

observations

INVESTMENT

Fear and Greed

BY Bill Hornbarger, CHIEF INVESTMENT STRATEGIST



Bill Hornbarger
CHIEF MARKET STRATEGIST

Most of us are familiar with Warren Buffett, the “Oracle of Omaha,” who has had a successful career following the quoted creed and swimming against the tide. Recently I spoke with a number of Moneta Family CFOs and clients about both their concerns and perceived opportunities in today’s environment. The unprecedented events during the past twelve months make this an opportune time to revisit our outlook and strategic investment strategy. It’s important to note that in large part, our strategy worked well in an economic cycle more volatile than anything we’ve experienced—and one far beyond our worse case

“Occasional outbreaks of those two super-contagious diseases, fear and greed, will forever occur in the investment community. The timing of these epidemics is equally unpredictable, both as to duration and degree. Therefore we never try to anticipate the arrival or departure of either. We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful.”

— Warren Buffett, 2001

scenarios. Treasuries, high-grade munis and disciplined rebalancing helped most portfolios avoid disaster even as we dealt with epic swings in the equity markets, failures and mergers in the financial services industry, and government’s expanded role in the wake of the financial crisis.

The Fears That Stalk Investors Minds

Inflation, a declining dollar, the deficit and job creation (or the lack thereof) are significant and legitimate concerns which may weigh on investment portfolios.

However, much of the potential future impact is contingent on future, unknown policies. In the short term, the overall inflation rate (as measured by consumer prices on a year to year basis) is likely to increase over the next six months, particularly as compared to last year when oil was closer to \$45/bbl and prices were declining as the economy fell into recession. This increase will likely fan inflation fears of those who worry about the rapid creation of credit by the Federal Reserve. Outstanding

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As 2009 comes to a close, our Chief Market Strategist, Bill Hornbarger, takes a substantive look at the two nemeses which haunt many investors: Fear and Greed. His discussion is particularly related to these emotions during the unprecedented events of the last 12 months.

Investment Analyst Luke Ferraro presents a practical commentary on inflation fears, while Principal Linda Pietroburgo addresses Socially Responsible Investing, a topic garnering a lot of interest in industry publications and one clients may want to know more about.

Your feedback is not only welcome, but is a valuable tool in helping us shape our newsletters to serve the needs and expectations of you, our clients. If you have ideas or suggestions for future **Investment Observations** newsletters, please contact Nancy Powers, Marketing and Communications Director, at npowers@monetagroup.com or call 314-244-3340.

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reserve bank credit close to \$2.1 trillion today, coupled with 0 percent interest rates, is elevating inflation concerns. We agree that credit growth is one of the components of inflation, so we also must consider credit growth from sources other than the Fed. The Fed is currently replacing only a percentage of credit lost from other areas of the economy.

That combined with very low capacity use and relatively high unemployment gives us some comfort in terms of near and intermediate-term inflation rates. However, if the Fed continues to pursue the current highly stimulative monetary policy as the recovery becomes self-sustaining, we could have a recipe for higher inflation. While we aren't concerned about inflation in the near and intermediate term, we continue to advocate some exposure to commodities and real estate (domestic and global REITS) as part of our asset allocation mix. These two asset classes, along with equities and, where appropriate, TIPS, offer inflation participation for a portfolio.

The declining value of the U.S. dollar is another source of anxiety. Zero percent interest rates and an uncertain economic outlook, coupled with an increase in the deficit and federal debt, have weighed on the dollar. Looking at a longer time frame, relative to a broad basket of currencies from our

major trading partners, the dollar actually peaked in early 2002 and has since been in decline. Recent weakness follows a period of strength last year when investors flocked to the U.S. currency in a flight to safety. To date, the decline in the value of the dollar has been orderly, and a weaker dollar does offer some benefits to the U.S. economy, most notably more competitive exports. One would expect the dollar to benefit from higher interest rates when the Fed ultimately reverses the current reflationary policies.

