LFM&P

Your Personal Financial Advisor

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Outlook & Trends

The economic expansion is fully underway. Investments in stocks, bonds and real estate are all behaving differently today than they did a year ago. 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

Talk of a jobless recovery has dissipated as the economy has added almost a million new jobs in the last three months. The Federal Reserve has become confident enough of the sustainability of the recovery that they have begun to raise interest rates again. This does not mean that they are tightening yet, just taking away some of the extra economic fuel. The growth rate during the first quarter of 2004 was 4.4%, a bit higher than the last quarter of 2003. All indicators are up. Consumer confidence, dragged down by the Iraq situation, is back to a fairly normal level after rising fairly steadily for a little over a year. Corporate profits, a main driver of stock prices, are rising strongly. Along with the economy, consumer prices are rising more strongly as well, with gasoline being the prime example. For the moment, the specter of deflation is gone. This condition may be true for some time, if the government budget deficit is not controlled. Globalization and the accompanying growth of imports and outsourcing of jobs, however, may continue to put downward pressure on price increases over the long term.

Financial Markets

If all the news is good, why is the Dow Jones average just about where it started the year? Other than profits, interest rates are the second important driver of stock prices, so rising rates puts a damper on stock prices as well as bonds. The Federal Reserve had been telegraphing yesterday's increase in the federal funds rate since the beginning of the year, giving investors a chance to reduce positions that took advantage of low rates. As these positions unwound, long-term rates rose significantly, putting pressure on both bonds and stock prices. Ten-year Treasury bonds now yield about 4.7%, almost exactly the four year average of 4.73%, but are likely to go higher before the recovery is over. What does this mean for stocks? If interest rates become steady for a while, after the Fed's accommodative posture is removed, and profits continue to rise with an expanding economy, the economics suggest that stock prices will rise. In fact, the "Fed model" suggests that stocks are still 24% undervalued in relation to bonds, an amount that has not changed very much since the beginning of the recovery. As profits rise, lingering concerns about high price/earnings ratios may dissipate as well.

Investment Management

Financially aware people know that building savings for retirement and college expenses is critical these days. Companies have placed the responsibility of building retirement savings on employees by shifting retirement benefits to 401(k) plans. People nearing or in retirement have an even more critical task: to maintain asset growth ahead of both their income needs and inflation, because they no longer have the ability to catch up through salaries. Over a financially successful lifetime, financial investments will grow larger and become more important than real estate, and will provide an important income stream to live on. The problem is that many people find management of their investments confusing, and have not taken the steps to appropriately structure these most important of personal assets. If you, like the majority of people, find yourself in this category, you may want to consider the following brief ideas:

- The buy-and-forget strategy that worked well in the 1990's may not work as well in the 2000's. Conditions have changed and active investment management may be necessary to reach your goals.
- Proper diversification is important. One of the major benefits is that when one kind of asset "zigs", another "zags", so the movements tend to balance out and reduce overall risk.
- The mixture of assets you choose determines the amount of risk in a diversified portfolio, as well as the potential return. Studies have shown that if you have a diversified portfolio, 91% of your portfolio results depend on the asset allocation mixture and only 5% depends on the individual stocks you or your mutual fund managers choose.
- The asset mixture that is appropriate for you, and its accompanying risk level, depend on your stage in life and your individual circumstances. Consider generalized recommendations carefully before adopting them. What is right for one person may not be right for another.
- Mutual fund expenses, while often hidden, are important to you. They directly reduce your return. You pay sales fees ("loads", or "surrender charges" in the case of annuities), management expenses, and 12b-1 distribution fees. It has not been shown that paying any of these fees improves returns. Buy no-load mutual funds.
- Many people have acquired a collection of IRAs, old and current 401(k)s and brokerage accounts that include a variety of different mutual fund fee structures, and possibly even an annuity or two thrown in. Simplify if you can. Fragmented accounts limit your flexibility and make management difficult.

For many, it is important to get the management of their investments back on track after a period like the 1990's when almost anything worked. We encourage those of you who have the time and inclination to actively manage your investments to consider these ideas and make sure you remain on course to fulfill your goals. For others, we encourage you to engage a financial advisor who will give you on-going and personal advice, active investment management, and make sure that you have addressed these issues in your investment structure.

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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