

## Not So Great Expectations

February 2011

While pondering what to write about this quarter, we considered a number of options. As we have said before, we seek to find important, specific issues to focus on in these letters, something to enlighten, that encourages thought and discussion. We avoid regurgitating the market data and commentary to be found everywhere. A couple of important themes popped up in our brain housing groups:

- **Municipal Bonds** – interest rates did rise in Q4, and credit issues hit the headlines again, causing losses in municipal bond portfolios. We chose to address this topic; see below. Important.
- **The New Normal** – we have found this theme to be a useful foil, examining the ideas and analysis behind it, respecting the work of the PIMCO people but not accepting their broad market prognostications, which have been decidedly negative. This quarter we decided to give this one a rest; after last quarter, when equity rose sharply yet again, they seem too easy a target. But they continue to have outstanding performance as bond managers, make no mistake about that.
- **Callan Capital Market Expectations** – these were lower last year, meaning Callan projects lower returns on equity and bonds and from portfolios. This year's results are more of the same, and we will discuss them as our main theme.

But we decided to start off on another topic, a thought triggered by an article in a recent issue of *The Wall Street Journal* entitled "Deficit Outlook Darkens." In this short article, there is a chart which got my full attention. It shows the magnitude of the deficit in historical context, as it approaches 10% of our economic output (again; it also did so in 2009). The article speaks for itself. My only comment is that we face a dire threat, and we need to choose between taking effective action to cut spending now, or putting that off for another day in the hope that it will be easier later, or that more government spending (now called "investment") will actually achieve something important which will in turn lessen the problem. I recommend reading the article and thinking about the issue. This is a very big deal.

By the way, let me take the opportunity to suggest that you can track some of our communications on LinkedIn (or even Facebook). I commented on this article today and made it available to everyone. But if you would like to connect with our firm (or to Roger directly) please do! Just make sure you tell us if you are a client or friend of our firm and we will be glad to have you as a connection.

## Callan Capital Market Expectations

Last year's expectations for market returns were lower than the previous year's, according to Callan and most of the other institutional consulting firms. Across the world of pension plans the waves of unhappiness rippled, as projected returns from portfolios dropped below 8%. And as you will recall, we were looking back at 10 years of returns on the S&P 500 that were negative, highly unusual. For an institutional pension plan, this was a double blow – reduced assets (from low 10-year returns) coupled with reduced future earnings (from reduced Capital Market Expectations). Amidst considerable wailing and gnashing of teeth, investment committees grappled with actuaries demanding that larger pension contributions be made and return expectations reduced.

Well, this year there is good news and bad news. First, the good news: the market did very well! The S&P 500 was up over 15% in 2010, after rising 26.5% in 2009. This, along with the -37% return in 2008, does represent a sharper downturn and less recovery than occur during and after most bear markets, but it is a recovery. Assets are up, and by considerably more than expected.

The bad news is that, with interest rates at historic lows, the expectations for Capital Market Returns are down yet again. Future equity returns were thought likely to be 8.5% last year; this year Callan expects perhaps 8%. Expected bond returns fell even more, by about 0.75% to an incredibly low 3.75%. So a portfolio with about 60% equity might have expected to earn 7.7% based on last year's expectations, but this year, it is expected to make about 7.1%.

## What Does This Mean To You?

Well, several things. First of all, pension plans are bound in a variety of ways to use these numbers for funding calculations and to make contributions based on the expected results. However, the average person does not need to do this. You are, in fact, free to acknowledge how much variation in actual outcomes we are likely to see. These expectations may turn out to have been too low and too conservative. For that matter, as we all know, we could have another big problem, the next Lehman, and another bear market. We simply don't know – that's why they call it risk. We rely on broad diversification and discipline to carry us through, knowing the future is always unpredictable.

So when we look at your financial plans, you can expect to see lower projected results as the “expected case,” just to give you fair warning. But as always, the actual outcomes we experience will probably surprise us, hopefully on the upside this time (we can dream, can't we?).

## Municipal Market Update

Speaking of letters and muni bonds, I saw two good articles by Vanguard the other day called “Municipal bonds: Looking beyond the headlines” and “California is not Greece.” We wrote about these issues in a recent client letter (see our new portal, it's there!), so I won't revisit all the same territory, except to address the fears we have seen in recent headlines as muni bond portfolios lost money in Q4. Interest rates went up, and supply flooded the market before the Build America Bond program expired, but headline credit issues also hurt muni bond prices. The second Vanguard article is pretty reassuring; after reading headlines one might think the States were about to go under, but that is unlikely. The level and burden of debt relative to the various states' economies is very small. Painful steps will need to be taken, and in fact **MUST BE TAKEN**. Bond holders for solid credits are in pretty good shape, actually. State employees and pensioners are another matter, of course.

That being said, another recent article from *The Wall Street Journal*, “Bondholders Left in the Dark” points out that many small issuers of muni bonds do not publish much financial information, and some have gone under without warning. Which begs the simple question: how do people end up with such bad bonds in the first place?

The sad answer to that question is that these entities issued municipal bonds through investment banks that had the retail sales forces needed to place the bonds with mom and pop, who thought they were smart and saving money, buying their own bonds. In effect, they were, for better or worse, acting as their own amateur bond managers. And it clearly was for worse. The broker was a salesman, not an advisor, and had no obligation to his customers to warn them about the bonds they were buying. Let’s face it, there was zero due diligence being performed, and now people are paying the price.

By way of contrast, the Vanguard muni funds we recommend to many clients have extensive due diligence being performed. The separate managers we often recommend for larger muni bond portfolios (e.g., > \$2 million) do the same kind of professional job on due diligence. The Vanguard Intermediate Tax Exempt fund has nearly \$30 billion in assets, invested in almost 3,000 separate muni issues, all carefully researched and monitored. This is the only way we recommend investing in muni bonds, hiring outstanding professional money managers (in a fund or a separate account). Working with an advisor like Hewins, you can have these managers at low cost, with screening and monitoring of the managers themselves – another important layer of due diligence.

#### **Executive Summary: The Overall Muni Bond Market Ought To Be Fine**

Although headlines and changes in interest rates can cause fluctuations in value, states and strong issuers are unlikely to default. If you have professional management with extensive due diligence on the credits, not to mention broad diversification, you need not fear the worst. On the other hand, if you bought bonds yourself, you might want to give us a call.

Sincerely,



Roger C. Hewins III  
President

## References

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