

JOSEPH CAPITAL MANAGEMENT, LLC

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CAPITAL MARKETS COMMENTARY

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UNCERTAINTY, THE SCIENCE OF INVESTING, AND EXPECTED RETURNS OF VARIOUS ASSET CLASSES

Uncertainty. It's often said to be the only "certainty" as to what the future of investing holds.

Yet, probabilities can often be quantified. Uncertainty is really about *unknowable probabilities*, not probabilities which we know about.

For example, we know that today, armed with computers and databases of historical information, we can test various investment strategies to find those that "stand the test of time."

And we can discern from analysis of the data many observations, including the historical success of various investment strategies (in both U.S. and foreign capital markets). The results – if confirmed by peers in academia and in industry research centers – can then serve to guide us in the future management of our client's investment portfolios.

The Science of Investing. That's what the *Science of Investing* is all about. It is not our attempt at "guessing." Instead, we apply the lessons learned from sound academic research to improve the odds, often substantially, of investment success.

All this is not to say that we can predict the future. We don't make such claim, and we are highly suspect of those that do profess to have a consistently working crystal ball.

We are pleased to announce the return of Ron's *Capital Markets Commentary* – a more in-depth periodic look at investment principles, risks, expected returns of various stock asset classes, and observations about the economy, and what all this means for investors.

This *Capital Markets Commentary* will be produced occasionally and distributed to our clients and friends. Our monthly newsletter, *Wealth Perspectives*, will also continue – with articles of more general interest.

For example, we always *knew* that stock markets don't always go "up" – and we repeatedly warned our clients of this fact (and continue to do so). In fact, on a calendar-year basis from 1926 through 2008, the S&P 500 Index had 59 "good years" – but it also had 24 "bad years" (years with negative returns). Looking deeper, we find that over the same period the S&P 500 Index (with dividends reinvested) had 616 months of positive returns, but also had 380 months of negative returns.

Some Risks in Investing are (with a High Degree of Probability) Compensated, Some are NOT

Adequately Compensated. Risk should be rewarded. We can observe that some types of risk, such as exposure to the overall equity (stock) markets through a highly diversified, tax-efficient portfolio, are typically compensated over longer periods of time. We also know that certain risks are not adequately compensated with a high degree of probability, such as investments in concentrated stock positions.

The Expected Returns of Various Asset Classes. Risk should be rewarded, especially over the longer term, but we observe that "starting points" also plays a critical role. In essence, if today high valuations exist for an asset class, there is a high statistical probability of lower inflation-adjusted returns over the future 15 years. Similarly, if low valuations for an asset class exist today, expected returns over the next 15 years are likely to be somewhat higher for that asset class.

One of the many aspects of investing we study is the longer-term (next 15 years) expected return of various asset classes. In our search for asset classes (consisting of diversified portfolios of individual securities with common characteristics), we look for those particular asset classes which are likely to possess outperformance over "safe" investments, such as U.S. Treasury Notes (or, over the longer term, U.S. Treasury Bonds), or have a low correlation to all U.S. stocks (as an asset class), or both. A recent academic paper summarized the work of other academics, and combining that data with our own data, this confirms our current choice of asset classes for constructing our clients' portfolios.

ASSET CLASS and Its Description	Estimate of Forward-Looking Geometric Mean¹ Average Annual Return Above the Risk-Free Rate of Return²	Estimate of Asset Class' Variance, as Measured by Historical Annual Standard Deviation
U.S. SMALL CAP VALUE STOCKS – using methodology for construction of this asset class developed by Professors Eugene Fama, Sr. and Kenneth R. French	12.0%	29%
U.S. SMALL CAP (CORE) STOCKS – using methodology described above	11.0%	27%
U.S. LARGE CAP VALUE STOCKS – using methodology described above	9.0%	25%

