THE RUDD COMMENTARY

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We are excited to publish this edition of *The Rudd Commentary*, which is a periodic publication designed to bring you a professional opinion on the current investment environment and some developing trends. Please feel free to forward *The Rudd Commentary* to family, friends, and business associates who might find this information valuable.

THE BIG PICTURE

I hate to admit it, but I just don't like watching most sports events on television. I am the guy that doesn't participate in this month's basketball pool and couldn't tell you how the Longhorns are doing this season. As I have added a few years (or pounds) under my belt, I have developed a desire to eliminate unnecessary stress and volatility in my day and try to make more efficient use of each heartbeat. Eliminating frustration is easier done with an official of basketball than one of government or business. Instead of any psychoanalysis, I have decided to just admit this secular male shortcoming and worry about more important things.

I would highly recommend a similar approach for investors as they filter through the sports-like financial news channels this quarter, checking up on their investments. The stock market is currently having a very good start to the season, and I believe valuations are still attractive, but I would encourage investors to wait before they check the win column. Mr. Market, our manic depressive friend, will likely remain with us a while longer and, without warning, crash in our living rooms many nights after randomly overdosing on hope-ium the day before. In this commentary I will discuss why we should not immediately jump on the headline bandwagon (fear or greed), and point out some long-term trends at work in the American economy that I believe are more important than the short-term news.

ABNORMAL EXPECTATIONS »

In the late 1990's, it was hard to have a casual conversation and not hear the word "nasdaq". Usually it was dropped in after hearing about someone's stellar personal investment performance that was clearly due to their own foresight and genius. As I am fond of saying to my private clients, the 1990's took investors to new lofty expectations where 10%-12% rates of return were expected and 18% in a year was a God given tail wind. Looking back, I even recall some ridiculous analyst growth forecasts of a certain well know technology company (known for switches and routers) that, if achieved, would have meant their revenue would have eclipsed the Gross Domestic Product (GDP) of the U.S. (which they are a part of). Yes, you read that correctly. Price expectations got so far ahead of plausible reality that investors began to ignore their common sense and rationalize the ridiculous. It does not matter how many times we tell ourselves "it's different this time," the size and growth rate of our economy has the largest influence over our investment returns in the long-term.

So how does this apply to the investment environment today? To put it simply, long-term domestic stock returns can be broken down into three components: GDP or the "growth rate" of our economy, price inflation, and any abnormal returns that can achieved above that. As I just implied with an extreme example, GDP has the largest influence over how most investments perform in the long-term. We just cannot escape the strong economic currents, positive or negative, that drive the business cycle. The health of the economy along with the unavoidable meddling from our politicians have a tremendous influence over how our investments perform and can sometimes make or break a new start-up business venture. Being in the right place at the right time reigns supreme.

The other two variables require much less explanation. Inflation, when added back to net GDP expectations, provides the most realistic return expectation for investors that includes the fact that prices rise over time. In order to earn returns in excess of this number (called "abnormal returns"), we either have a skill others don't, access to non-public information, or we are the only one that has willing money in a time of pandemonium. The next time we are asked about our investment return expectations, we can flip over a napkin, estimate GDP and inflation, and come up with a number. Unless we have the creativity of Steve Jobs, nefarious schemes of Raj Rajaratnam, or intestinal fortitude of Warren Buffett, normal expectations will suffice.

THE GOOD BOOK TO FACEBOOK »

Demographic trends will also have a tremendous influence over the performance of any investment strategy. Since World War II, the baby boom generation has provided a tailwind for many growing companies including Gerber, Schwinn, Chevrolet, Harley Davidson, and now the financial and pharmaceutical industries. These shifting demographic winds do not dictate the ultimate success or failure of a retirement strategy, but rather offer investors an opportunity to make more appropriate asset allocation decisions which could lead to better long-term investment performance. While the spending patterns of our wealthiest generation are now on the minds of every corporate marketing manager, many investors fail to see the more important multi-generational trend that is only visible from a historian's perspective. Let's take a quick look beyond the boomers.

