

Lowly Analyst Newsletter

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The Market

Investors and their advisors are entering March jittery and with recession fears. The Wilshire 5000 declined 3.8% in the 12 months to February. However the World minus US increased 4.5%, Canada was up 27%, Brazil 85%, Russia 15%, India 43%, China 48%, BRIC (Brazil, Russia, India, China) 66%. Clearly, BRIC is where the action is.

Many economists hold that the US will escape a recession. I believe for all practical purposes we are in a recession, no matter what the statistics say. In a recession, housing prices typically increase in \$ terms since they are a fixed asset. However people are losing their homes and getting a loan is difficult.

Election uncertainty is adding to market worries. Most worrisome is that both Hillary and Obama talk about trade restrictions. Both Hillary, and particularly Obama, have a record of free trade in the past.

Officially consumer prices are up at 4.3%, purchasing power of wages and retirement income are declining. Inflation and the stock market do not go in lockstep. The market is forward looking. Domestic earnings are dreadful. 4Q GDP growth was 0.6%. Profits generally fall when GDP growth is below 1.5%.

Asset Classes: For Feb., small value up 9%, mid growth down 1%, large growth down 2%, small growth down 3%, micro down 3%, mid value down 3%, large value down 4%.

Sectors: For Feb. Silver up 17%, Steel 14%, Metal & Mining 13%, Agriculture 12%, Oil Equipment & Srvcs 11%, GSCI Commodities 11%, Oil 11%, Energy 9%, Natural Resources 9%, Gold 5%, Global Materials 5%, Basic Metals 4%, Swiss Frank 4%, Euro 2%, Intl. Utilities 0%.

Foreign Investing: For Feb. Taiwan up 13%, Brazil 9%, Latin Am. 8%, Russia 6%, Canada 6%, BRIC 5%, Sweden 4%, Switzerland 2%, Austria 1%, China 1%, Australia 1%, Mexico 0%, World-US 0%, Europe 0%, Emerging Markets 0%, Singapore -1%, S. Korea -1%, Japan -1%, US -2%, Pacific-Japan -3%, Malaysia -4%, Hong Kong -8%, India -12%.

Live It Up Without Outliving Your Money

1. Introduction

We are reviewing Paul Merriman's book *Live it Up Without Outliving Your Money*, published in 2005. Merriman is an advisor turned journalist. The book is easy to read and is intended to educate individuals that have a financial advisor. The following charts show his data.

2. Successful Money Management

1. Don't let your emotions dictate your investments and trade too much. This is your biggest danger.
2. Find out what is important to you.
3. Identify your financial goals.
4. Develop a written plan.
5. Take an appropriate amount of risk.
6. Use qualified plans [IRA, 401(k), 403(b) if available].
7. Don't buy illiquid financial products (annuities, alternative investments).
8. Don't emphasize short-term performance.
9. Focus on asset allocation.

I would add:

10. Prepare a portfolio policy statement.

Merriman deals with returns instead of purchasing power; he does not emphasize investment expenses and taxes.

3. Risk Return

Generally returns are related to risk, as shown in Figure 1 for the period 1974 - 2004. Here Merriman uses 12 month nominal (portfolio value) loss as his risk measure. A better measure would be loss in purchasing power that considers inflation.

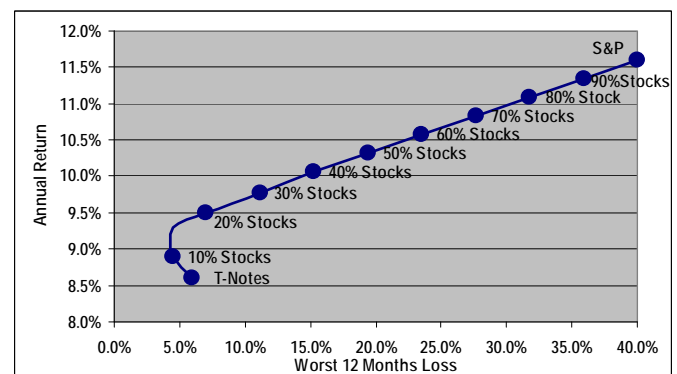


Figure 1 S&P Return vs. Risk

4. Small Cap Funds

Figure 2 shows changes in risk return as small cap funds are added to the S&P for the period 1974 - 2004. Unfortunately in Fig. 2 and the following figures Merriman measures risk in standard deviations and not 12 months loss. Small cap funds are stocks with asset value (price time shares outstanding) between \$300M to \$2B. Each mark is an additional 10% of small cap. Both return and risk increase as small caps are added. Returns increase sharply at first. Above 40% small cap returns continue to increase slightly, but risks increase even faster.