ASSET CLASS and Its Description	Estimate of Forward-Looking Geometric Mean¹ Average Annual Return Above the Risk-Free Rate of Return²	Estimate of Asset Class' Variance, as Measured by Historical Annual Standard Deviation
<p>ALL GLOBAL STOCKS – consisting of approximately 40% U.S. stocks and 60% foreign developed markets and emerging markets stocks (market cap weightings applied among countries, and within countries; as a result, small-cap stocks make up only 15% of global stocks). Joseph Capital believes that U.S. stocks and foreign developed markets stocks are likely to possess rates of return which are similar over the very long term.</p>	7.0%	20%
<p>PRIVATE EQUITY – there are many “private equity funds” available to high net worth investors; some research has shown overperformance of private equity investments (as an asset class) relative to global stocks as a whole, while other more recent data shows underperformance. Joseph Capital provides this estimate. Data sets seek to correct for survivorship bias. Some data indicates that the standard deviation (a measure of volatility) for private equity is twice that of global stocks, but a more conservative 50% greater standard deviation figure is utilized for purposes of this discussion.</p>	5.5%	30%
<p>REAL ESTATE – various studies have shown both higher and lower returns (above the risk-free rate) for real estate investments than the return shown at right. Much of the variance of these studies can be viewed as a distinction in the types of real estate investments measured (office buildings, apartment buildings, other forms of pooled investment vehicles), the often high management fees associated with pooled management of real estate vehicles, and data which is affected by survivorship bias. Joseph Capital provides this estimate of the expected returns above the risk-free rate of return over the next 15 years, which yields a total average annual expected return of 7%,</p>	3.75%	16%
<p>FUNDS OF HEDGE FUNDS – due to biases in many hedge fund indices, survivorship-free estimates of the returns of hedge funds are scarce. We average an aggressive estimate of “fund of hedge funds” returns over the risk-free rate of 2.5% with a more conservative estimate of “fund of hedge funds” returns over the risk free rate of 0%, yielding the 1.25% estimate provided at right.</p>	1.25%	12%

ASSET CLASS and Its Description	Estimate of Forward-Looking Geometric Mean¹ Average Annual Return <u>Above</u> the Risk-Free Rate of Return²	Estimate of Asset Class' Variance, as Measured by Historical Annual Standard Deviation
<p>COMMODITIES – an unleveraged investment in commodities results in returns which can be derived from various indices. Various studies have shown that the average historical rate of return for commodities is equal to the risk-free rate (a very low rate of return); more recent historical data sets indicate a higher rate of return. While demand for commodities overall is expected to grow worldwide, and certain commodities may become more scarce, other commodities may see lower pricing due to the rise of alternatives (thereby lessening demand) or due to efficiencies achieved in production and/or distribution. Hence, while a case can be made for a higher average annual rate of return going forward (nearly equal to the risk premium garnered by stocks), the more conservative view is that commodities have no expected risk premium over the risk-free rate of return. We utilize the average of these measures in the table at right.</p>	2.25%	26%
<p>HIGH YIELD CORPORATE BONDS – high yield bonds require a higher default risk premium than high-quality corporate bonds, due to the lower creditworthiness of the issues of subordinate debt. However, looking back over the past 35 years until the end of 2008 (when high-yield bonds were priced substantially below historical prices of such bonds), the premia for high-yield bonds over high-quality corporate bonds was nearly non-existent. While the data for high yield bonds only exists for some 30 years, and evolution has occurred in the pricing of high-yield bonds, we estimate the return of high-yield bonds as slightly above that of higher-quality corporate bonds, going forward.</p>	1.50%	11%
<p>CORPORATE (INVESTMENT GRADE, OR HIGH-QUALITY) BONDS – Generally, the historical rate of return of long-term corporate bonds exceeds the risk-free rate of return by approximately 2%. However, due to the low interest rate environment which exists at the present time for U.S. government bonds, we anticipate that the expected rate of returns of corporate bonds of longer maturities over the next 15 years will be approximately 1% less than the historical risk premium.</p>	1.00%	7%
<p>U.S. GOVERNMENT BONDS – the historical rate of return of long-term U.S. government bonds is slightly less, over the very long term, than the historical rate of return of U.S. Corporate Bonds. However, due to risk aversion, U.S. Government Bonds are likely to be priced high relative to historical pricing, which is likely to temper expected returns over the next fifteen years.</p>	0.50%	8%

