

No Pain, No Recovery

By Maye Albanez

The most important contribution of your investment counselor is helping you find the proper balance between risk and return in your portfolio. Historically, stocks have outperformed bonds and cash. According to Ibbotson records from 1926 to 2002, average annual returns for stocks were 12%, bonds were 5.5% and cash was 3.8%. It is well known that higher returns come with higher volatility (risk). The three asset classes are combined in a portfolio because there is little correlation between them. When stocks do well, bonds normally do not, and vice versa. Establishing the proper weighting of these assets in your portfolio, and still meeting your investment objectives, is commonly known as asset allocation.

At Clifford Associates, we do not rely on precise equations or specific formulas to arrive at asset allocation decisions. Instead, we have many discussions with you at the beginning of our relationship. From those early meetings, we assess your return and income goals, your risk tolerance, your tax situation, your legal situation, your liquidity needs, and anything else about you we feel is

relevant to your investment objectives.

To us, the most critical piece of information about you is what stage of your life you are in, and how that relates to your current portfolio assets. Are you still working or have you retired? Is the portfolio your only source of support? Do you have significant other assets? Are you saving the portfolio for your heirs? Often, the longer the time horizon we have to work with on a portfolio, the higher the risk the portfolio can afford to take, and vice versa.

A clear illustration of the above is the difference between Client "A," a retired person who depends on his/her portfolio and Social Security income for survival today, and Client "B," the forty-year old who is still employed and is building a portfolio for anticipated retirement in 25 years. It goes without saying that Client "B" can afford to take more risk than Client "A."

It is important to realize that asset allocation decisions are not cast in stone. Life circumstances change, and as that happens, asset allocation decisions should and must be



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Bonds Just Bonds

By Randy Zaharia

Most of you probably do not often think about the value added by the bonds in your portfolio. The most obvious benefit of bonds in a portfolio is to provide balance and diversification across asset classes. (*See related article, "No Pain, No Recovery"*). Over the last two years, the stock market has declined more than 20% annually. During the same time period, bonds have returned about 11% annually, providing a counter-balance and minimizing portfolio deterioration.

At Clifford Associates, we follow a structured process prior to selecting bonds for our clients' portfolios. Several of our investment counselors have handled bonds for 20 or more years, providing significant experience and expertise. Below is a typical list of items to consider:

Yield Curve

We analyze the yield curves (taxable and tax-exempt) to determine what market expectations are and compare them with our own.

Maturity

We identify attractive maturities inside the short to intermediate areas for purchase. We usually do not buy long-term bonds.

Issuers

We review and analyze bond issuers and their credit support, in order to maintain a high-quality portfolio.

Sector

We evaluate various bond sectors (e.g., government bonds and municipal bonds) for relative attractiveness.

Taxes

We factor in tax consequences (e.g., capital gains/losses) of not only your bonds, but your entire portfolio, trying to minimize adverse tax situations.

Once we assess the issues above, we generally utilize as many as 10 to 15 brokers and dealers who

provide us an extensive inventory of bonds. Many of those brokers have had relationships with Clifford Associates and/or our counselors for 20 years plus, which ultimately allows us to provide "best execution" to our clients.

To illustrate the impact of "best execution" as it relates to bonds, recently we sold a \$100,000 par value municipal bond on behalf of a client. We gathered three bids from three different brokers: 102.077, 104.947 and 105.432. We sold the bond to the highest bidder. By doing so, our client collected \$3,356 more than if he had sold the bond to the lowest bidding broker—a difference of over 3%. We find similar pricing inconsistencies on both buys and sells.

Another interesting impact of our analysis occurred in recent months. We witnessed a shortage of California short-term insured municipal paper. The shortage of these bonds, coupled with the high demand for them, created an artificially expensive (low yield) market in California bonds. If we had funds available for investment and if appropriate, we purchased insured, out-of-state, non-California municipal bonds with two-to-five-year maturities for our California resident client portfolios. Even after factoring in additional state income taxes, these non-California bonds provided an additional 0.2% to 0.4% yield when compared to insured California municipal bonds—a relative increase in yield of 10% to 15%.

Another example of our bond contribution relates to the precipitous decline in interest rates. Thirty-year fixed mortgage rates are currently below 6%, 10-year Treasury rates have declined to 3.6%, while long term California municipal bonds yield 4.5% today. Many of these rates are at their lowest level in 40+ years, raising concerns about potentially increasing interest rates down the road. The result is our focus on shorter maturities, where price deterioration is less relative to longer bonds.

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Looking Beyond the Vale

By David Andrew


The market is most dangerous when it looks best; it is most inviting when it looks worst. Advice from Frank J. Williams, a successful investor of the early 20th century, provides some hope to today's investors facing the worst market slump in 30 years. The number of stocks taking big hits has now spread far beyond dot-coms and telecom companies to many one-time stalwarts. Certainly, there has been no shortage of pessimism during this lengthy bear market. Some say that investors have gone from "irrational exuberance" to a state of "irrational despondency." We must remember in trying times like these that the pendulum swings both ways.

