

NAVIGATOR



Letter from the Directors

IT'S A SMALL WORLD

As I write this Alberto Contador of Spain just won the Tour de France and Spain beat the Netherlands to win the World Cup. Obviously a good year for Spanish athletes. Not so good for the Spanish economy. In the wake of the collapse of Spain's property bubble, unemployment is over 20% and the country is adjusting to a new era of austerity.

I was in Brussels the day the Tour de France arrived, where I had the opportunity to see the riders and mix with them at the end of the day's stage. The crowds lining the Tour's route measured in the millions. They cheered for their favorites as they passed.

The World Cup brought thousands into the streets of Brussels and the city literally shook when goals were scored. Fans lived and died with the successes and failures of their chosen team. But at the end of the day the emotions faded and the financial challenges reminded.

The emotions that surround these great sporting events bring to mind the intense emotions that we have all felt over the last two turbulent years in the financial markets. People have spent an enormous amount of psychological capital following the markets. It is fun or painful depending

on the market's actions. At the end of the day consider if it was worth the angst you potentially put upon yourself?

In June and July, Jim Hemphill was in South Africa for five weeks with his two sons to watch the World Cup. How quickly the world came to know about the outrageously loud "vuvuzela." And, to my delight, you can now watch the Tour de France in high def from your living room.

I am struck by how the world is increasingly connected. In the fall of 2008, those connections spread the problems in U.S. real estate into a world-wide financial panic. The after-effects of that financial meltdown are still with us in the form of unemployment and slow growth. But it is also these world-wide connections — voluntary, unplanned and mutually beneficial — that will help us to emerge from the current economic downturn.

If you stay out of peoples' way, they will travel, trade, innovate, create, compete, and make us all wealthier. And that is cause for optimism.

For the firm,

David Burd

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Inside the Black Box

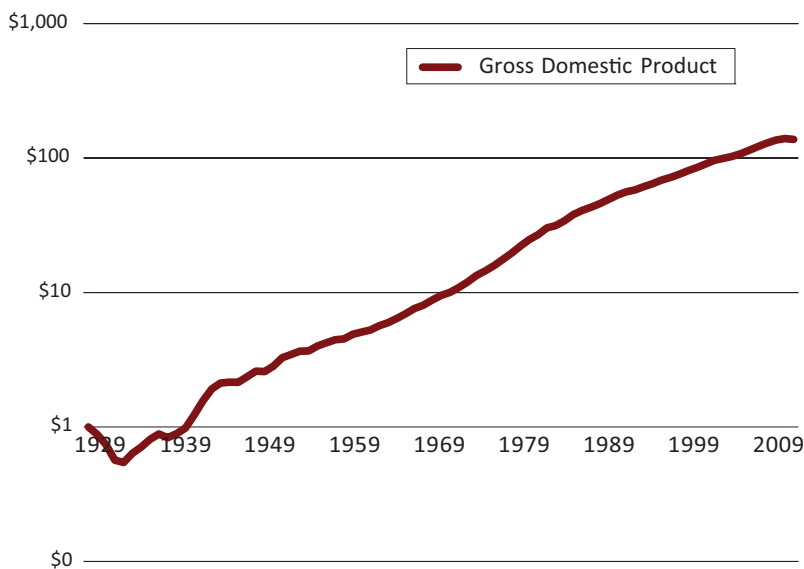
IS IT REALLY ‘THE ECONOMY, STUPID?’

by James S. Hemphill, CFP® ChFC CIMA

In recent months the financial markets have been distressed by worries about a possible double-dip recession. As employees and employers, citizens and taxpayers, we all have concerns about the current economy. But how important are recessions to us as long-term investors?

Consider the following chart of U.S. Gross Domestic Product, which starts in 1929, immediately before the onset of the Great Depression. (For the sake of consistency, all charts are adjusted so the December 31, 1929 value is \$1.00.)

Graph 1: U.S. Gross Domestic Product



What does this chart tell us? First, we Americans are a fortunate people. The modern market economy, tempered by regulation, has made us many times richer than were our parents or grandparents at similar ages. In fact, the standard of living of the average American at the end of the Roaring Twenties, immediately before the Great

Depression, would be considered Third World today. We often forget just how lucky we are.

Second, long-term GDP growth has been quite stable, except during the decade of the Great Depression. Once World War II jump-started industrial production, real economic growth (economic growth minus inflation) has averaged between 2% and 4% per decade. The recession of 2007-2009, which saw a maximum contraction of economic activity of 3.8%, was one of the most severe of the last fifty years. But using

a logarithmic scale (as we must to make the data understandable, given the huge compounded growth over time) the recent recession is barely even visible.

