Quarterly Report

Union Financial Partners **October 23, 2011** Quarter 3, 2011

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Financial Planning Reduces Anxiety

If you understand how the integrated financial planning and investment management process works, then you will better be able to assimilate sensationalized news about the market and you will have less anxiety about your investments. Financial Planning does not forecast the future. It does, however, assign specific numbers to future financial goals. This tells us two important pieces of information: How much money you are going to want from your portfolio (Cash Flows) and when you are going to want it (Time Horizon)? With this information we can set a specific future portfolio value as a goal, and we can determine a target portfolio rate of return. It is this information that directs us to recommend a specific Risk-Targeted Portfolio for you. This article describes the process and the foundational theory behind our investment process. My hope is that, armed with this understanding, you will sleep better at night despite the gloomy economic news we are bombarded with day after day.

The financial plan provides a dynamic context for all financial decision-making, including investments. Hypothetical clients Sue and Jim want to retire in 10 years. At the time they retire, they want $60,000 per year from their investments. That $60,000 is in today's dollars - $60,000 purchasing power. In ten years, with 3% inflation, that will mean $81,000 per year. Rough calculation – they will need $2,024,030 at retirement in 10 years and a target rate of return of 8% to provide $81,000 per year – increasing each year with inflation. They have a long time horizon—around 45 years. When they retire, they

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What's New About A "New Normal?"

The 2008 global market crisis and the struggling economy have left many investors fatigued. Despite two years of strong equity returns, some investors have been slow to regain market confidence. Many are accepting the talk about a "new normal" in which stocks offer lower returns in the future.[1]

The concept of a new normal is anything but new. In fact, throughout modern history, periods of economic upheaval and market volatility have led people to assume that life had somehow changed and that new economic rules or an expanding government would limit growth. What they could not see was how markets naturally adapt to major social and economic shifts, leading to new wealth creation.

Let's look at other periods when investors had strong reasons to give up on stocks, and consider the parallels to today:

1932: The US stock market had just experienced four consecutive years of negative returns. A 1929 dollar invested in stocks was worth only 31 cents by the end of 1932. Hopes were sinking during the Great Depression, and many people felt as though the economy had permanently changed. Many investors left the market, and some would not return for a generation. Amidst what is considered the roughest economic time in US history, the markets looked ahead to recovery.

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Recommended Reading

The Investment Answer

by

Daniel C. Goldie, CFA, CFP

and

Gordon S. Murray

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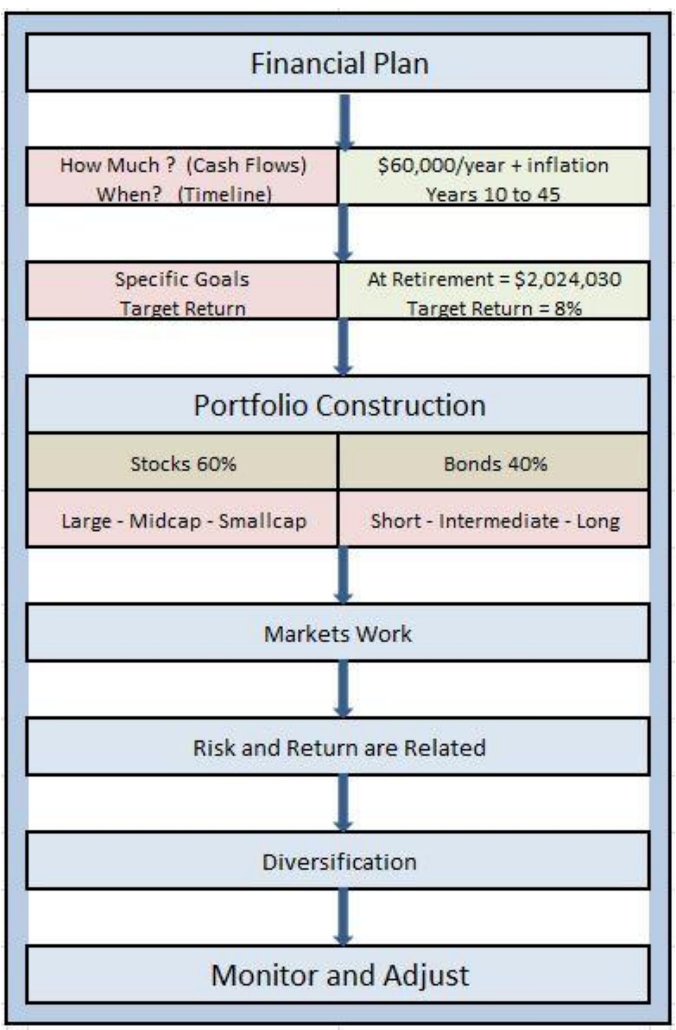
will have $81,000 the first year, $83,000 the second year, $86,000 the third year, etc. How should Sue and Jim invest?

