Weekly Commentary
June 28, 2010

The Markets

Can world governments "cut" their way to prosperity?

It's no secret that many countries are incurring large--and unsustainable--budget deficits. What's interesting is the approach each country is taking to try to lower their deficits to a manageable level. Britain, Japan, Germany, and Greece, for example, are focused on cutting government spending, according to Bloomberg, June 22. Conversely, the U.S., while concerned about government spending, seems more focused on keeping the stimulus spending alive and raising taxes until (hopefully) the economy can catch fire and grow on its own.

Who's right?

According to Harvard University professor Alberto Alesina, “There have been mountains of evidence in which cutting government spending has been associated with increases in growth, but people still don’t quite get it.” In addition, a study by Ben Broadbent and Kevin Daly of Goldman Sachs Group, Inc. as reported by Bloomberg on June 22, "discovered that reducing expenditures by 1 percentage point a year boosted average annual growth by 0.6 percentage point. Raising the ratio of taxes to GDP by the same margin cut growth by an average 0.9 percentage point." And, from a stock market perspective, the same report said, "The equity markets of the countries that sliced spending beat those of other advanced nations by 64% during a three-year period."

Like many things related to finance and economics, we won't know "who's right" until time passes and the market delivers its verdict. Between now and then, expect the vigorous debate on spending cuts versus stimulus spending to continue among academics, investors, and world leaders.

Data as of 6/25/10	1-Week	Y-T-D	1-Year	3-Year	5-Year	10-Year
Standard & Poor's 500 (Domestic Stocks)	-3.6%	-3.4%	17.0%	-10.4%	-2.0%	-3.0%
DJ Global ex US (Foreign Stocks)	-2.0	-8.6	13.9	-11.7	1.9	0.4
10-year Treasury Note (Yield Only)	3.1	N/A	3.6	5.1	3.9	6.1
Gold (per ounce)	-0.2	13.6	33.8	24.4	23.3	16.0
DJ-UBS Commodity Index	0.2	-7.5	3.1	-8.9	-4.2	2.1
DJ Equity All REIT TR Index	-3.0	11.7	65.9	-6.7	1.7	10.6

Notes: S&P 500, DJ Global ex US, Gold, DJ-UBS Commodity Index returns exclude reinvested dividends (gold does not pay a dividend) and the three-, five-, and 10-year returns are annualized; the DJ Equity All REIT TR Index does include reinvested dividends and the three-, five-, and 10-year returns are annualized; and the 10-year Treasury Note is simply the yield at the close of the day on each of the historical time periods.
Sources: Yahoo! Finance, Barron’s, djindexes.com, London Bullion Market Association.
Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly. N/A means not applicable or not available.

ARE THE FINANCIAL MARKETS "NORMALLY DISTRIBUTED" and should you even care? Consider this. The average height of an American male is 69.4 inches, according to the National Center for Health Statistics, October 22, 2008. If we randomly chose 1,000 American males and calculated their average height, we would likely come up with a number close to 69.4 inches. Now, in an un-random fashion, let's assume we found an 8-foot tall man--who is clearly an

extreme outlier--and we have him join the previous group of 1,000. By recalculating the data, we now find the average height of this group of 1,001 men jumps by a very *underwhelming* 0.03 inches. In other words, adding an extremely tall outlier to this group of average height men had very little effect on the overall average height of the group. Without getting too technical and assuming "tall outliers" are just as likely to be found as "short outliers," we can say the height of men follows a "bell curve" or a normal distribution.

By contrast, let's consider the average net worth of American households. According to the Federal Reserve, February 2009, the average American family had a net worth of $556,300 in 2007. Like above, if we randomly chose 1,000 families, this group would probably have an average net worth near $556,300. However, for fun, let's add Warren Buffett--and his $40 billion net worth--to the group. Recalculating the data, we find the average net worth of this group of 1,001 Americans jumps to $40.5 million! Clearly, adding an extreme outlier to this sample dramatically changed the average of the sample.

As it relates to the financial markets, do you think their distribution of returns looks more like the average height of American men (where an extreme outlier doesn't really affect the average) or the average net worth of American households (where an extreme outlier could have an extreme impact)? If you think the returns in financial markets look like the average height of American men, *but it turns out they behave more like the average net worth of American households*, you could lose a lot of money. In fact, much of modern portfolio theory is based on the assumption that financial markets follow a normal distribution, i.e., they look like the average height of American men. Unfortunately, experience suggests otherwise.

Warren Buffett-type outliers such as the October 1987 stock market crash, the 2000-2002 bursting of the internet bubble, the 2007-2009 bear market, the 2008 credit crisis, and last month's "flash crash," suggest that the financial markets are subject to large outliers that can significantly affect your financial well-being. Knowing that, we do our best to try to limit the damage to your portfolio if one of these outliers occurs during your investing lifetime.

Weekly Focus – Think About It

"In the business world, the rearview mirror is always clearer than the windshield."
--Warren Buffett
Best regards,
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Wealth Advisor