Longer-term we would expect foreign investors to continue to diversify currency holdings, and the high debt-to-GDP ratio will cause concerns, some of which can/will be offset by a change in Fed policy, the fact that the U.S. has the largest and most transparent financial system in the world, and a continued progression towards a self-sustaining recovery. Looking at three possible outcomes—stronger dollar, dollar crash, or continued gradual descent—we would assign the highest probability to the third scenario. We recommend a weighting to international equities as part of a diversified portfolio, a strategy that tends to benefit from a declining dollar. It's also important to note that approximately 50 percent of the revenues from the S&P 500 are earned outside the United States.

And Now About Greed

Gold and emerging market equities have gained significant attention. Gold outperformed the broad basket of commodities represented by the CRB index last year when it was viewed as a safe asset in an uncertain world, and global reflationary policies are providing it a significant tailwind. Despite that, year-to-date, gold is not a top performing commodity, ranking below industrial metals like lead, copper and even silver. A global economic recovery and a weaker dollar would suggest that commodities could continue to perform relatively well. However, we prefer to own a representative basket with broader exposure as opposed to a single commodity.

Emerging markets such as India, China and Brazil represent exciting opportunities in the years ahead. Simply put, there are much greater opportunities for growth of the "middle class" in developing economies than in Japan, the United States and Western Europe. And while we agree that these countries and markets represent interesting opportunities, we also remember the mantra that "price matters." The recent news from Dubai and Greece indicates that risks remain in many of these markets. Based on current valuations, we feel reluctant to significantly overweight allocations to these emerging economies.

What Would Warren Do?

It appears we are past the point of maximum, systemic risk that so severely damaged the markets last fall and spring. Many questions remain regarding the pace and shape of the current recovery and whether or not the markets have gotten ahead of themselves. It is judicious to remember that Japan has pursued many of the same policies currently pursued by the U.S. with, at best, mixed results. It is also reasonable to believe the current recovery will be more moderate than history suggests.

If the Fed continues with its reflationary policies as the recovery becomes self-sustaining, inflation could potentially become a problem. Deciding when the current path is no longer necessary is the issue that confronts the Fed. Instead of entirely discounting our historical investment process, we choose to continue to advocate a diversified asset allocation and rebalancing discipline—a strategy that has benefited clients through this turmoil. Our commitment is to periodically challenge our asset allocation assumptions and, as fundamentals and evaluations—not fear or greed—suggest, adjust them accordingly. ❖

Socially Responsible Investing

BY Linda Pietroburgo, MBA CFP®



Linda Pietroburgo
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We all make judgment calls about how to spend our money. We choose to fund our children's education instead of other, more frivolous, expenditures; we give to family members when we see a need; we prioritize our wants, and support charities we feel are worthy and that are aligned with our beliefs and values. An ever-increasing group of investors are applying similar measures to the companies in which they choose to invest. The practice is commonly known as socially responsible investing (SRI), and, according to Social Investment Forum's 2007 Report on Socially Responsible Trends, it is one of the fastest growing segments of the market, representing more than \$2.71 trillion of the roughly \$25.1 trillion in the U.S. investment marketplace.

Socially Responsible Investing is generally grouped into three primary categories: social or environmental screening; shareholder advocacy; and community investing. The practice has evolved from very

black-and-white elimination of "bad" products from a portfolio to positive, more broadly-stated mission statements that encourage companies to be good corporate citizens, approaches measured by a whole slew of value-based guidelines. And companies are getting the message.

I recently attended the 20th Annual SRI in the Rockies Conference and was surprised by the number of big-name companies that sponsored and/or actively participated. We heard from Dell, Chevron, Unilever, Campbell's Soup, Coca-Cola, Merck, WalMart and Aspen Skiing Company. Maybe Aspen Skiing Company isn't as impressive a name, but I love skiing! All these companies are enacting environmental, "green" type programs as well as dealing with social governance issues. Socially responsible investors believe that there is a connection between good corporate citizenship and positive financial performance—performance that has a longer-term focus and advocates for sustainable growth.

The most common hindrance to investing in this manner is finding strong-performing portfolio managers, whether through separate accounts or mutual funds. The large cap blend category offers the most depth, and there are at least three mutual funds that compare favorably against their peers

on a five-year basis; Parnassus Equity Income, CREF Social Choice and Neuberger Berman Socially Responsible. There are also some newly-developed exchange-traded funds (ETFs) that track the Domini 400 Social Index, such as iShares KLD 400 Social Index Fund. The challenge is building a well-diversified portfolio because other areas, like small cap and international, are very new and unable to meet Moneta's most basic quantitative screen of manager tenure. But as the field evolves and the universe of socially responsible mutual funds grows, there will certainly be more choices.