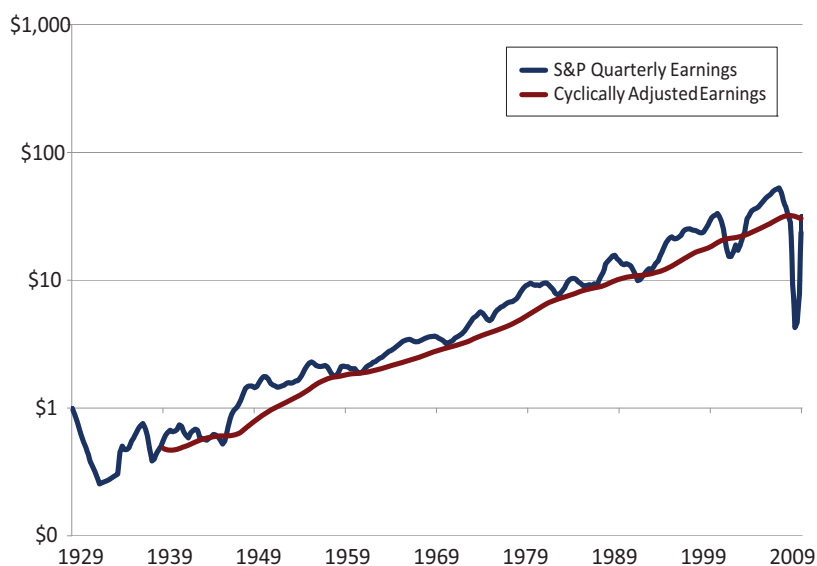
Our current level of public and private debt may well act as a drag on economic growth. Ditto the gap between our public-sector ambitions (government spending) and resources (tax revenues). But assuming we avoid the policy errors that turned a financial panic into a persistent Depression back in the 1930s, and to the extent that investment returns are a function of long-term economic growth, this chart suggests that investors should stop worrying about the economy.

Or maybe not. We know that investment returns over the last ten years have been poor, even when the economy was growing.

Perhaps there is more to the investment picture than simply economic growth?

Classic investment theory assumes that stocks have value because they will provide us with a series of future cash flows in the form of dividend payments. By discounting each of those future cash flows to the present, we can

Graph 2: S&P 500 Earnings



determine the value of a company's stock. The updated version of that theory says stock investors are paying for future earnings, and need not receive those earnings in the form of dividends as long as they are prudently reinvested and create shareholder value. Similar principles apply, whether we are talking about an individual company or about the market as a whole.

Dividends are quite stable and change slowly, even during times of significant economic turmoil. Earnings, on the other hand, are highly variable in the short term. Seldom more so than during the Great Panic of 2008-2009, when earnings cratered. (See blue line in Graph 2 above.)

But if we adjust earnings to reflect the cyclical nature of the economy, by using a ten-year trailing average, the volatility largely disappears. (See red line above.) The earnings chart now looks very much like the prior chart of Gross Domestic Product. If we assume the world economy is not going into another decade-long depression, once again we appear to have reason to remain optimistic. We now have a model in which the main variables (GDP growth, corporate

earnings growth and stock dividends) are quite stable and predictable over a time frame relevant to the long-term investor. Maintain a long-term perspective, have a little patience, and we are home and dry. Our portfolios will be fine.

Or will they? All might be well if the story ended with corporate earnings. But it does not. When we add price into the picture, much of our confidence disappears. The *price* investors are willing to pay for common stocks, compared to the underlying *earnings* of public corporations, is wildly variable. Part of that variation is rational, reflecting short-term uncertainty about the economy, corporate earnings, interest rates and inflation expectations. But a great deal of it is irrational, and reflects short- and long-term trends of optimism and pessimism, greed and fear.

Consider the fluctuation in market prices during the panic. A 4% decline in GDP triggered a 90% decline in month-by-month corporate earnings, but only a 5.6% decline in ten-year trailing earnings – *yet it caused a 56% decline in the broad stock market*. Stock market prices are *ten times* more variable than trailing corporate earnings, and as much as *twenty times* more variable than the growth of the overall economy.

Here is a model for thinking about investment returns: *future investment returns can be conceptualized as a function of the slope of the line between today's prices and a constellation of possible values that lies out in the future*, clustered around the long-term growth trends of the economy, corporate earnings and dividend payments. The slope of the line (expected future annual returns) is a function of the two points through which the line is drawn. The steeper the upward slope of the line, the higher our rational expectation of future returns.

In the graph below, I've illustrated compound earnings growth at 6% (twice the long-term growth potential of the economy) and at 2% (below the historical growth rate of the economy).

