SUMMER 2010

in Context

WEALTH STRATEGY FROM A DIFFERENT PERSPECTIVE

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The Rule, Not the Exception

The period from March 2009 through April 2010 was a great reprieve for investors. The S&P 500 Index had lost 51 percent from November 2007 through February 2009. Over the following 14 months, in one of the greatest rallies ever, it gained 65 percent.

In May 2010, the market was once again buffeted by a crisis that began with fears of Greece defaulting on its debt. Those fears were exacerbated by the concern that the crisis would spread to other countries (such as Portugal, Italy, Ireland, Hungary and Spain), causing a "contagion" similar to the Asian Contagion crisis that began in Thailand in 1997. That crisis hit the U.S. markets the following year. In just July and August of 1998, the S&P 500 Index lost more than 15 percent. The fear of a repeat performance in 2010 hit global equity markets hard, and volatility soared. Once again, investors began to panic.

The most important lesson investors can learn about equity investing is it always entails a high degree of risk, and frequent crises — whether political, economic or caused by Mother Nature — are the norm, not the exception. Since 1973, we have experienced at least 15 crises, or about one every 2.5 years. Despite that track record, the S&P 500 Index and the MSCI EAFE Index have both provided returns of more than 8 percent per year. In fact, it is because stocks are perceived as very risky that they have produced such large returns: Investors demand a large risk premium to accept the risks of equities.

Those who know their financial history understand that frequently occurring crises are the norm. What we don't know is when the next one will be, how long it will last and how deep it will be. Unfortunately, as much as we would like to think otherwise, there is no one who can protect us from crises because they are unpredictable.

Over the past few months, we've heard plenty of bad news on many different fronts, but that doesn't mean the market has to go lower. Prices have already fallen because of risks of which we are now fully aware. If the news turns out to be as bad as

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Shelf Life

Financial markets are a collection of arguments. The less transparent the market and the more complicated the securities, the more money the trading desks at big Wall Street firms can make from the argument.

— Author Michael Lewis on the potential value of credit default swaps on subprime mortgage bonds from *The Big Short: Inside the Doomsday Machine* (2010)

The Sick Man of Europe

In 2004, the Fourth of July was celebrated more in Greece than in the United States. On that day, the national team beat tournament host Portugal to win the European Football Championship. Six years on, Greece is the sick man of Europe. What happened?

The Greek crisis bears some resemblance to the financial crisis in the United States. However, instead of housing, massive debt in Greece was used to finance generous but unsustainable public benefits.

Greece has a statist economy. The public sector accounts for 40 percent of gross domestic product (GDP). Most Greeks take early retirement. Greeks are also getting older. Fewer people are working and paying taxes to support expensive retirement, health and other benefits.

European Union aid represents 3.3 percent of the Greek GDP, which helps. However, that is not enough. In the past, the government funded public spending by borrowing heavily from European banks. Now it's time to pay some of that back, and the Greek government doesn't have the means to do so. Nor does it have the ability to print money or to devalue the currency, as Greece did before it joined the Euro.

The Greek economy is not particularly large. On a global scale, the main concern is not with Greece itself but with the stability of Western European banks that lent to Greece. This is why the European Union and the International Monetary Fund stepped in to help.

Financial markets are aware of these problems and we believe fully reflect their implications.

Too Big to Fail?

By Eugene F. Fama

Overview: In late May, Professor Fama was interviewed on CNBC's *Squawk Box* about the recent financial crisis and financial regulatory reform. Following is an excerpt from that interview.

EFF: The big gorilla in the room at this point is the whole concept of "too-big-to-fail." That's perverting activities and incentives in financial markets all over the place. Basically, you are giving the big financial firms a license to increase risk where the taxpayers will bear the downside and firms will bear the upside. That is not capitalism. Capitalism says, you perform poorly, you fail.

So, we basically have to take too-big-to-fail off the table. This bill, 1,500 pages of it or whatever, I think wants to do that, but the problem is, it's way too complicated.

Complicated regulation may be a nice idea in principle, but in practice it never works because eventually, with regulations very complicated, the regulators get captured by the regulated. We're seeing that being claimed at this moment with respect to the regulation of the oil and gas industry.

But it's not unusual. It happens all the time that the regulators get captured by the regulated. We need a reform that basically takes too-big-to-fail off the table and is self-enforcing.

About This Excerpt: This video link was posted on June 1, 2010, as part of an ongoing series called "Fama/French Forum," hosted by Dimensional Fund Advisors. To view the entire CNBC interview, visit: http://www.dimensional.com/famafrench.

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already expected, prices don't have to go lower. If the news turns out to be bad but not as bad as expected, prices will rise. Therefore, it is too late to act on the bad news.

Clearly, there are risks, including housing prices continuing to fall, the Greek crisis becoming a contagion, overly aggressive new regulations, increasing taxes and even the threat of trade wars. That is why the market is priced where it is.

Investing in stocks is always risky. The market has certainly provided us with enough reminders of that over the recent past as we have experienced two of the five worst bear markets in just the past 10 years. In a strange way, the recent crisis has provided many investors with another opportunity to make needed changes. When investors realize they are taking more risk than they have the ability, willingness or need to take, the right thing to do is to correct the error. Smart investors know that hope is not a strategy.

Making Plans

Core Estate Planning Documents and the Revocable Trust
By Benjamin Kelly

With great consistency, individuals who have done no estate planning want to start with advanced planning techniques such as an irrevocable life insurance trust or a family limited partnership. But where should any individual or family start the estate planning journey? At the beginning.

The beginning involves executing one's core estate planning documents, which include a revocable trust, "pour-over" will, living will and health care power of attorney, and financial durable power of attorney. Although many people think a will can sufficiently dispose of their assets, the fundamental document to have in place is the revocable trust.

With a revocable trust, it is possible to avoid the costly and public probate process. Revocable trusts also provide surviving spouses and children protection from creditors and divorce. To a certain degree, they offer estate tax protection for generations.

A will serves as a catch-all for those assets not transferred to the trust. More importantly, parents name guardians for any minor children through wills. With a personal health care directive, individuals express their wishes regarding their health care in the event a situation occurs in which they cannot do so.

No matter an individual's net worth, it is essential to begin with the core estate plan. Although it can be difficult to broach some of these topics, individuals who have such documents ultimately have peace of mind knowing their loved ones are protected.

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