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Return of the Bond—Exodus of the Insider

-J. Kevin Meaders, J.D, CFP®, ChFC, CLU

October, 2009 - Well, I've got good news and I've got bad news. First the good. You may remember this from a letter I sent earlier this year:

> "Right now you're thinking that I'm crazy to think that this economy will ever turn around—but it is you, my friend, who's crazy if you think it will spiral down to zero and never recover. Just remember this when I try to force those boring bonds on you again.
>
> Speaking of bonds, I want you to look at your statements. Look at the percentage of your assets that are in bonds versus stock. You will see that more than 70 – 80 percent of your assets are in cash or bonds, and though the stock positions have practically collapsed, the bonds are relatively steady and continue to pay nice dividends."

When I wrote that back in March, the Dow Jones had just dropped below 7000 for the first time, and bond prices were also at a low. But take a look at what your bonds have done since then:

The chart above represents the majority of the bonds our clients are holding in either a tax-deferred account, such as an IRA advisory account, or a variable annuity, be it Jackson National, ING, Hartford, MetLife, or Allianz.

The chart below represents the majority of the bonds our clients are holding in a tax-efficient advisory account. Though this one is for Georgia, other states look very similar, including Alabama, Arizona, California, Colorado, Florida, Illinois, North Carolina, Pennsylvania, Virginia.

Even our most conservative defensive income models—which hold approximately 80% in bonds—have seen nearly a 20% increase since February 1, 2009, all the while paying a historically robust dividend.

And there you have the good news. Now for the bad.

If you've been listening to any economic commentators (not that I recommend it, but I know you can't help yourself), you no doubt have heard that the stock market is not following basic economic principles.

Simply speaking, our national economy after 2008 is altogether different from any we've ever experienced. We are not entirely socialist, but we are not entirely capitalist either. Government intrusion into several sectors of the economy has forced economists to retool their methodology.

It may sound overly simple, but the basic raison d'être of the whole stock market is earnings—profits—making money—however you fancy it. Thus, the underlying reason one would buy a stock is because the company earns a profit. I know this is a foreign concept nowadays to companies like Chrysler and GM, but it has always been true for most enterprises in the capitalist world. Economists therefore go to great lengths to value companies based on what? You guessed it, earnings!

Current earnings are not the only deciding factor, but future expected earnings as well.
You may remember poor Martha Stewart serving time for what the regulators call "insider trading." An "insider" is someone who knows information that the general public is not privy to. This is usually a CEO, CFO, COO, some other high ranking company official, a board member, or someone owning more than 5% of the outstanding shares, though not limited to just these.

Paradoxically, "insider trading" happens every single day. To make it legal, one simply needs to file with the Securities and Exchange Commission (SEC). This information is compiled and reported to the public, so that even though we don't know why the insiders are selling (they almost always report it is for "personal reasons") we can at least see who is selling, how much, and when. According to these reports,

> "…one indicator has turned distinctly bearish: Corporate officers and directors have been selling shares at a pace last seen just before the onset of the subprime malaise two years ago.

> While a wave of insider selling doesn't necessarily foretell a stock market downturn, it suggests that those with the first read on business trends don't believe current stock prices are justified by economic fundamentals.
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> "It's not a very complicated story," said Charles Biderman, who runs market research firm Trim Tabs. "Insiders know better than you and me. If prices are too high, they sell."
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> Biderman, who says there were $31 worth of insider stock sales in August for every $1 of insider buys, isn't the only one who has taken note. Ben Silverman, director of research at the InsiderScore.com web site that tracks trading action, said insiders are selling at their most aggressive clip since the summer of 2007."[1]

Now, nobody buys shares when they think earnings are lower because that (normally) translates into lower prices. Likewise, few would sell if they thought earnings were as good as or even better than expected because—you guessed it—the price usually rises.

So what does it tell us that insiders are selling 31 to 1? What is it that they know that we don't know? Could it be earnings? Could it be that internal sales are down?

According to Yale University's Robert Shiller, "price-to-earnings ratios using a decade of data show stocks aren't [currently] cheap. Equities trade [today] close to 19 times profit, above the 16.3 average for the past 128 years. The professor uses 10 years of earnings to smooth out short-term fluctuations."