History has proven over the years that markets do eventually recover. In fact, the present market environment could create enormous opportunities for investors willing to increase their stock exposure at drastically reduced prices. Down markets also provide us the opportunity to buy shares in some companies that have looked attractive – but overpriced – for some time. Once investors decide that the outlook for the economy and stock prices is not as bad as they currently fear, stocks should benefit from the mountain of liquidity now on the sidelines. Professor Jeremy J. Siegel, who has extensively studied the stock market, recently commented: "History is definitive that once investors have suffered this much pain, subsequent stock returns will be very rewarding."

As our economy strengthens, the stock market pendulum could begin swinging in the opposite direction. Many U.S. corporations have adjusted to these leaner times through expense reductions and delayed capital improvements. As confidence builds in the strengthening economy, corporate earnings and cash flow will improve. Increased corporate spending should also fuel further recovery. Eventually, we will experience both an economic and stock market recovery – and it could be a powerful one. Investors have not forgotten that common stocks have clearly provided the best returns over long periods of time.

The market has already surpassed the 48% peak-to-trough loss of the 1973–1974 bear market. Yet, despite the many issues facing investors today, there is no comparison to the crisis in confidence we faced during the last major bear market. Many will recall the Watergate scandal, the OPEC instituted oil embargo, block-long lines at the gas station, wholesale prices jumping 21% in the aftermath of the Vietnam War, and a 6% U.S. unemployment rate – the worst since the 1930's. It is important to remember that the 1973–1974 bear market had an end. In the years that followed, stock prices recovered, and investors prospered. Just as it would have been a mistake to lose faith in the stock market during the mid 1970s, so too would it be now.

Today, inflation is nearly non-existent, short-term interest rates are below 2% and falling, mortgage interest rates are the lowest in a generation, property values are at record highs and most companies are experiencing moderately improving trends. Also, while the Standard & Poor's 500 Index has fallen almost 30% this year, most clients of Clifford Associates with balanced portfolios have done substantially better. Clients would normally be quite pleased if they were able to "beat the market" by 10 to 15 percentage points. This should apply in both good and bad markets.

Historically, investing in common stock has been an attractive route to accumulating wealth. Despite occasional rough patches, stocks are still the best long-term investments for the preservation of purchasing power. As we finish off another year, it is worth remembering a few facts based on U.S. history: the scars which have shaken investor confidence will eventually heal, the economy will recover and common shares can move dramatically in a positive direction. Time and again throughout the last two centuries, American society has demonstrated an incredible capacity to heal and reform itself. We are confident it will do so again. 

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reevaluated. This is part of the ongoing service we provide to you.

In today's market, as you watch the stock market decline, keep in mind that your investment counselor at Clifford Associates took into consideration what level of risk you could afford to take. An appropriate asset allocation was selected accordingly, with full knowledge of the historical performance of securities. Provisions were made in your portfolio for upcoming liquidity needs and/or potential reversals in investment returns. In general, balanced portfolios have fared substantially better than all-equity portfolios in this recent bear market.


If you are new to Clifford Associates and we started out with a cash portfolio or one with no capital gains tax implications on sales, we also established a long-term asset allocation for you. However, recognizing the risk in the market over the past few years, we have moved cautiously buying stocks. In many cases, we have avoided buying certain stocks on the basis they are too pricey, and in others, we have bought partial positions of stocks knowing they could go lower. At the same time, we have accumulated substantial reserves (cash and bonds) in the portfolios. As the market begins

to recover, we will shift some funds out of reserves into stocks.

These are trying times, and we understand that. We realize the last time we had three negative stock years in a row was 1939 to 1941. We also know that when the market recovered after those three negative years, it was followed by four positive years with annual returns ranging from 20% to 36%. In 1973 and 1974, stocks were down for two consecutive years. In 1975 and 1976, the stock market returned 37% and 24% respectively.

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We have no way of knowing how long this bear market will continue, but we do know the dangers of exiting a bad market at the bottom. History has shown us many times before that when the market bounces back, it may recover rapidly in a very short time period. This is why efforts to time the market are largely futile. If you want to participate in the recovery, which will come, you have to endure the pain and remain invested.

The best advice we can give you is to stay focused on the long term, and on the original parameters which we discussed when our relationship began. As long as your time horizon allows, and you have adequate liquidity, the best decision is to retain the current structure of your portfolio. 

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A majority of our recent bond purchases have been in the two- to- four year maturity range. In addition, we are in the process of evaluating the longer maturity bonds, along with many of our fixed income mutual funds. In both cases we are considering shorter maturity alternatives to replace them. 