

## Market & Economic Outlook after First Quarter 2011 Chaos & Rewards

Stocks tumbled hard in mid-March amid Mid East uprisings and following Japan's earthquake and tsunami on March 11 – and the nuclear issue. With strong underlying market fundamentals, and valuations in large caps at about 20-year lows, markets are recovering again from the panic selling.

**Overall, a Great First Quarter 2011** - Through rain, sleet, snow, Middle East riots, earthquakes, tsunamis, sovereign debt crises, record budget deficits, the housing depression and prolonged high unemployment, the markets prevailed.

Hanging tight was rewarded: The Dow<sup>1</sup> had its best first quarter in 13 years. The Russell 2000 index<sup>1</sup>, a benchmark for small-cap stocks, hit the highest level since October 2007, before the credit crisis struck.

**Risk vs. Reward** - I monitor our recommendations and recommend those with strong outperformance (Alpha in Modern Portfolio terms) for the risk taken. I don't suggest toss your dart investing in index funds or risky ETF's. Investments should be widely diversified not only by sectors but by managers.

There are many potential opportunities in the market but always risks. I recommend timely alternatives without the volatility of the stock or bond markets as part of a diversified long-term portfolio.

**Bond Warning Continues** - Treasury bond rates (base for most bonds) rose only slightly off near record lows, yet it was enough that 10-year Treasuries had their longest losing streak since 1999. This was even with a brief recovery as investors fled to the secure safe haven of U.S. Treasuries with all the concerns in the first quarter.

The SEC, the Municipal Securities Rulemaking Board and the Financial Industry Regulatory Authority Inc. all proposed rules and guidance about what kinds of disclosures brokers need to make when selling municipal bonds.

Wells Fargo considered having brokers only sell muni bonds to investors that have e-mail addresses, to prove that full disclosure was sent, so an investor can't later say, "my broker never told me that." Other brokerage firms have raised the issue that many investors don't read all their e-mails. But it would be proof that disclosure of the risks was sent.

While muni bonds have special risks today, all bonds have interest rate risk and potential substantial losses if interest rates eventually return to more historical norms.

**Economic & Market Outlook** - We continue to have a slow economic expansion, earnings growth, and strong consumers who have reduced debt and continue to spend.

U.S. GDP growth for 2010 was the best in five years. Even with more unemployment from government cutbacks the overall economy is expected to continue its steady yet slow recovery.

Household liquidity is over \$7 trillion, commercial banks have more than \$1.3 trillion in cash and corporate cash is at historic levels. "When the dam of liquidity finally begins to flow market prices should follow suit as demand for risk assets increase." (Marketwatch March 31, 2011)

Economists point out that most data on growth are either showing strength or improving. Manufacturing orders have been growing rapidly, for example, while the private sector hired at the fastest pace in five years during the first quarter.

Near record profits continue for many corporations. Even with the good market returns of the past two years, corporate earnings have kept pace – resulting in the Price/Earnings Ratio for the S&P500<sup>1</sup> to be about 13.5 – the same as at the March 2009 recession low at what proved to be in a overstated fear of depression panic. The S&P500 has about doubled in value but so has earnings so the P/E ratio is still near the recession low.

Many retail investors are still fear struck from the 2008 crash. BlackRock, the world's largest money manager founder, Larry Fink isn't surprised by the recent climb in U.S. equities, as the asset class remains "very cheap". "People have under invested in U.S. equities for years; people have over-invested in fixed income."

As more investors flee the bond market when losses grow this should be positive for equities. Global growth is expected to be aided later in the year by massive Japan reconstruction spending.

**Optimism among Chief Executives Exceeds Pre-Slump High** Bloomberg 3/31/2011 reported: "Optimism among U.S. chief executive officers surpassed the highest level reached before the

recession as more business leaders projected increased sales, investment and hiring, a survey showed.”

**Investment Industry Battle – Fiduciary Responsibility vs. “Suitability”** Fiduciary responsibility has always been a requirement for firms like mine as a Registered Investment Advisor (RIA). As a Certified Financial Planner (CFP) our Code of Ethics requires us to operate as a fiduciary not just a suitability standard.

RIA's must offer advice that is in a client's best interest, while broker-dealers adhere to a less stringent rule that says their guidance must be suitable for an investor's needs, timelines and risk appetite.

Many traditional broker-dealers are against this imposition of a higher fiduciary standard.

“The Financial Planning Coalition believes that establishing a uniform fiduciary standard of care, consistent with the standard currently applied to investment advisers under the Investment Adviser Act of 1940, for all financial professionals who provide personalized investment advice to retail customers, whether those financial professionals are associated with broker-dealers or investment advisers, is among the most important investor protection initiative that the Commission could undertake,” stated the members of the Coalition (Certified Financial Planner Board of Standards, Inc. (CFP Board), Financial Planning Association® (FPA®), National Association of Personal Financial Advisors (NAPFA).

Most Republicans oppose a fiduciary standard. Republicans on the House Financial Services Committee are urging the SEC not to impose a universal fiduciary duty of care for retail investment advice. “It is our view that the Commission has not identified and defined clear problems that would justify a rulemaking and does not have a solid basis upon which to move forward,” stated a March 17, 2011 letter from Rep. Scott Garrett, R-N.J., chairman of the capital markets subcommittee, and 13 of his GOP colleagues on the panel, to SEC Chairman Mary Schapiro.

Some say that brokers shouldn't be held to the same fiduciary standards as RIA's because they're salespeople, not advisors. The SEC should concentrate on educating the public to the difference between product sales reps and investment advisors.

I wish the fiduciary requirement would also apply to insurance agents. Some states have imposed a suitability standard but only for annuities. The securities industry is far more regulated but only Registered Investment Advisors have legal fiduciary responsibility currently by law.

Being a fiduciary does not of course guarantee any results. It however means to make recommendations

you believe is in the best interest of a client. It does not mean only suitable, but perhaps having a higher commission to the registered rep vs. other options that may be more in the best interest of a client.

**SEC Required New Registered Investment Advisor "Narrative" Brochure** As of 3/31/2011 all Registered Investment Advisors were required to file "Part 2A of Form ADV" which is a total rewrite in narrative form of the prior disclosure document we give to all advisory clients.

It is estimated a third of advisors did not timely file due to the complexity of the requirements. Many securities lawyers are reporting they have had to turn away advisors because of a high demand.

I prepared and timely filed <http://davecfp.com/NarrativeADV.pdf> (near the bottom of the left frame at <http://www.davecfp.com>

**Summary** – *Markets will continue to be volatile based on daily events yet, some call the current equity market the timeliest in perhaps a generation for potential gains over the next few years.*

*Over the last 50-years 1961-2010, the unmanaged S&P500 index has had an average 9.7% total annual return. (Source BTN Research)*

*Although the outlook is good, there are market risks. I can recommend alternative opportunities without stock or most bond market exposure for more cautious investing, as well as more aggressive investment opportunities.*

**My Approach** - I do not recommend “dumb” index funds<sup>1</sup> or ETF's. I recommend managers with long track records of outperformance (Alpha in Modern Portfolio Theory) vs. risk taken (Beta), among other important factors.

I continue to be proactive, suggesting changes as warranted, to take charge of investment opportunities.

As there are always market risks, I recommend “participate yet protect” as much as possible strategies depending on individual investor objectives, investment time frame and risk tolerance.

<sup>1</sup>Investors cannot directly invest in indices. Past performance does not guarantee future results.

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