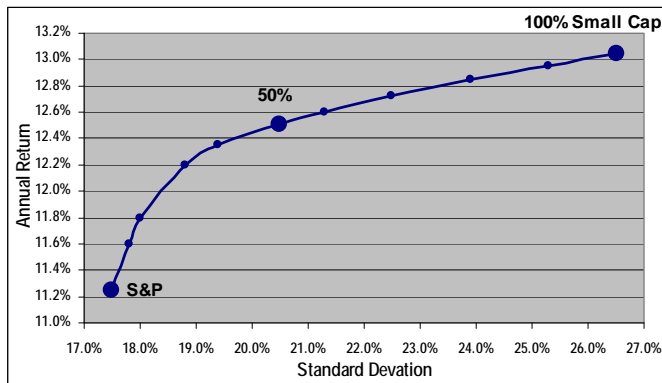


Figure 2 Adding Small Cap

5. Value Funds

Figure 3 shows changes in risk return as value stocks are added to the S&P for the period 1974 - 2004. Value stocks are stocks that are inexpensive by price to book value. Generally both return and risk increase as value stocks are added.

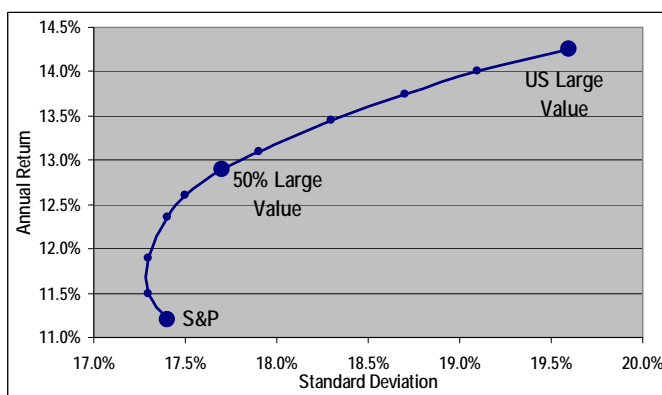


Figure 3 Adding Value Stocks

Value stocks are stocks that are out of favor. The opposite are growth stocks, with growing earnings that most investors like and therefore pay too much for them. Stocks are valued on future expected performance. In analyzing stocks one should not look at the last year or at earnings projections, but at several past years and then use an average.

6. Foreign Stocks

Figure 4 shows changes in risk return as foreign stocks are added to the S&P for the period 1974 - 2004. As foreign stocks are added risk decreases and the return remains essentially constant, up to 50% in foreign stocks. The reason is increasing diversification. Traditional low correlation between domestic and foreign stocks is increasing. Beyond 50% the return decreases, but risk continues to increase.

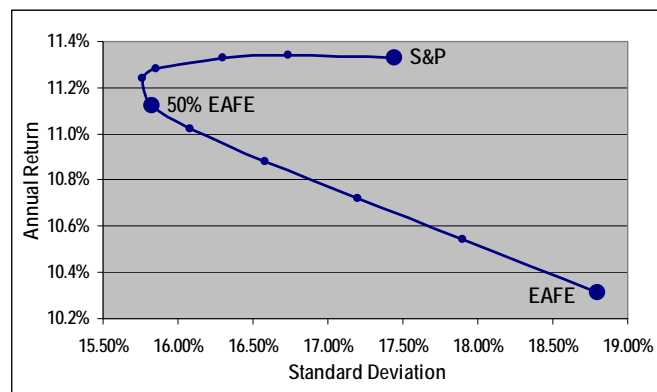


Figure 4 Adding Foreign Stocks

7. Merriman Model Portfolio

Below is one of Merriman's well diversified portfolios. Merriman prefers portfolios consisting of Dimensional Fund Advisors (DFA) funds. Since these funds are available only through a few highly selected advisors (including this lowly analyst), and not to individuals, I am not showing any of those. Merriman also recommends a 50% Bond/Stock split for retirement portfolios.

Merriman Equity Portfolio

US Large Cap Blend	12.5%	FSMKX
US Large Cap Value	12.5%	VIVAX
US Small Cap Blend	12.5%	NAESX
US Small Cap Value	12.5%	VISVX
International Large Cap	10.0%	FSIIX
International Large Value	10.0%	VTRIX
International Small Cap	10.0%	FISMV
International Small Cap Value	10.0%	TAVIX
Emerging Market	10.0%	VEIEX

8. Take Aways

- Returns generally increase with risk.
- Adding a small amount of small cap, value, and foreign stocks increases returns while decreasing risk, up to a point. Beyond that point risk increases while returns do not.
- It is very important to hold a diversified portfolio since diversified portfolios reduce risk.
- Some stocks should be held to generate returns; some bonds to reduce the risk to acceptable levels.