Changing the rate of earnings growth affects the future terminus of the line, which has an effect on the slope of implied future returns. But far more important is the left anchor of the line, which represents the current price.

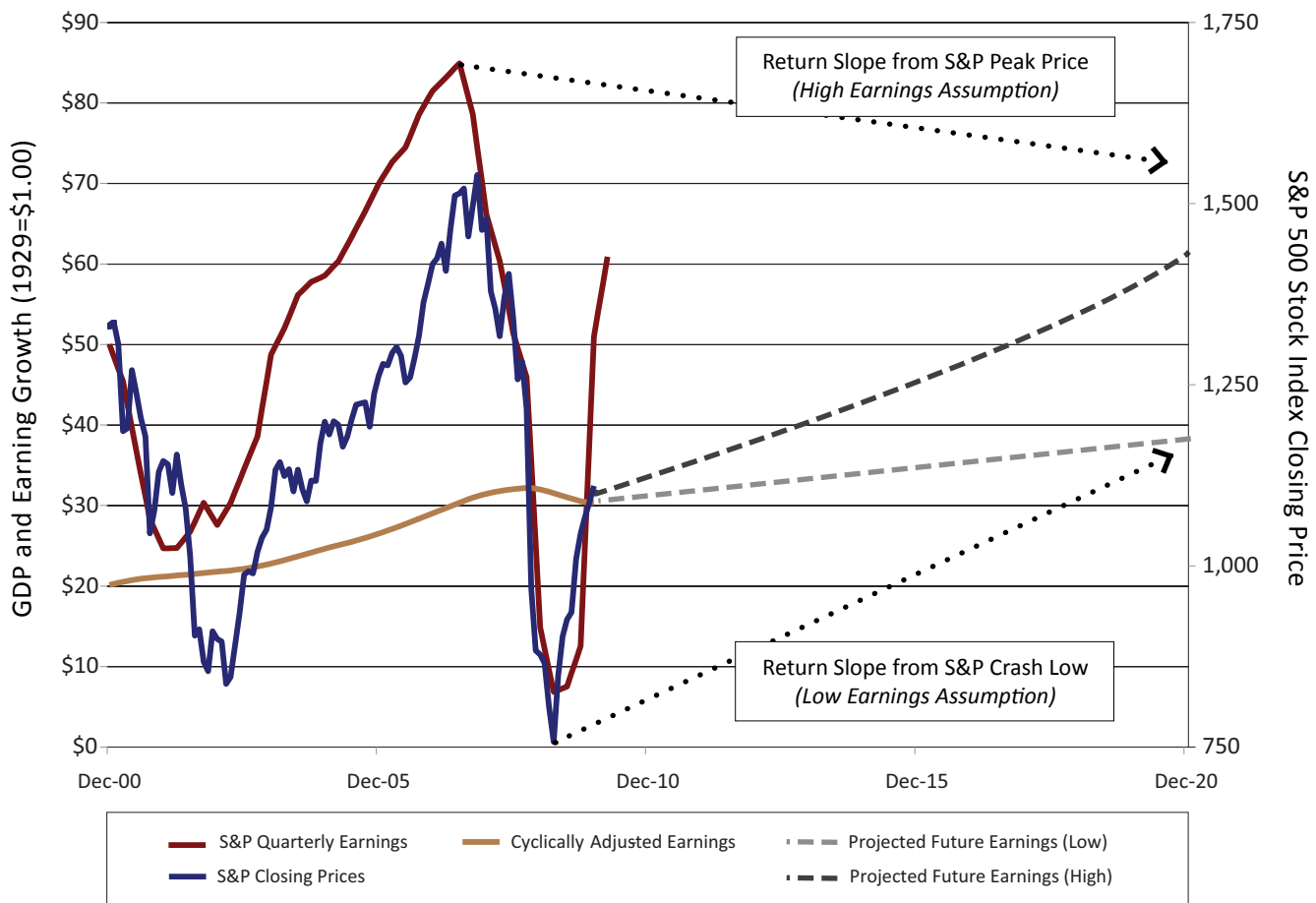
Stock prices are profoundly variable. Consider the recession of 2007 to 2009, and the financial panic that was both result and cause of that recession. At the market high in 2007, just before the onset of recession, the slope of implied future

returns was actually negative, even given an optimistic assumption of 6% compounded earnings growth. But at the 2009 market low, even a pessimistic earnings growth assumption suggested strongly positive returns.

What do we conclude? The endless obsession of the financial press and the cable business channels on projecting the near-term direction of the economy and corporate earnings is a massive distraction, of little interest to long-term investors. *But price matters.*

After a 70% recovery in the markets, what do today's prices for stocks and bonds imply about future returns? I'll return to that question in my next *Black Box* column.

