LFM&P

LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.
REGISTERED INVESTMENT ADVISOR

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Outlook & Trends

The economic expansion has taken firmer root over the last three months. The statistics point to improving conditions, but the increasing volume of political claims and counter-claims in this election year make it easy to lose focus on reality. To stay on course toward your financial goals, it is helpful to maintain an accurate perspective of where we are in the continuous flow of economic events, as well as having a sound investment strategy and a financial plan as a guide. Hopefully this letter will help you with the perspective.

Economy

The growth rate during the 4th quarter of 2003 slowed down to a more sustainable annual rate of 4.1% from the 8.2% reading during the 3rd quarter of 2003. All indicators are up. Even the employment picture is improving. The central theme of the recovery thus far has been the tremendous increase in productivity. Businesses are able to produce more, with fewer people working, as they use the efficiency and excess production capacity built up during the last recession. The importing of services from other countries (also known as "outsourcing" jobs) probably adds to this effect, although the overall impact is likely to be minor. Available capacity and low payroll growth continue to produce low inflation. Over the last year, consumer prices rose 1.7%. In addition to slower employment growth and low inflation, the other important aspect of this recovery has been continued low interest rates. The very same excess capacity and importing of low cost foreign products and services have brought about deflationary pressures that have compelled the Federal Reserve to keep interest rates low. As the tempo of business activity continues to increase, employment, interest rates and inflation are very likely to follow suit.

Financial Markets

Business profits have been increasing rapidly in tandem with the increases in productivity. Profits reported for tax purposes are well above those at the economic peak in 2000. Reported per share earnings of the S&P 500 companies, while still below their peak, are rising strongly, and financial analysts expect the trend to continue. Expectations of higher profits and lower interest rates drive stock prices higher. Because of higher expected earnings and current low interest rates, the value of stocks relative to bonds is no higher than it was a year ago near the stock market bottom. This significant imbalance can resolve itself by bonds falling (interest rates rising), stocks rising, or a combination of both.

Investment professionals and traders try to anticipate the future, which is why stock prices are a leading indicator of economic events. The stock market begins to rise before the economic indicators signal a bottom and begins to fall before a recession is apparent. Sometimes the anticipation is incorrect, which results in a bull market correction or a failed bear market rally. Often the anticipation is too optimistic and stock prices rise more than they should. Sometimes the consensus is overly pessimistic and stock prices fall lower than their fair value. Despite expectations of significant profit growth, stock prices finished the first quarter with mixed results and the Dow Industrials and NASDAQ posting losses, as excess optimism was scaled back. The consensus of investment advisors, which we have mentioned in previous letters, has maintained a record bullish level for almost a year. It recently dropped to a more normal (but still high) bullish percentage of 65% as enthusiasm waned a bit.

Investment Management

It is important to not only keep an eye on what should be happening based on the economy and profits, but also on what is really happening to investment prices. All bear markets begin as corrections when economic conditions could not look any better. Bull markets begin as "short-covering" rallies when conditions could not be worse. As Martin Zweig, a long-time market advisor has said, "Don't fight the tape", referring to the prices on the ticker tape, one should not assume the market is wrong. An interesting characteristic of the stock market is that it generally will not do what the majority of people think it should. The seeming ability to confound is inherent in the dynamics of an auction market. Investors tend to get more optimistic as prices rise. At a market peak, the last person to become an optimist and is willing to pay the price, buys stock. At this point, being an auction market, there are no more bidders, just when everyone is most optimistic (and fully invested). When there are no new buyers, prices fall.

Because of this reverse reaction to the prevailing sentiment, investing on an emotional level is likely to produce disappointing results. The tendency is to be too conservative when values are rising after a bear market and, having missed out during the rise, to be too aggressive at the beginning of the next bear market as values begin to fall. This leaves two alternatives for success:

- The first, which may require some fortitude, is to structure a static portfolio that fits your financial plan and your ability to tolerate risk, and stick with it, ignoring the economic and market cycles. This pre-supposes that you have developed, and have confidence in, your financial plan. If you do not have a plan in which you have confidence, it becomes all too easy to make investment decisions based on emotion, often at the wrong time.
- The second alternative is to develop a financial plan and follow a dynamic strategy that reduces risk when prices are falling and increases market exposure when prices are rising, following Zweig's admonition to not "fight the tape". This approach is intended to reduce risk, and make it easier to not let your emotions disrupt your strategy. A pre-requisite to this approach is to have an objective, non-emotional method designed to monitor and respond to market conditions, such as *LFM&P*'s MarketAware^{SM} approach.

LFM&P can provide you with either static allocation or dynamic MarketAware^{SM} investment management services. If you would like help managing your investments or planning how to reach your financial goals, please give us a call.

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Linnard Financial Management & Planning provides investment management, financial planning and financial analysis services for people who value unbiased assistance and advice. We believe that people in all stages of financial growth and maintenance can benefit from personal assistance that is focused on their individual goals and needs. Since we sell no products and accept no commissions, we are able to evaluate the best solutions for each client. Our mission is to know each client personally and design and manage financial solutions that match their needs and goals. We will be happy to help you analyze a financial question, plan and achieve your own path to financial success, or help you manage your investments.

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