ASSET CLASS and Its Description	Estimate of Forward-Looking Geometric Mean ¹ Average Annual Return <u>Above</u> the Risk-Free Rate of Return ²	Estimate of Asset Class' Variance, as Measured by Historical Annual Standard Deviation
<i>RISK-FREE EXPECTED RATE OF RETURN / 1-MONTH U.S. TREASURY NOTES, EXPECTED OVER NEXT 15 YEARS:</i>	3.25%	1%
<i>INFLATION (CPI-U), EXPECTED OVER NEXT 15 YEARS:</i>	2.50%	2%

The foregoing data presents estimates only; the future of investing and asset class returns is inherently uncertain due to many factors, including economic uncertainty, estimation uncertainty, and other sources of uncertainty. Hence, returns cannot be guaranteed, and rather reflect a “best guess” of long-range annual returns over the risk-free rate of return. Investment advisory fees and costs, mutual fund or other investment vehicle fees and costs, and the tax drag upon investment returns, and the impact of portfolio rebalancing decisions, are not taken into account; however, “fund of hedge funds” data does include assumed fund-level and hedge-fund level management fees. All data is adjusted to reflect Joseph Capital Management, LLC’s estimate of expected asset class returns as of May 31, 2009. Data is derived from a proprietary estimation methodology utilized by Joseph Capital, which makes various assumptions, including reversion to the mean of asset class valuations over the next 15-year period. Sources of data also include an article by Niels Bekkers and Trevin W. Lam, “Strategic Asset Allocation: Determining the Optimal Portfolio with Ten Asset Classes” (Feb. 2009 white paper), which summarizes historical rates of returns of various other academic studies for various asset classes shown. Historical data is also supplemented with annual average returns data from DFA ReturnsW Program, utilizing various indices with data supplied by Fama/French, Standard & Poors’, the Center for Research in Securities Prices, and Ibbotson Associates.

Additional notes regarding risk premium data:

1. Generally, “the arithmetic mean is more appropriate to use if you are using the Treasury bill rate as your risk free rate, have a short time horizon and want to estimate expected returns over that horizon. The geometric mean is more appropriate if you are using the Treasury bond rate as your risk free rate, have a long time horizon and want to estimate the expected return over that long time horizon.” – Professor Stern, NYU School of Business. Since Joseph Capital believes that longer-term time horizons (including multi-generational time horizons when dealing with wealth that is highly likely to be transferred from one generation to the next) are most important when structuring an investment portfolio consisting of any exposures to stocks, we rank the asset classes by geometric mean annual returns in excess of the risk-free rate of return.
2. The “risk-free rate of return,” as utilized, is the rate of return of 1-month U.S. Treasury Bills, which is assumed to be 3.25% going forward (over the next 15 years), and is expected to exceed the annual rate of inflation in the U.S. (as measured by the Consumer Price Index, Urban Areas) by approximately 0.75% annually.
3. For the risk premia geometric returns are shown with intervals of 0.25%. The interval for the standard deviations is 1% and for correlations (shown in the table following) 0.1. More precise estimates might have an appearance of exactness, which we want to prevent.

Other Parts of the Analysis – Asset Class Selection. Knowing the expected returns and the standard deviation of an asset class is only one piece of the puzzle. Another significant factor is “correlation” – a statistical measure of the relative movement of asset class returns “up” or “down” relative to the returns of each other asset class.

