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An SEC Registered Investment Adviser
918 N Main Street, Salado, TX 76571
(254) 947-1111 or (800) 914-7526

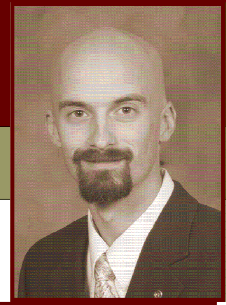
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THE WEALTH COACH LLC

Jeff McClure, CFP®

Jake McClure, CIMA®



jeff@tpwc.com

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jake@tpwc.com

TPWC Market & Economic Update

By Jeff McClure

A Decade of No Return

The Market that Went Nowhere

In my recent reading I have seen little evidence that much attention is being paid to the fact that we are at the end of the first decade of the 21st century. Part of that may be because we don't know what to call it. The '90s or '80s are a simple matter to name, but what do you call the first decade of a century, the "Ought's?"

The venerable Dow Jones Industrial started the decade having closed on December 29th at 10,769. This year on December 29th it closed at 11,585 having gained 7.6% in ten years. On January 14 of 2000 it had closed at 11,723, but the consensus was that this was a temporary downturn and we would soon again be seeing high double digit rises in the Dow each year. After all, we had just elected George W. Bush, a staunch conservative Republican as President of the United States following a bruising battle ultimately decided by the Supreme Court.

On the last market day of 2000, the S&P 500 closed at 1,320. As I write this, on December 31, 2010, it is at 1,259, 61 points below where it was a decade ago!

What that means for those who faithfully followed the dictates of the "efficient market" pundits and held faithfully to their S&P 500 Index fund of whatever brand, is that they effectively have seen a zero return after ten years of patient faith in index investing. After inflation the return goes negative.

It continues to amaze me that despite a decade of loss, the popular financial media still proclaim that investing in a broad market index like the S&P 500 to be the best and most efficient method to accumulate wealth for retirement.

The Management Advantage

The S&P 500 Stock Index is the prime example of what Morningstar Mutual Funds calls a *Large Cap Blend* index. While one cannot actually invest in the Index, there are funds that make a valiant effort to emulate the S&P 500, the largest of which is the Vanguard 500 Index Fund. The Investor class of that fund, primarily through re-invested dividends, managed to eke out an average annual rate of return of 0.71% for the last ten years ending in November. For

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Recovery & Danger

The U.S. Recovery Gathers Steam

A couple of weeks ago the GDP growth in the third quarter was retroactively adjusted to 2.6%. That, by itself is not a big issue. 2.6% is still below the long term norm and not fast enough to get the unemployment numbers down. What is encouraging is that the first numbers released were closer to 2%.

Economic change initially occurs at the margins, not in the middle. What that means is that it is in the nooks and crannies of the economy where the future can be seen. In a slowing economy the successive updates for GDP come in lower and lower while in an accelerating economy those later numbers come in higher.

Sure enough, here at the end of December new jobless claims fell to

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New Web Page and Blog

The Personal Wealth Coach has a new web-page that should be up and running by January 1. Go to either www.thepersonalwealthcoach.com or better yet, www.tpwc.com. We will be posting blog entries as events occur and beginning with the new year, pod-casts of our radio shows.

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Saturday Mornings 10:00-12:00 at: www.myktem.com or in Central Texas, 1400 AM

every \$100 held in the fund over the last decade, the largest and least expensive publically traded Index fund would have produced \$107.33.

Now for the real news. The *average* large-cap blend mutual fund tracked by Morningstar would have produced \$135.05 for the same period. In other words, ***over the last ten years the average large-cap blend manger outperformed the most efficient Index fund available to the public by a whopping 25.8%!***

As the late night commercial announcers so famously say, “*But wait! There’s more!*” If instead of believing in the Efficient Market Hypothesis, which claims that no fund can beat the market for an extended period of time and that an index will always beat a managed fund, you had been a bit more rational and researched the best long-term asset class, *and* used active management, you probably would have done even better.

Over the really long term (30+ years) the best performing asset class has been ***Mid-Cap Value U.S. Stocks***. Let me clarify that just a bit. It was not the highest return, but does have the best return for the risk level it brings. The actual best return record is held by *Diversified Emerging Markets* but the price paid for that return is the requirement to tolerate large, sudden downturns with sometimes many years until new highs are reached.

Mid-Cap Value has several indexes that claim to represent the class, but generally the average annual ten year return was around 7.5%. Ten years ago there were simply not any index funds to use in that class, so an investor could not have “indexed” there. What an investor could have done was to

select from the better long term performers in that asset class from the active management funds. Had an investor done so back at the end of 2001, ***the hypothetical \$100 would have become \$241.78 by the end of last month***¹.

The Lesson to Learn

That number is drawn from the average of the historically better performing funds that were available ten years ago¹. Unfortunately for them, with the barrage of publicity claiming the S&P 500 Index funds were the only reasonable choice for an intelligent investor, it is unlikely that there were many who diversified among the better Mid-Cap Value managers.