UFP portfolios are constructed based on sound academic principles: Markets Work, Risk and Return are Related, and Diversification Mitigates Risk and Captures Returns (Fama-French 3-Factor Model). Let's discuss each of these principles.

When a person says '**Markets Work**' they are saying that they agree with the 'Efficient Market Hypothesis.' Passive Investing is based on the Efficient Market Hypothesis which says that stocks prices at all times reflect the correct market consensus. Active Managers, by contrast, believe that stock prices are "inefficient." They believe that they can find special advantages in stock prices and can capitalize on inefficiencies in pricing. To Efficient Market advocates, the fundamental, technical, and market timing methods of active managers are pure speculation. Because buyers and sellers have access to the same information, it is not possible to extract profits from forecasting consistently over time.



'Markets Work' means understanding that the price of stocks always reflects the equilibrium point, the meeting point between buyers and sellers. The current price is the only consensus. For every seller, there is always a buyer, and the buyer and the seller both think that they got a good deal at that price. The price reflects what people think is fair at any given moment in time. Even when the price is falling and people are 'panic selling' there is someone out there buying. For every investor who thinks that a stock will go down, somebody else thinks that the stock will go up. Expectations of future prices are baked into the consensus current price.

Both buyers and sellers have access to the same information. Therefore, any attempt at making a prediction about who is going to be right in the future is completely subjective – to the point of being useless. Despite all of the complex processes that exist to back up the prediction, it is still subjective. Individual investors as well as active fund managers, as buyers or sellers, can justify their prediction with complex "fundamental" or "technical" analysis. But at the end of the day, they cannot both be right. Fundamental analysis is a process of developing a reasonable explanation to back up a predetermined, desired conclusion.

Consider Exxon-Mobil - XOM at $73.89/share. What is the market saying about XOM? The aggregate consensus of buyers and sellers is an agreement about the current price, both the current value of the company and expectations about the future. (It is the expected future value discounted for the aggregate consensus required rate of return). The price cannot be anything but that.

However, when Genius Fund Manager says that the "correct" current price is not $73.89, but really $92.00, what is he saying? He is saying that the 'market' will ultimately move the stock price from it's current, incorrect (or inefficient) price, to the real correct price of $92. He is saying that he knows better than anyone else on the planet what the "right price" should be. He believes that returns come from the "mis-pricings" of a "broken" or "inefficient" market.

There are a whole lot of these mangers/players in the market attempting to "best" each other on a daily basis by guessing the future price of the stock. For every genius fund manager who thinks that the "right" price is $92 there is an equal and opposite genius fund manager who thinks that the "right" price is $56. These disparate opinions result in the aggregate consensus price of $73.89. Ironically, the "market's" efficiency is the result of millions of inefficient decisions at every moment in time.

Risk and Return are Related is a natural concept: more risk, more return. Markets price securities in large part based on risk and the perception of risk. When market participants perceive there is a higher element of risk, prices fall and expected return (or demanded return) goes up as compensation for the added risk. August 30, 2011 Bloomberg Reported "US Consumer Confidence Falls to Two-Year Low," the weakest since April 2009. Yes, at a point when consumer confidence is at its lowest, is when the market is most likely to surge upward. Indeed, March 2009 was the lowest point following the

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"New Normal?"

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US Stock Market Performance after 1932*			
	5 Years	**10 Years**	**20 Years**
Annualized Return	15.35%	10.07%	13.19%
Growth of $1	$2.04	$2.61	$11.92

*All stock market returns based on CRSP 1-10 Index.[2]

1941: World War II was raging, and the US had just entered the conflict. The US stock market had experienced two consecutive years of negative performance, and the economy had shown signs of sliding back into depression. Although conversion to a wartime economy would revive industrial production and boost employment, investors struggled to see beyond the conflict. Many expected rationing, price controls, directed production, and other government measures to limit private sector performance.