Many other factors exist in determining whether to utilize an asset class, including: (1) whether there exists an ability to access the asset class in a diversified manner, in order to eliminate uncompensated risks; (2) whether the asset class can be accessed with a low amount of “total fees and costs” – and there are many forms of these; (3) the tax characteristics (qualified dividend income, non-qualified dividend or taxable interest income, long-term capital gains, short-term capital gains, tax-free income, foreign tax credits, etc.) of each asset class, which affects asset class placement and which may affect an investor’s long-term after-tax rate of return; (4) the inherent risks of investment vehicles available to access the asset class (for example, most hedge funds are not subject to intense government oversight and lack transparency); and (5) the availability and accuracy of historical data.

The Choice of Investment Vehicles within Asset Classes. Even after discerning the asset classes which are worthwhile to invest in, close attention must be paid to selection of the investment vehicles which will best secure the long-term returns of that asset class. This involves an intensive “due diligence” process which we undertake for our clients. (I’ll discuss this a great deal more in a forthcoming white paper you’ll be receiving.)

Market Timing – Part of the “Loser’s Game.” Another factor shaping our overall investment philosophy is determined by our answer to the following question: “Can we discern when ‘good times’ lie ahead, or when ‘bad times’ loom?” Unfortunately, knowing that the market goes “up” and “down” does not translate into an ability to predict when to get in or when to get out. The reasons are varied. One observation comes from noted investment sage Charles Ellis, author of the book, WINNING THE LOSER’S GAME: “Investment history documents conclusively that the very first weeks of a market recovery produce a substantial proportion of the gains that will be experienced. Yet it is at the crucial market bottom that a market timer is most likely to be out of the market – missing the very best part.”

This is not to say, however, that we completely foreclose the use of asset class valuations as a means of judging risk and return. There may come a time when we believe that the expected returns of an asset class we currently recommend to our clients are so low, and/or that the risks posed to the client are so great, that long-term investments in the asset class are not likely to be rewarded. But this conclusion would only result from a substantial overvaluation in a particular asset class, as was seen in early 2000 for growth stocks, and which existed for long-term U.S. government bonds at the beginning of 2009 (which overvaluation, we believe, persists today, but in a much lower way).

What is the Probability of Higher Returns from “Stock Picking”? Resoundingly Negative. Stock selection techniques (*i.e.*, “stock picking” or “active stock fund management”), while they may occasionally bear fruits, do not consistently work in favor of individual investors. The (SPIVA) Scorecard report stated “performance comparisons corrected for survivorship bias, shows equal- and asset-weighted peer averages, and provides measures of style consistency covering actively managed U.S. equity, international equity and fixed income mutual funds.” (per release by Standards & Poors, April 20, 2009). The Scorecard also recently reported: “Over the five year market cycle from 2004 to

2008, [the S&P 500 index] outperformed 71.9% of actively managed large cap funds, [the S&P MidCap 400 index] outperformed 79.1% of mid cap funds and [the S&P SmallCap 600 index] outperformed 85.5% of small cap funds. These results are similar to that of the previous five year cycle from 1999 to 2003.” *In other words*, all of the effort, spent by so many mutual fund managers, in attempting to “picking winning stocks,” results in underperformance the vast majority of the time. The following table presents in more detail the SPIVA Scorecard report results:

Percent Of Active Funds Outperformed by Benchmarks Over Market Cycles:

<u>Fund Category</u>	<u>Benchmark Index</u>	<u>2004 to 2008</u>	<u>1999 to 2003</u>
All Domestic Funds	S&P Composite 1500	66.21%	50.76%
All Large-Cap Funds	S&P 500	71.90%	53.41%
All Mid-Cap Funds	S&P MidCap 400	79.06%	91.36%
All Small-Cap Funds	S&P SmallCap 600	85.45%	69.38%
Large-Cap Growth Funds	S&P 500 Growth	80.51%	43.40%
Large-Cap Core Funds	S&P 500	77.55%	55.12%
Large-Cap Value Funds	S&P 500 Value	53.19%	54.96%
Mid-Cap Growth Funds	S&P MidCap 400 Growth	76.58%	95.50%
Mid-Cap Core Funds	S&P MidCap 400	76.15%	83.33%
Mid-Cap Value Funds	S&P MidCap 400 Value	79.17%	93.02%
Small-Cap Growth Funds	S&P SmallCap 600 Growth	95.58%	69.86%
Small-Cap Core Funds S&P	SmallCap 600	81.36%	62.94%
Small-Cap Value Funds S&P	SmallCap 600 Value	69.51%	61.95%

