



“Buy and Hold” is Dead and Gone

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

May, 2009 - We’ve certainly seen better days; but I think we can safely say we’ve also seen worse.

It would appear that the financial markets have started to partially stabilize, and we are optimistic—but *cautiously* optimistic. Job losses, though unhealthy, seem to have waned; and the bank stress tests weren’t as bad as some had feared.

Nonetheless, in spite of some good news here and there, some pie-in-the-sky jargon from useless economists, things are not normal. Even before the credit crisis reached full pandemonium, I said that mortgage defaults were the initial impetus for the unraveling of the economy. And yet we hear very little today about the status of these empty homes. Well, here’s a hint: they’re still empty, and more are foreclosing everyday. A recent report¹ by Milton Ezrati, senior economist and market strategist at Lord Abbot states it plainly:

According to the Federal Reserve Board (the Fed), overall loan charge-offs in this area [mortgages] reached 1.58% of the total outstanding during fourth-quarter 2008 (the most recent period for which complete data are available), up from 1.46% during the prior quarter and 0.44% in 2007.

The Fed also reported that delinquencies -- that is, loans that are 30 or more days behind in their payments -- stood at 6.29% of all residential mortgage loans during fourth-quarter 2008, up from 5.22% in the quarter before and 3.00% in 2007. Less complete data through February show a further modest deterioration, with delinquencies climbing to 7.0% of all loans, but with defaults holding about where they were in the fourth quarter.

These figures show a mix of very different experiences between prime and subprime mortgages. The vast bulk of the overall default figure reflects the deep trouble in the subprime area. Prime mortgage defaults, though rising, remain negligible, as usual, even in hard times. On delinquencies, two-thirds of the overall figure reflects the experience with subprime, which, though only 10% of mortgages outstanding, is suffering delinquencies at 40% of loans outstanding.

Granted, this is not the only variable in a massive and complex economy, and the extension of this thought process to the global economy is difficult to maintain at the same level of scrutiny.

¹ Milton Ezrati, *Loan Delinquencies Leveling Off*, Investors Soapbox PM, May 6, 2009

It would therefore seem prudent to remain cautious about the short term health of the domestic economy, and thus we remain so. This is not to say that there is not opportunity in other countries or in specific sectors. As a matter of fact, we believe opportunities abound in several “satellite” positions.

This may be a new word for you as it pertains to the investment world, and it goes straight to the point I made in my January letter: “the days of buy and hold are dead and gone.” Everyone should be painfully aware by now that 2008 was a year unlike any other: the “Black Swan Effect”, if you will.

In a world where we had always believed non-correlating assets existed, 2008 taught us that everything can drop—dramatically—at virtually the same time. We saw AAA-rated Georgia general obligation municipal bonds drop in value by 35%. Not possible, and yet, it happened. This is tantamount to telling Egyptologists that the Giza pyramids were built by aliens—it turns the entire discipline on its head. And so it has been for the investment world.

Thus, a new paradigm demands a new approach. We have been working diligently behind the scenes in the midst of our transition to ING Financial Partners to develop a more refined strategy to accomplish the ever-present goal of enhancing returns and reducing risk. The fruits of our efforts have produced what we call a “core and satellite” strategy. Here’s how it works:

Somewhere between 60 to 70% of assets are invested in a “core” allocation, which includes your usual suspects: large cap growth, large cap value, international exposure, corporate bonds, and treasuries of various maturities. The “core” is invested using the typical modern portfolio theory of asset allocation and seeks to hold non-correlated assets.

The remainder of the portfolio can then be allocated to “satellite” positions. Satellite positions are generally temporary in nature, and consist of specific opportunities that are relatively apparent. Today, we are researching specific satellite positions for certain areas and sectors of the global economy where the potential for appreciation is greatest. These areas include China, India, Brazil, crude oil, basic materials, base metals, and grain commodities. Obviously real estate and financials are greatly oversold, but it is not clear whether these sectors have stabilized, though certainly they are on the watch list.

In our opinion, the optimum investment vehicle for use in the satellite positions is the Exchange Traded Fund (ETF). ETFs are funds that allow exacting specific parameters like very narrowly-defined mutual funds, but they trade like a stock. This means that we can use buy-limit orders and sell-limit orders to enter and exit these very specific positions.

Let me give you an example. Let’s say that oil is trading at \$50 per barrel today and we strongly believe that at some point in the future, probably not too far in the future, it will rise to \$75. We might place an open order to buy oil when the price drops to \$45. Even though oil is at \$50 today, if in fact it drops next week or next month to \$45, our system will automatically buy oil at \$45, or better.

The question then becomes: “do we want to hold this forever—watch it go up, and then go back down?” After 2008, the answer is a resounding “NO!” So then the question becomes: “how greedy do we want to be?” Let’s say that we would feel quite fine with a 50% return in the oil sector (and I would venture to say that 20% may be enough in most cases) and thus we want to take our profits when oil hits \$75.

Now once the buy has been made, we then go in and set a predetermined price to get out by simply placing a sell-limit order, in this case \$75. Just as in the case with the buy order, we just sit back and wait for the price to hit \$75 or better, and automatically the trade will execute, exiting us from that satellite position.

We can already see signs of life returning to the global economy, and we believe this general trend will continue, but not without significant volatility. We believe that the second quarter results (coming out in July) will give us a better idea as to whether we really have pulled out of this. We are a nation of consumers, and our economy relies heavily on our continued consumption. It should therefore come as no surprise when this quarter's earnings reports come out that consumption has slowed in several sectors.

Even so, the general economy's long road to recovery has already begun, and certainly the panic that gripped the financial markets last September has abated. Cautiously, we expect the next couple of quarters to have significant volatility as investors waffle between low returns on treasuries and price/earnings ratios in the teens. When a stock price is low, its company's earnings are more attractive. These valuations, however, are based on past earnings. This becomes more difficult to value when future earnings are in question. If we stop and take a look around, it certainly *seems* like people are spending less.

In any event, the longer term result will be higher stock prices and greater earnings—this is almost a certainty. In the shorter term, however, stock prices look very attractive when compared to historical earnings—but the real mystery is future earnings, at least for the next few months.

Obviously, we are watching developments carefully, and believe it may soon be prudent to reduce bond and cash holdings in favor of equities and certain sectors and commodities.

The views are those of J. Kevin Meaders and should not be construed as investment advice. All information is believed to be from reliable sources; however, we make no representations to its completeness or accuracy. All economic and performance information is historical and not indicative of future results.

About J. Kevin Meaders

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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

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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.magellntax.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.

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