Andrew Carnegie is often credited with the saying "shirt sleeves to shirt sleeves in three generations," meaning that wealth created by an individual or family in one generation will typically be gone by the third. The wealth that was created by the entrepreneurs through hard work and a frugal lifestyle is very well maintained and protected by the second generation, who usually hold the family's highest levels of formal education and training at the expense of their parents. In most cases, the wealth is completely consumed by the grandchildren of the wealth creators as they attempt to maintain a very high lifestyle without any meaningful business experience or relevant formal education. Most families we advise are very interested in breaking the 3 generation curse. To do so takes significant effort in personally educating each generation, involving them as early as possible in the family business, and having the wisdom and fortitude to allow them to fall flat on their face and experience the pain and failure that breeds long-lasting business success.

As Andrew Carnegie might agree, our American Family is being identified by many of the same generational characteristics listed above. The Greatest Generation built much of the life style we are enjoying today through their sacrifices in World War II in which America emerged as the world power we know today. We are now on the leading edge of the greatest wealth transfer in history, as their baby boomer children pass what's left of their assets to the grandchildren who now expect a college degree, a government provided pension plan and free healthcare. It is this multi-generational trend that will have a profound impact on social and economic policy as we try to maintain this new lifestyle. Much is needed to encourage this third generation and help them carry on the productivity and innovation that got us here. We only hope that Facebook can provide this generation with all the wisdom that The Good Book provided their grandparents.

LIFE IS NOW FAIR »

In order to explain the power of compounding interest to young investors, I use the following simple example:

If Christopher Columbus would have invested $1 at 5% simple interest right when he got off the boat in this new land, how much would his ancestors have today? The numbers I get in response to this question vary, but they are usually in the millions. The answer can be computed as follows: 2012 - 1492 = 520 years x 5 cents a year (simple interest) = $26 dollars. My young audience is not only shocked, but accuses me of playing a politician's trick on them. Next I explain, if he would have invested the same amount at the same rate compounded annually he would have $104,336,320,364.95 or 4 billion times as much. This is the kind of answer they were looking for, but they are still shocked at the difference between the two figures. To make sure they understand the power of compounding, I ask them to consider one more piece of information from the example above. Compounding at 5% annually, it took 425 years for Chris's dollar to grow to $1 billion, but only 72 days to create the most recent billion dollars. Time is a powerful ally for those in the wealth building stage whose income is greater than their expenses, but for those relying on debt to bridge their budget deficits, it can quickly snowball out of control ending in a large crash at the bottom of a very tall mountain.

The example above could be considered extreme if our view of financial success is limited to one life span (currently about 67 years). When we broaden our view to include our parents, children and grandchildren, the example above becomes very relevant. The current generation in government has borrowed heavily over the last two decades. As of January 31, 2012 U.S. total public debt outstanding was up to $15,356,140,493,616[1]. While this may not mean much without a point of reference, consider that this number was $9,238,008,288,942[1] on January 31st, 2008 and $5,711,285,168,951[1] on that date in 2000. In other words, what took us 224 years and two world wars to accumulate, we have tripled in 12 short years. By borrowing primarily from China and Japan, we have turned the tools used to protect our culture of freedom and opportunity into a crusade for social fairness. Without large scale changes to our use of debt and reforms to our swelling entitlement programs, we can expect a profound impact on after-tax investment returns for decades to come.

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Like the recent stock market performance, many of the sensational short-term issues that will come up this year won't have a big impact on our long-term investment performance. The slowing growth rate of the economy, our current lifestyle choices and our willingness finance them with debt are the material forces that will have a profound influence on our investment returns over the next several decades. Like the first generation entrepreneur, the wisdom we pass on to our children and grandchildren will have the largest influence on what rate our prosperity will continue to grow. Even if we have made some mistakes in the recent past, it is not too late to step back and re-adopt the principles that made us successful in the first place. The second generation still has a few years to go before they pass on what's left of their principle.

Invest Long and Prosper,

Josh Rudd

[1]Source: U.S. Government: "Total Outstanding Public Debt" report available at www.treasurydirect.gov.