital backed this commitment - a leverage ratio of roughly 97:1.

As risky as this sounds, in a sector as historically strong as the municipal bond market, the insurance companies were probably not over-leveraged. The insurance companies' problems arose when they began venturing into the subprime and structured asset markets in search of higher margins. When those markets began spiraling down last year, the party ended. With the demise of their capital base and falling credit ratings, many analysts now wonder what role, if any, bond insurance will play in the future. This year through May 31st, according to Thomson Reuters, only 12.5% of new municipal bond issues came to market with insurance, dropping from a peak of 57.1% in 2005. Municipal issuers, like many analysts and investors, are beginning to question the value of insurance. Below is a chart illustrating just how far the fortunes of the previously triple-A rated monoline insurers have fallen.

#### Former Insurance Heavyweights

<u>Insurer</u>	<u>Former Rating S&amp;P/Moody's</u>	<u>Current Rating S&amp;P/Moody's</u>
Ambac	AAA/Aaa	BBB/Ba3
CIFG	AAA/Aaa	CC/Ba3
FGIC	AAA/Aaa	Defunct*
FSA	AAA/Aaa	AAA/Aa3
MBIA (NATL)	AAA/Aaa	A/Baa1
XL Capital	AAA/Aaa	CC/Ca

\*Most of FGIC's muni portfolio was sold to MBIA to raise cash.

This collapse of the municipal bond insurance industry presents challenges to both municipalities and bond investors alike. For municipalities struggling to secure financing, the loss of the perceived safety of insurance will translate into higher borrowing costs. For example, according to CNBC, the average yield on California's G.O. debt is currently about 6.2%, with some analysts expecting it to rise to near 7%. Without viable insurance protection, any new debt issued by the state would be extremely costly to its taxpayers. To its credit however, the federal government recognized the risk to municipal issuers and created a new type of municipal bond - Build America Bonds (BABs). The Build America Bond

program allows municipalities (from states to local library districts) to issue debt at higher interest rates with the federal government providing a 35% subsidy to either the issuer or directly to the bondholders via tax credits. This subsidy helps defray the higher borrowing costs to the issuer. At the same time, thanks to their higher interest rates, BABs have increased the demand for municipal bonds via their appeal to lower income investors who otherwise would not purchase munis. Be mindful however, the interest on BABs is taxable to the investor at the federal level. Thus, BAB yields should be compared against other types of taxable bonds and not against tax-exempt munis.

Thanks to insurance, many bonds of questionable underlying credit quality have made it to market. The challenge for investors therefore becomes the financial assessment of the issuer. Of particular concern is that the historical default rates on high-quality municipal bonds cited earlier do not consider if or when insurance was called upon to assist with interest and/or principal payments. Moreover, given the lax regulation of the municipal bond market such events are often not reported to the proper monitoring agencies, making the collection of accurate data nearly impossible.

We have always viewed bond investing with an eye towards quality. Admittedly, like nearly all bond analysts, there was a time when we placed a value on bond insurance. However, when buying insured bonds, we also emphasized the issuer's underlying credit quality. Additionally, with our focus on general obligation and essential service revenue debt, we have generally avoided many bonds backed by riskier sources of financing such as certificates of participation, special assessments, and projects subject to annual appropriations. This vigilance has paid off. Our client bond portfolios have, in general, held their values well given the groundswell of recent credit downgrades, and only on rare occasions have we sold bonds due to credit concerns.

