



Year to Date 2012

Stock markets around the world fell in the second quarter after experiencing one of the strongest first quarters in over ten years. The S&P 500 began the year at 1,258 and then rose almost 13% to 1,419 on April 2nd before falling 10% to 1,278 on June 1st. It ended the quarter at 1,362 up 9.49% year to date.

Foreign stock markets followed a similar pattern with most rising more than the S&P 500 in the first quarter and then proceeding to fall even further than the S&P 500 in the second quarter. The graph below lists the six month returns YTD for various asset classes.

Once again equity investments continued to be volatile and fluctuate widely. Many investors are asking themselves whether these fluctuations are normal. In this newsletter we'll take a look at that question. We also discuss how corrections create fear, which leads to emotionally driven investment decisions and subsequently to poor returns; and how this cycle often leads to excellent long-term investment opportunities for more rational investors.

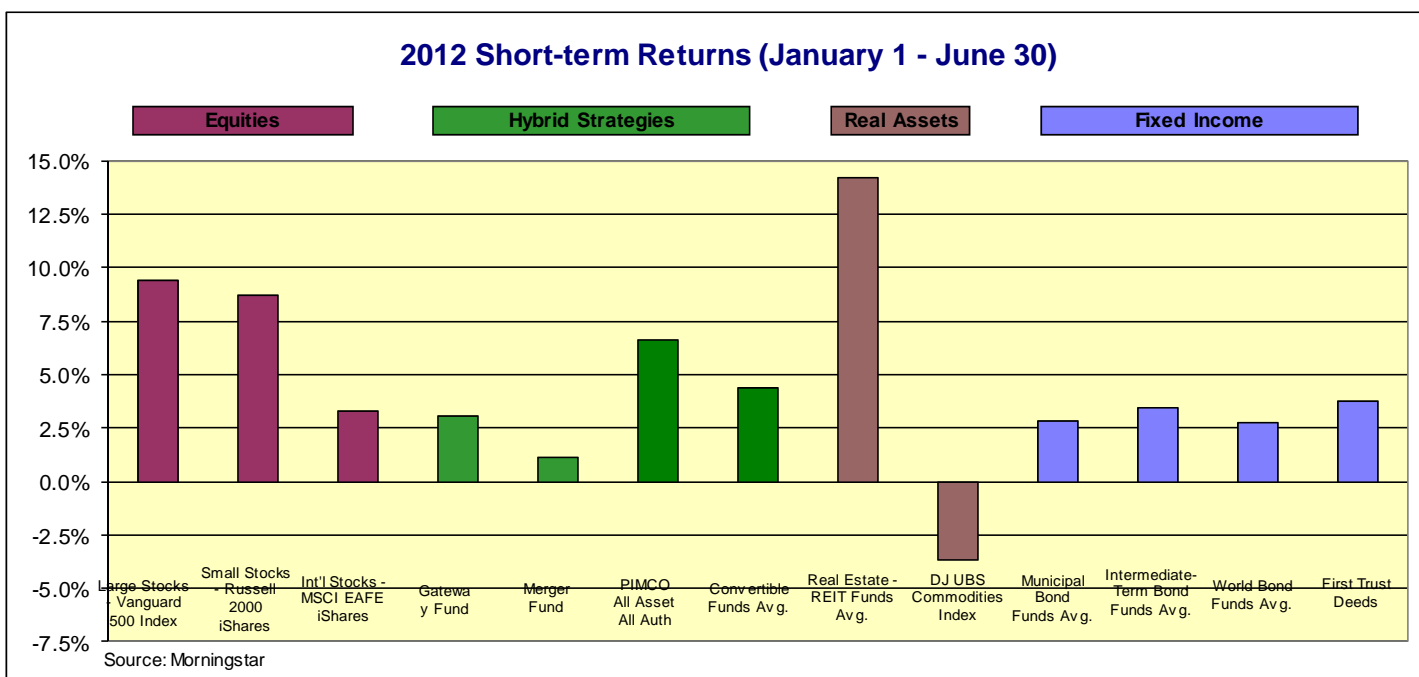
We will cover whether fear has created attractive investment opportunities in Europe; how staying diversified helps investors avoid emotionally driven investment mistakes; and finally we list a few of the bullish and bearish arguments investors point to in an effort to support their outlook.