Source: Standard and Poors, SPIVA Scorecard, April 20, 2009.

Despite all of the evidence, why do so many investors continue to adhere to stock-picking strategies? For one reason, financial firms certainly contribute to this confusion. The general message from Wall Street is that stock picking is both easy and profitable. This message is reinforced by the financial press, which offers a steady flow of stories about undervalued stocks and successful fund managers. (How else would they grab their viewers’ attention, and fill their advertisement quotas?)

One stock broker, in response to the overwhelming academic evidence on the failure of stock picking, was heard to have stated “Even if we can’t beat the market, we have a moral obligation to try.” What? Wait a minute, bucko. *It’s not your money.* What right do you have to gamble or speculate with your client’s hard-earned funds?

HOW WE ADD VALUE. Joseph Capital discerns investment and portfolio management strategies, as well as many other ways to add value. The many ways we benefit our clients include:

- We structure investment portfolios to take advantage of the equity, small-cap, and value premia. Our research has revealed a substantial probability that the small-cap and value premia can be utilized to increase the long-term expected returns of the stock portion of a client's portfolio, thereby permitting a more conservative overall allocation (less stock asset classes, greater fixed income), which in turn will usually lead (over longer time periods) to less volatility (as measured by standard deviation) in the client's overall portfolio.
- Through a comprehensive due diligence process, we seek out, and provide clients with access to, those investment products which best provide exposures to these risk premia.
- We seek to substantially reduce of "total fees and costs" relative to the receipt of financial planning and investment advice and investment products – relative to the products often sold by those product salespeople who are in arms-length (non-fiduciary) relationships with customers.
- We seek to substantially reduce various forms of investment risk for which there is inadequate compensation over time, including but not limited to: (1) specific company risk (and, in the context of bond investing, default risk); (2) manager risk; and (3) specific industry/sector risk.
- Nearly all of our clients share a common enemy - the insidious march of inflation. Defeating this opponent is one of the critical goals of our portfolio management strategies.
- We seek to take advantage of opportunities presented by tax law, to save income taxes (and other forms of taxes) over the long term for our clients.
- We ensure that each client's investment portfolio is well-designed as we seek a higher probability of success and attainment for the client of his or her unique lifetime financial objectives.
- We counsel each client in order to adhere to the discipline required for long-term equity investment success – this is an especially powerful way to add value given that most individual investors react emotionally, and wrongly, to short-term stock market "ups" and "downs." We counsel our clients to "buy low" and "sell high" (through a disciplined approach to portfolio rebalancing). Not surprisingly, most individual investors who are not aided by our firm or those few other investment advisors who follow our investment philosophy do precisely the opposite, and thus cause themselves long-term harm through underperformance.
- We seek to ensure that our client's other planning needs are addressed, working in conjunction with other professional advisors and applying our own team's expert professional knowledge across multiple disciplines.
- We are there to act as trusted professional advisors. We don't sell any products. We don't receive fees from anyone except our clients. We offer our counsel, our experience, and our expertise, and for that we are reasonably compensated. What is the value of having that rare team of professional advisors in whom you can place your complete trust and confidence?
- Lastly, *we care*. For our select clients, we seek to have long-term relationships, in order that we may partner together in this journey called life, seeking to accomplish each clients' lifetime financial goals along the way.

- Thank you for the continued opportunity to serve. Ron