US Stock Market Performance after 1941*			
	5 Years	**10 Years**	**20 Years**
Annualized Return	18.63%	16.67%	16.29%
Growth of $1	$2.35	$4.67	$20.47

1974: Investors had just experienced the worst two-year market decline since the early 1930s, and the economy was entering its second year of recession. The Middle East war had triggered the Arab oil embargo in late 1973, which drove crude oil prices to record levels and resulted in price controls and gas lines. Consumers feared that other shortages would develop. President Nixon had resigned from office in August over the Watergate scandal. Annual inflation in 1974 averaged 11%, and with mortgage rates at 10%, the housing market was experiencing its worst slump in decades. With prices and unemployment rising, consumer confidence was weak and many economists were predicting another depression.

US Stock Market Performance after 1974*			
	5 years	**10 years**	**20 years**
Annualized Return	17.29%	15.92%	14.89%
Growth of $1	$2.22	$4.38	$16.07

1981: The stock market had delivered strong positive returns in five of the last seven calendar years, and the two negative years (1977 and 1981) were only moderately negative. Despite these results, investors were weary from stagflation, which was characterized by high annual inflation, anemic GDP growth, and unemployment, and from fears of another economic downturn. In late 1980, gold climbed to a record $873 per ounce—or $2,457 in 2010 dollars. (By comparison, spot gold reached $1,256 per ounce in 2010.) Memories of the 1973–74 bear market lingered. A 1979 *BusinessWeek* cover story titled "The Death of Equities" claimed inflation was destroying the stock market and that stocks were no longer a good long-term investment.

US Stock Market Performance after 1981*			
	5 Years	**10 years**	**20 Years**
Annualized Return	18.82%	16.58%	14.54%
Growth of $1	$2.37	$4.64	$15.11

1987: On "Black Monday" (October 19, 1987), the Dow Jones Industrial Average plummeted 508 points, losing over 22% of its value during the worst single day in market history. The plunge marked the end of a five-year bull market. But in the wake of the crash, the market began a relatively steady climb and recovered within two years. The effects of the crash were mostly limited to the financial sector, but the event shook investor confidence and raised concerns that destabilized markets would increase the odds of recession.

US Stock Market Performance after 1987*			
	5 Years	**10 Years**	**20 Years**
Annualized Return	16.16%	17.75%	11.89%
Growth of $1	$2.11	$5.12	$9.46

2002: By the end of 2002, investors had experienced the stress of the dot-com crash in March 2000, the shock of the September 11 attacks, and the early stages of wars in Afghanistan and Iraq. Although October 9, 2002, would ultimately mark the market's low point, investors had endured three years of negative performance and an estimated $5 trillion in lost market value. A younger generation of investors had experienced its first taste of old-world risk in the "new economy."

US Stock Market Performance after 2002*			
	5 Years	**10 Years**	**20 Years**
Annualized Return	13.84%	—	—
Growth of $1	$1.91	—	—

2008–Today: The market slide that began in 2008 reversed in February 2009—gaining 83.3% from March 2009 through 2010. Despite two years of strong stock market returns, memories of the 2008 bear market and talk of the "lost decade" have led many investors to question stocks as a long-term investment. But earlier generations of investors faced similar worries—and today's headlines echo the past with stories about government spending, surging inflation, deflationary threats, rising oil prices, economic stagnation, high unemployment, and market volatility. Of course, no one knows what the future holds, which brings the concept of "normal" into question. What exactly is the status quo in the markets?

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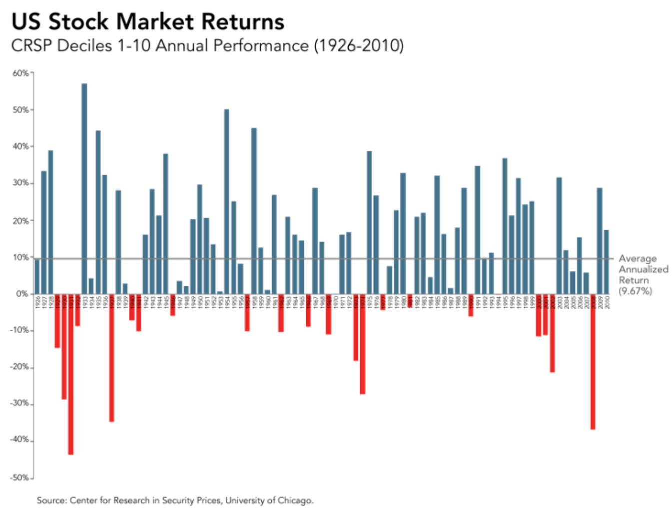

The chart left shows the annual performance of the US market, as defined by CRSP deciles 1-10. Since 1926, there have been only four periods when the stock market had two or more consecutive years of negative returns. In addition, annual returns are rarely in line with the market's 9.67% long-term average (annualized). The most obvious normal may be that, over time, stocks offer expected returns reflecting the uncertainty and risk that investors must bear.