Executive Summary

- Stock markets around the world fell in the second quarter after experiencing one of the strongest first quarters in over ten years.
- Equity investments continue to be volatile and fluctuate widely.
- Market declines of 5%, 10% & 20% occur on a far more regular basis than most investors realize.
- Market corrections and the ensuing fear often create attractive long-term investment opportunities for more patient, rational investors.
- Poorly timed, emotion investment decisions often cause investors to severely underperform market averages.
- Heightened fear in Europe may have already created attractive long-term investment opportunities.
- A disciplined rebalancing strategy assures that investors behave in a slightly contrarian fashion which over the long-term should improve investment performance.

Frequency of Market Corrections

Most people have no idea how volatile the stock market really is in the short term. Before you read any further guess how often on average 5% corrections have occurred over the last 110 years from 1900 -2010. Now



make the same guess for 10% corrections and 20% corrections.

- 5% corrections – have occurred on average 3 times per year!
- 10% corrections – have occurred on average once per year!
- 20% corrections – have occurred on average once every 3.5 years!

Source: Capital Research and Management.

As you can see, market corrections occur on a regular basis and are far more frequent than most people realize. They have always been a normal part of long-term equity investing and will remain so. There is no reason to fear these market fluctuations if you are a long-term investor, and have a diversified portfolio with a disciplined rebalancing strategy.

Fear and Greed

These market corrections create tremendous fear. They always have and they always will, the greater the correction the greater the fear, this will never change. Quite simply put, this fear is one of the biggest obstacles to successful long term investing.

Fear causes average investors to make emotional decisions and sell rather than buy assets that have become cheaper. As the Dalbar study graph on page 3 shows, this behavior causes investors to underperform investment markets. Simply staying with a disciplined rebalancing strategy will assure that an investor behaves in a slightly contrarian fashion which in turn will improve chances for better investment performance.

Has Fear Already Created Attractive Opportunities In Europe?

According to one well known European fund manager, David Marcus from the Evermore funds, the answer to this question is yes. In a recent interview, David had this to say about Europe, "There is so much distress right now that investors are panicked, everybody is running every which way. This is one of those markets where logic has departed and emotions are running things, which means that if you can keep your head, people will sell you things at crazy low prices."

Marcus says that behind the headlines, hidden from public view, he's watching the rebirth of huge sectors of Corporate Europe. As is often the case in investing, the darkest gloom tends to hide the most interesting opportunities. He says, "Someday this period of obsession with Greek debt, bank restructuring and single-digit P/Es may be known as The Great Oversell."

Staying Diversified

While many investors are selling their international investments, especially those in Europe, we will not. The above anecdotal information from David Marcus leads us to believe that now is not the time to sell foreign investments.



They could always go lower, and in fact there is a good chance they will. To sell now would be to follow the crowd of emotional investors that are selling after assets have become cheaper and represent good long term value.

The GMO 7-year valuation forecasts (that we often refer to) also predict higher 7-year returns for foreign stock investments versus most other investment asset classes. We believe that because our foreign investments were already conservatively allocated in our client portfolios, there is no need to reduce equity exposure at the current time.

Instead we will continue to remain diversified and if the sell off in stocks becomes extreme, we will consider rebalancing our client portfolios and adding slightly to their stock positions.

Summary Perspective

In summary, we like the diversified mix of investments we currently hold in our clients' portfolios. If equities experience an extreme sell off of another 10% to 20%, we would consider rebalancing and adding slightly to equities.