Yet, we are not resting on our laurels. Given the current changes sweeping the municipal market, we have tightened our purchasing parameters even further. In addition to requiring a strong underlying rating, we now more actively pursue larger issuers with more resources to battle budget constraints. We have also added a renewed focus on school district bonds backed by some form of state program or investment pool. While these guarantees resemble bond insurance in that they are only called upon in the event of financial hardship, most programs are constitutionally chartered and provide access to the state's larger pool of resources ■

## Focus on the Economy

The current economic meltdown will undoubtedly be documented in volumes of texts for years to come. Put simply though, the crisis boils down to one word: debt. The roots of the current recession lie in the subprime housing crisis and the massive financial leveraging of consumers and corporations. Irrationally loose credit terms were granted to millions who clearly did not deserve them. These loans were then packaged into complex securities that were purchased by investors, many of whom were banks. When the housing bubble popped, it became impossible to sort out the good mortgages from the bad, and all these packaged securities became impossible to trade, and more importantly, impossible to value. This immense loss of value led to a massive liquidity crisis that effectively froze the financial markets.

Months of government actions, corporate “restructurings”, and consumer reactions bring us to the present. We all want to know - where are we now and more importantly, where are we going tomorrow? The answer to the former question is largely affected by one’s perspective. National, regional, and local populations have all felt the effects differently. Each state government and economy is dealing with different issues in regards to budgets, jobs, tax codes, the housing crisis, stimulus plans, etc. Economic data have been progressively “less bad” for months now, but what the economy needs is growth. The key to a turnaround is essentially in the hands of the consumer, whose spending represents 70% of the U.S. gross domestic product. Several indicators such as inventories and confidence levels are improving, however as the Federal Reserve noted in their June meeting minutes, “household spending has shown signs of stabilizing but remains constrained by ongoing job losses, lower housing wealth, and tight credit.” The difficult reality is that consumer spending is what generally sparks job and economic growth. To encourage spending, consumers need to have increased confidence, stabilized housing prices, and available credit. These factors encompass the heart of our current economic challenges.

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To address the latter question from above, where are we going tomorrow, let us take a long-term point of view. The consensus among economists remains that the stock market is a leading indicator of the economy. Although data has not yet turned positive, the market is up substantially from its March 9<sup>th</sup> bottom. So then is this a bear market rally or a true recovery? Short term predictions tend to be futile, but several things seem very apparent. Growth will be greatly strained and slow for many quarters to come. High unemployment, currently approaching 10% in the U.S., will linger well past 2009; though it typically does not improve until after the economy does. The deleveraging of corporations and consumers will be measured in years, not quarters. While we have not purged all of the excesses of the previous decade, we are drastically more aware of their existence than before. There is still plenty to fear, but it is apparent that companies and investors are now much better informed and prepared. Now more than ever, we see a fundamental need for balanced portfolios that rely on prudent diversification of assets and continual supervision.

Aside from market direction, a great debate exists today regarding future inflation. Every day it seems we read competing articles calling for either hyperinflation or alarming deflation. Most often authors focus their attention on the massive creation of dollars by our federal government increasing the money supply (M1) by over 15% in the last year. Skeptics of high inflation argue that this influx is merely replacing a large part of the money supply lost through the deleveraging of the financial system. In addition, this money is not being lent out as before because banks and consumers are all saving right now. Hyperinflation fears are further dampened by the fact that labor inflation accounts for 70% of corporate costs. Current and foreseeable high unemployment should keep those costs in check. Certainly other factors are at work. For example, forecasters of high inflation point to massive future government liabilities with regards to unfunded entitlement programs such as social security and Medicare. These are unquestionably major worries for policy makers. In the end, individuals should find themselves somewhere between the two extremes. From an investment perspective, treat inflation as a risk that should be addressed, not as a fear that handcuffs a portfolio ■

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## New Cost-Basis Reporting Requirement

The Emergency Economic Stabilization Act of 2008 became law on October 3, 2008. One of the provisions of the act included a requirement for brokerage firms and mutual fund companies to begin reporting cost basis to the IRS, in an effort to combat the under-reporting of gains and over-reporting of losses, as well as to simplify the tax reporting process. The law provides for the phase-in of reporting for various types of securities as follows: stocks beginning January 1, 2011, mutual funds and dividend reinvestment plan shares beginning January 1, 2012, and debt instruments, options, and other securities beginning January 1, 2013 ■

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