End Notes:

1. Adam Shell, "'New Normal' Argues for Investor Caution," *USA Today*, August, 16, 2010. The term "new normal" originally referred to a post-global financial crisis environment characterized by several years of sluggish economic growth, below-average equity returns in developed markets, high market volatility and risk, high unemployment, and a world in which the range of possible financial outcomes is wider than normal and wealth dynamics are moving from developed to emerging economies.

2. Returns for all periods of the CRSP 1-10 Index are annualized. Data provided by the Center for Research in Securities Prices, University of Chicago. Data includes indices of securities in each decile as well as other segments of NYSE securities (plus AMEX equivalents since July 1962 and NASDAQ equivalents since 1973). Additionally, includes US Treasury constant maturity indices.

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crash of 2008-9. From March, 2009 to March 2011 the S&P 500 went from 683.38 to 1321.15 – a gain of 93%! When consumer confidence is at its highest, the market is generally going to fall.

Risk in investing comes in different flavors. Market Risk is what we experience when stock prices fall. Good companies and bad are all affected by market risk. The worst part about owning stocks is market risk. However, stocks are the best remedy for another type of risk: purchasing power risk. Purchasing power risk is the risk of inflation -- the risk that your dollar will not buy as much 10 years from now as it does today. Investors in CD's will not experience market risk. However, over time, they will experience purchasing power risk. CD investments will not protect purchasing power as the return on CD's is never high enough to pull ahead of inflation.

Diversification is the process of blending dissimilar investments together to mitigate the risks inherent in any one type of investment. To have diversification, you have to combine investments that are significantly dissimilar. Stocks and bonds are significantly dissimilar and are thus considered separate 'asset classes.' Stocks are equity; bonds are debt. Stocks and bonds respond to different market forces. The two fulfill different functions in a portfolio: bonds protect principal, stocks protect purchasing power.

Stock asset classes are based on size (large cap is a separate asset class from midcap and smallcap) and value (value stocks are a separate asset class from growth stocks). Value is defined as low book value to market value or "book to market." Value stocks are "cheap" and Growth stocks are "expensive" on a book to market basis. These are the only features of stocks (called 'factors') that have been proven academically to be significant. There is a heap of academic evidence to support the fact that smallcap stocks behave differently from large cap. This academic foundation about asset classes is the basis of the widely-acknowledged 'Morningstar Style Boxes' which divide the stock universe into Large/Small, Value/Growth characteristics.

These asset class factors are described in the Fama-French Three Factor Model. This model gives us a methodology for diversifying a portfolio while targeting a specific level of risk and expected return. The three factors are:

1. Stocks return more than bonds over a long period. Stocks have more risk than bonds. Choose a ratio of stocks to bonds in your portfolio to target risk/return.

2. Small stocks return more than Large stocks. There is a 'size premium.' Target proportions of large and small stocks in your portfolio to pinpoint the desired target risk/return.

3. Value stocks return more than Growth stocks. There is a 'value premium.' Target proportions of value and growth stocks in your portfolio to pinpoint the desired target risk/return.

In the process of targeting the desired risk/return profile of a portfolio we come back to the cash flow and timeline needs which are defined in the financial plan. We monitor financial progress by comparing the accumulation of investment assets with the accumulation projection that was established in the original financial plan. Hypothetical clients Sue and Jim can monitor and evaluate their investment program to see if they are 'on track' towards meeting their financial goals. When they hear "the Dow is down 248 points" they can be reminded that the market goes up just as dramatically as it goes down. When they hear "consumer confidence is at an all-time low" they can understand that the fear factor will coincide with a market that must pay investors more for their continued participation. When people want to dump stocks forever, this is the process we use to help all of our clients maintain their focus on objectives.