As always there are reasons to be bearish and many pundits cite the following to back up their bearish point of view:

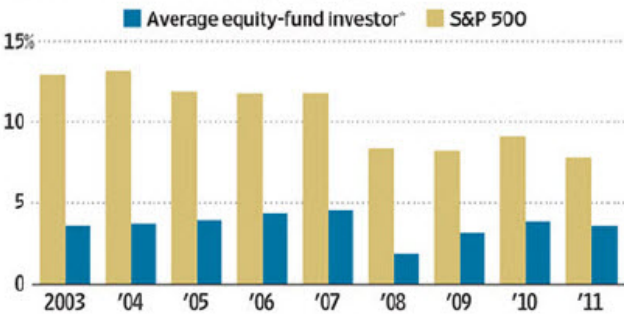
- If our nation's unsound fiscal policies persist, we may be on the cusp of a decade of extreme economic and financial market turbulence due mainly to out of control debt.
- Both political parties in the US have shown incredible fiscal ineptitude and unwillingness to be truthful with the American people when it comes to dealing with the debt and deficit.
- The European debt crisis is far from over.
- Japan faces a huge headwind due to a governmental debt to GDP ratio of about 200%.
- Corporate earnings have been strong but near record pre-tax profit margins are unlikely to continue.

Investor Irrationality on Display

The following charts illustrate that investors continue to react to market movements and the news. One of the most startling and ongoing facts is that at no point in time have average investors remained invested for sufficiently long periods to derive the benefits of the investment markets. ... The result is that the alpha created by portfolio management is lost to the average investor, who generally abandons investments at inopportune times, often in response to bad news.

Longtime Laggards

Annualized returns on a rolling 20-year period



*Calculated from the change in total mutual-fund assets after excluding sales, redemptions and exchanges using data supplied by the Investment Company Institute.

Source: Dalbar

The Wall Street Journal

“Over the years, there has been a huge gap between what [mutual-fund] investors could have done versus what they put in their pocket,’ says Louis Harvey, CEO of Boston-based investment research firm Dalbar. The reason is most investors fail to hold mutual-fund investments for long enough, and instead try to time their investments. But they tend to enter the market after it has risen, Mr. Harvey says. So they are likely buying at a higher price. They also are apt to leave the market after it has dropped, therefore selling at a lower price. The result: investments that will massively underperform against their benchmarks. The average equity-fund investor saw annual returns of only 3.49% in the 20 years through 2011, according to the latest analysis from Dalbar. Compare that with the average 7.81% annual return of the S&P 500.²

¹Quantitative Analysis of Investor Behavior prepared by Dalbar, Inc. April 2012 www.dalbar.com

²Wall Street Journal, April 7, 2012.

There are also reasons to be bullish and other pundits cite the following to back up their more optimistic outlook:

- P/E ratios are not high considering how low interest rates are.
- Values in Europe are becoming more attractive.
- The US economy will continue on its slow growth path.
- The Europeans will begin to make the tough decisions they need to make and the extent of this crisis is already known.
- Lower oil prices will reduce prices at the pump and put more cash into the hands of the consumer.

As stated above we will continue to remain diversified, calm, cool and collected and look for opportunities to rebalance in a contrarian manner - while at the same time focusing on each of our clients’ individual goals and objectives.

Thank You for the Referrals

As always we want to thank those of you who continue to refer your friends and family to us. Most of our clients have been referred to us by other clients and related professionals. If you know anybody looking for an objective advisor, feel free to give them our number and if we are not a good fit for them, we will be sure to refer them to another fee-only advisor that will take care of them.

Please don’t hesitate to call us if you would like to discuss anything you read in this newsletter in greater detail. We hope you are enjoying your summer.

Past performance is no guarantee of future results. All content in this newsletter is intended as general information, not specific advice. Performance data listed is for illustrative purposes only. Portfolios are personalized and often consider many variables, including investment objectives, age, time horizon, risk tolerance, and tax variables. Information contained herein has been obtained from sources believed reliable, but not guaranteed.

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