Community investing was another equally hot topic at the conference, even if a bit subdued as it continues to struggle for liquidity in the aftermath of the mortgage and housing-crisis. My son is studying Political Science in college. He was taught that there are three 'legs' essential for democracy to be at its best, and ideally these are equally balanced; civil society, private enterprise, and government. SRI really speaks to the first of these, civil society, which is about the power of the individual to have a voice in the free market system. Community investing seeks to make capital available to 'Main Street,' and may help boost investment in an underrepresented segment of our economy. The best example is purposely investing in certificates of deposits issued

by banks that, in turn, make loans to disadvantaged or non-traditional borrowers. Contrary to what I would have expected, many of these banks and credit unions claimed to be more financially sound because they retained their loans in-house, and thus performed more diligent underwriting. They also tended to avoid overleveraging.

Will the growth in socially responsible investing continue? I believe that it will. We are a generation that is fully integrated; most people connect by handheld devices and cell phones, work and leisure time are hard to differentiate, cultural norms and ethnic diversity continues to become more homogeneous, and global reach is blurring geographical boundaries. The notion of the world as one 'family' has become a topic of great interest. Is it any wonder that investors are also viewing their money in transformative ways? At Moneta Group we continue to seek strategies that help our clients stay ahead of the curve. Principals routinely attend conferences on a variety of topics so we can more readily respond to your needs.

As always, there are individual issues to consider. If SRI is something you're interested in learning more about, there are a number of Web sites and publications you can access. As always, your Family CFO is one of your best resources. ❖

Inflation: Let's Worry About Something Else...

BY Luke Ferraro, INVESTMENT ANALYST

In recent weeks, I have had a number of conversations with Moneta Family CFOs about the dollar and inflation — concerns many clients are discussing in review meetings. I thought I'd attempt to articulate the Investment Department's current view.

Weakening Dollar

◆ Yes, some aspects of a weakening currency are problematic. We may have trouble refinancing our growing debt. But it is not all bad to have a weakening dollar. For example, a weakening dollar:

- Helps with the current account deficit, making domestic companies more competitive globally.
- Helps the U.S. economy. More consumers buy American products — like Fords — because the weakening dollars makes foreign products — like Audis — more expensive.



Luke Ferraro
INVESTMENT ANALYST

- ◆ I'm a believer in 'eventual purchasing power parity.' If the dollar weakens enough, our goods will become an overwhelming bargain (both at home and abroad), resulting in dollar demand.
- ◆ Moneta clients' portfolios are more hedged against the dollar than may be apparent to many:
 - About 45 to 50 percent of earnings from companies in the S&P 500 are derived overseas.

- Most of our international equity exposure (Stocks and Real Estate) are invested in foreign currency (Tweedy, Browne being the exception).
- Commodities are priced in dollars. A falling dollar should benefit commodities, although if you recall my article from last quarter's *Investment Observations*, you already know I am not a fan of buying only gold.

◆ Neither China nor Japan favor a weak dollar, because it makes their goods less competitive in our consumer markets.

Inflation

- ◆ Huge government spending does not absolutely mean there will be the hyperinflation everyone fears. Japan, over the past 20 years, would be a perfect example of that scenario.
- ◆ In order for inflation to exist you need:

- Easy credit. We're not there yet.
 - A rise in aggregate demand. Besides short-term stimulus (Cash for Clunkers, for example), demand for goods is not strong.
 - An economy running at full capacity. We are not even close.

◆ The best indicator for inflation, in my opinion, would be to keep monitoring the unemployment rate, currently, at around 10 percent. I don't think inflation is going to be an issue until this rate gets closer to 5 or 6 percent. If unemployment falls by 1 percent annually, and we are currently at the high (which is probably unlikely), inflation may become an issue around 2013 - 2014 at the earliest.

Concerns over a New World reserve currency:

- ◆ Show me a viable alternative. I do not believe one currently exists. ◆

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