Today the consensus seems to be that gold or some form of bond investing or even guaranteed return investing is the only rational approach to the market. Given the near certainty that interest rates will rise at some point in the next decade, that belief may well be at least as flawed as the faith in the Index was a decade ago.

The critical lesson here is that whatever the popular media declare to be the absolutely best and only reasonable investment class is probably due for a massive fall within the next few years.

Here at the end of 2010 we are starting to see investors move out of bonds and into equities (stocks), which bodes well for all of us. The money continues to pour into gold though and given the generally unregulated and currently irrationally priced market for that metal, it is likely that at some point in the next few years a sudden “crash” in gold prices will occur.

Another truth about asset class manias, or bubbles as they are sometimes called, is that they can go on for a very long time. The same applies to asset classes that

are irrationally undervalued. Just as the S&P 500 large-cap stocks were first overpriced and then massively overpriced in the late 1990s, during that same period smaller sized companies in many cases had stock prices that were at a ridiculously low valuation for several years.

No Need to Rush

There is both good news and bad news in those observations. The good news is that there is no rush to move into or out of any given asset class. Yes, Mid-Cap Value as an asset class had magnificent performance over the past decade, particularly when compared with the broad U.S. equity markets, but the window to move into that asset class and profit from the move was actually several years long.

The bad news is that it is very, and sometimes, extremely difficult to have one’s invested money in a set of asset classes that are undervalued while some other class has year after year of outsized gains! That was certainly true in the late 1990s and for some it is very true today when gold is soaring to absurd heights.

At this moment in time we are moving from European Large-Cap Value stocks into other areas. While the danger is very real of a European market collapse as the still unresolved sovereign debt crises slowly unfolds, the key is that the danger is well understood and the time frame is measured in months, not days or hours.

In essence, recognizing that any class of investment that rises rapidly to absurd levels will likely come down very fast combined with the recognition that good management generally outperforms no management are two keys to long term success. \$\$

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a seasonally adjusted 388,000 nationwide for the week. Now the thing to watch is the four week moving average of net jobs added. While all of 2010 saw job gains of about 90,000 per month, we need over 100,000 to just break even. Surveys of business owners and decision makers indicate that the number should creep up to around 160,000 for 2011.

The other number we need to watch for is the 4th quarter GDP number. If as it is widely predicted the annualized domestic growth of the U.S. economy jumps to 4% we are on the way to full recovery.

Stimulus and Response

There have been many pundits who have loudly proclaimed that the government stimulus measures have not worked. The reality is that they have. Inflation is and has been effectively at zero for the last two years while we have been inching back to a growing, healthy economy.

Compare that with the Europe Union where there was no coordinated effort to create a stimulus package because there was no central government to coordinate that action. As recently as a month ago the head of the European Central Bank (ECB) was criticizing Federal Reserve Chairman Bernanke for the announced plan to purchase Treasury Notes on the open market. Since then the ECB has had to plunge full force into purchasing sovereign debt of Ireland and will almost certainly have to do the same thing for Portugal in the near future.

Absent stimulus, the economic recovery in Europe is in severe danger of collapsing into a series of defaults, high interest rates, and possibly a failure of the Euro. At the very least the ECB, backed by the German government has the unpleasant

choice of cranking up the money machine at full capacity or seeing Europe sink one nation at a time.

A New Round of Stimulus

The passage of the extension of the “emergency” tax cuts originally enacted under the Bush administration combined with an extension of unemployment insurance and a significant reduction in Social Security taxes for 2011 will put about \$1 trillion into the pockets of Americans that otherwise would not have been there. That increase in spendable income coupled with the \$600 billion being pumped into the banks by the Federal Reserve may be just what the doctor ordered.

It is notable that only with all of those actions in place are we seeing banks start lending again, employers suddenly willing to hire more employees, and consumers beginning to spend on durable goods.

Perhaps most encouraging of all the data is the reading of the Chicago Business Barometer, a survey of regional purchasing managers which is one of the most reliable long term leading economic indicators. Last Thursday it was announced to be at 68.6, the highest it has been in 22 years! Once again the signal is in place that business decision makers are reaching the conclusion that we have turned the corner.

Last but not least in the good news area is one of my favorite indicators, tourism spending. The Commerce Department announced that domestic tourist spending, which is Americans spending tourism money in America, is up 8% year over year. People who are afraid of financial failure tend to cut vacations first. Once expenditures on domestic tourism go up things are getting back to running on a more normal track.

Things to Concern Us

The issues that could knock us

back into troubled territory are largely out of our control. What we can do is watch and hope the central bankers and national governments involved make wise decisions.