Now lets focus a little of our thought power on what's going on around us in the real world. All around you, do you see people spending more, or less? When you go out to eat, do you see crowds or empty tables? Do you know people who have lost their job? Do you know people who are afraid of potentially losing their job? What is your take on this year's Christmas season? Will people be shopping like they did in 2007 or even in 2008? What do the retailers think?

According to a recent survey by Hay Group, a human-resources consulting firm, "Fifty-seven percent of retailers are cutting staff heading into the holiday season, compared with 29 percent last year. With the nation's unemployment rate at 9.7 percent, 62 percent of retailers said they are seeing more holiday job applications, according to the survey."[2]

So from my perspective, it doesn't look like the earnings are there currently, and it doesn't look like they're going to be there for Christmas either.

On the other side of the coin, direct government intervention and ownership of certain banks and companies and some $700 Billion in TARP money have skewed the otherwise level economic playing field. How much of this money is in the system? How much has made its way to the balance sheets? What earnings are real and what is attributed to cost cutting and government (or I should say "your") money?

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[1] *Insiders Sell Like There's No Tomorrow.* CNN Money, September 12, 2009
[2] *U.S. Retailers Plan to Hire Fewer Holiday Employees, Survey Shows*. Bloomberg. September 23, 2009

To confuse the issue even more, how long can investors stomach the non-existent returns on cash before they overcome their risk aversion precipitated by last year's crash? Simply put, when will Greed overcome Fear? There's a ton of money on the sidelines, and no matter what earnings are or are not, more than $3 Trillion infused back into the system will send prices soaring.

> "Investors placed $1.45 trillion in U.S. money-market funds in 2007 and 2008 during the worst financial crisis since the Great Depression, based on data from Washington-based ICI. The amount has dropped $439.5 billion since reaching a record $3.92 trillion in the week ended Jan. 14.
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> A broader measure of reserves that includes cash, bank deposits and money-market funds has climbed to $9.55 trillion this month, based on data compiled by the Fed. That's enough to buy all of the companies in the S&P 500, which have a combined market value of $9.37 trillion, Bloomberg data show. Since 1999, so-called money at zero maturity has on average accounted for 62 percent of the stock index's worth." [3]

This is extremely significant, and is partially the reason I am optimistic about next year—that is, after January 2010, once the fourth quarter results have re-tested America's endurance. Even so, you can see the monumental dilemma with which we are faced.

Our first priority is to protect your assets from loss. Knowing all of this, how could we in good faith become more aggressive right now under these conditions? We simply can't.

Opinions expressed are not intended as investment advice or to predict future performance. All information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy. All economic and performance information is historical and not indicative of future results.Past performance does not guarantee future results.

[3] *Obama Stock Advance Persists on Money Fund Hoarding*. Bloomberg. September 28, 2009

About J. Kevin Meaders

kevin@magellanplanning.com

Kevin Meaders graduated from Oglethorpe University in Atlanta with a double B.A. in Philosophy and Political Science, and then obtained a law degree from Georgia State University College of Law, focusing on estate planning and trust law. He has earned the designations of Certified Financial Planner (CFP®), Chartered Financial Consultant (ChFC) and Chartered Life Underwriter (CLU). He holds a General Securities Principal and Registered Representative registration and Investment Advisor Representative registration through ING Financial Partners (member SIPC).

About Magellan Planning Group

www.magellanplanning.com

Magellan Planning Group was established in 2000 to provide a service uniquely tailored to the needs of our affluent Atlanta community. We concentrate on *personalized* retirement planning through tri-disciplinary coordination:

- Financial planning with our Certified Financial Planner™ to prepare a retirement plan that takes into account your needs and expectations. We are a fee only asset management firm with a $500,000 minimum relationship.

- Estate planning with our in-house Attorney-at-Law to determine and prepare the documents needed to minimize family liability and maximize privacy. (www.magellanlegal.com)

- Tax planning through a relationship with our in-house CPA to manage tax obligations throughout the year and prepare a tax return that takes into account current tax laws. (www.magellantax.com)

Our relationship doesn't begin and end with the preparation of a plan and the appropriate documents. We establish close personal relationships with our clients and their families and maintain those relationships through regular 'check-ups', market commentaries and educational Lunch & Learns.

4170 Ashford Dunwoody Rd. NE, Suite 480
Atlanta, GA 30319
404-257-8811

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