1. The Euro Zone

The Euro Zone is in deep trouble. The ultimate result lies in a combination of willingness of the German voters to, in essence, bail-out several countries, and those countries willingness to in effect submit to German financial rule. Greece is now effectively subject to executive orders from Germany regarding its every economic move. Ireland has submitted to the reality that its government and its banking system are under the authority of its German creditors, and will be for many years to come.

Next on the watch list are Portugal, Spain, and Belgium. Belgium has the advantage of having a reasonable rate of growth, but is carrying a sovereign debt that is rapidly becoming a multiple of its annual GDP. Portugal, like Greece, has little growth, an aging population, and more debt service Euros to pay than it can make in a year.

In each case it is ultimately Germany that must come to the rescue of those nation-states. The Germans are unhappy that their hard earned savings are being shoveled out to free-spending countries facing financial collapse, but much of the debt those countries have accumulated resulted from the purchase of German goods and services. Germany's recovery from its reunification and strong growth since has largely been based on exports to Euro-Zone nations who before the common currency introduction were simply too poor to afford all those finely made German goods.

Like GM, Germany not only was willing and ready to sell them the goods, but had a great long term

finance package to allow them to make the purchases. Unfortunately, like many another entity that was in the business of financing its own sales to less well off customers, Germany got caught in its own export trap. Failure to prop up its customers would result in a huge blow to the German economy and banking system.

The big question is whether the German people will be able to keep shelling out Euros to people and nations who are not longer going to be able to buy those goods. If the voters in Germany determine that as a matter of principle they need to stop propping up the “deadbeats” then Europe could easily find itself in a serious financial crisis.

For better or worse, we live in a very closely interlinked world. A major financial crisis in Europe would have implications here. This is not news to either the Federal Reserve or the Treasury Department. As a result, both are doing what they can to provide support to the ECB in its efforts to stabilize the situation.

If the Eurozone partially collapses it will be a negative for our economy as we export a lot of goods and services to the Europeans. On the other hand, because our economic leaders are and have been so aware of the risks we have almost certainly made preparations for the possibility.

2. The Economy Doesn't Get Better by the end of 2012.

The effective stimulus passed by Congress and signed into law by the President in the form of the Job Creation Act which extended the Bush tax cuts and created several stimulative cash-flows to lower income people appears to have pushed the

economy past the tipping point into self-sustaining growth. The combination of the remainder of the 2009 stimulus bill with the bill just passed will pump over a trillion dollars into the economy before 2013.

The problem arises when the stimulus runs out. Either at that point we have an economy ready to go off of life support or we could be in for a big fall. Just ending the stimulus effect by itself will probably be sustainable at that point barring some unexpected shock. The critical issue is that we have just elected a set of fiscally conservative members of the House of Representatives. Under the Constitution, spending bills must originate there and I would be quite surprised if the Republicans did not follow through on their pledge to cut spending.

Cutting spending is a nice concept, but it means that people will lose their jobs. It will require new laws to be passed by both the House and the Senate and signed by the President to touch the bigger areas, and that will not happen. All that is left are things like the federal funds in the “No Child Left Behind” program. That means that school districts will be laying off teachers.

If municipalities have not seen a fairly significant increase in revenue between now and then the current rising lay-off rate of local government employees will become an avalanche as federal funds dry up. If the private sector is up to speed the local taxes will cushion that and some of those local employees will be able to find employment in the private sector. If not, things could get dicey.

3. China has a Hard Landing

China injected about twice the

stimulus money into its economy that we did in terms of a percentage of GDP. As a result the downturn virtually did not happen there. What did happen was a lot of economic activity and loans that had little or no economic validity. In other words, a bubble.

China is today experiencing a real estate boom that looks an awful lot like the one we had five years ago. While annual inflation for the first six months of the year only ran at about 5.5%, in the third quarter it jumped to 10%. That has the Chinese government worried, with good cause.

Unfortunately, for the Chinese banking and government authorities, this is a new phenomenon. The driving factor in all things done by the Chinese government is the maintenance of stability at all costs. As a result, the increase in rates of only 0.25% by the Central Bank of China is probably far, far too little. If inflation starts to get out of control, a typical governmental response would be to clamp down hard. If that happens it could result in a sudden, hard recession in the Chinese economy. The Chinese buy a lot of goods from us (and a lot of bonds). The potential is there for a problem in our economy.

The Bottom Line

If our economy gets rolling again, we can weather all of those issues, and the mere fact that we are up to speed may just prevent any of them from happening. The odds are in our favor, but we need to keep watching. Meanwhile a combination of Markowitz asset class optimization and careful observation of valuations and managers appears to be the best option for all of us.

1. Using Morningstar Principia the three mid-cap value funds with the best historic record from 1990-1999 averaged together for the decade ending in November 2010 produced a 9.23% average annual rate of return net of all fees and expenses but not taxes.

Past performance is no guarantee of future returns. For tax or legal issues consult with a qualified tax advisor or attorney. Information in this letter should not to be used as investment advice. Individual portfolio design must be tailored to individual needs, values, risk tolerance, and objectives.