Graph 4: Historical and Potential Earnings Growth



*Market Commentary***PROTECT WEALTH IN UNCERTAIN TIMES***by Marvin L. Barron III, CFP®*

In late May, we gathered under the bright white tent at Appleford Estates to listen to Jim Hemphill and I discuss the markets. Almost three months have passed since then and the market's behavior hasn't brought us (and we're guessing you) much comfort.

There are six main factors that cause us to be worried and optimistic:

1. Easy money

Worry: Easy money drives speculation and stupidity.

Optimism: It also drives asset prices and strength in the markets.

2. Regulations

Worry: Recent financial reforms have given more power and funding to the same regulatory bureaucracies that failed us in 2007-2009.

Optimism: In the 1930's, it took from the Crash of '29 until the passage of the Investment Company Act of 1940 to put the new regulatory regime fully in place.

3. Deficits

Worry: U.S. deficits are on an unsustainable path.

Optimism: We know this. The American people are more concerned with debt and deficits today than at any time in recent years. It is possible to rein in out-of-control spending and reclaim fiscal health. (At least if you are Swedish).

4. Demographics

Worry: Most of the wealthy democracies face a demographic crisis as populations age and social programs becomes unaffordable.

Optimism: The U.S. is in better shape than almost any other OECD country. Between high rates of immigration and healthy birth rates, the U.S. population continues to grow.

5. Valuation

Worry: Stocks are expensive around the world.

Optimism: It was a great deal worse in 2000 and again in 2007. Equity prices are high, but not insane. Our research suggests low positive returns going forward.

6. Volatility

Worry: Volatility has spiked again.

Optimism: It has simply returned to normal pre-2003 levels.

Our top strategies to protect and grow your money:

- 1. Sell anything that's stupidly priced.**
- 2. Reduce portfolio risk.** In a low-return environment, a total loss in one part of the portfolio can't be recovered with high returns elsewhere.
- 3. Manage tax liability across time.** Taxes on earned income, capital gains, dividends and estates are all scheduled to increase next year.
- 4. Turn off CNBC, Fox Business News and other sensationalized short-term market commentary.** To stay informed, we recommend sources such as *The Economist* magazine.
- 5. Keep political opinions and investment decisions separate.** Don't take investment advice from Glenn Beck. Ditto Paul Krugman.
- 6. Own real things.** We believe there are only four "real" things in which you should invest serious money: stocks, bonds, real estate and cash.
- 7. Know what you have.** We are often surprised by the number of successful people who don't know their net worth plus or minus \$1 million.

If you missed the presentation, *Dark Clouds and Silver Linings: Protecting Wealth in Uncertain Times*, at Appleford in May, it is available to view on TGS Financial Advisors' website, www.tgsfinancial.com, on the Publications page.

THE MARKETS *at a Glance (ending June 30, 2010)*

INDEX	ANNUALIZED RETURN		
	One Year	Five Year	Ten Year
Dow Jones Industrial Average	18.9%	1.7%	1.7%
Standard & Poor's 500 Stock Index	14.4%	-0.8%	-1.6%
Morgan Stanley Europe, Australasia, and Far East Index (EAFE)	5.9%	0.9%	0.2%
Barclays Capital Aggregate Bond Index	9.5%	5.5%	6.5%
Barclays Capital Municipal Bond Index	9.6%	4.4%	5.6%
Six Month Certificates of Deposit	0.5%	3.3%	3.1%
Inflation (Consumer Price Index)	1.0%	1.5%	2.3%

Inclusion of these indices is for illustrative purposes only. Keep in mind that individuals cannot invest in any index, and index performance does not include transaction costs or other fees, which will affect actual investment performance. Individual investors' results may vary. Past performance does not guarantee future results.

Don't wait

REFINANCE NOW

Mortgage rates continue near record lows, with a 30-year fixed-rate mortgage dipping below 4.4% in August. If you have a higher-rate fixed mortgage, or any adjustable-rate mortgage (ARM), we suggest that you act now to ensure that you don't miss this historic opportunity.

While there is no way to know how low rates might go, we fear that high inflation in coming years may push rates higher — perhaps significantly.



Source: The Cartoon Bank

*Buyer Beware***ALL ANNUITIES ARE NOT CREATED EQUAL***by Vincent R. Barbera CFP®*

A new class of combined investment/insurance contracts is making a big splash. To the consumer who has been beaten up by the volatility of the market over the last couple of years, a product promising guaranteed returns sounds like sweet music. We have concerns about the appropriateness, the marketing and (in certain cases) the safety of some of these contracts. Let's start by clarifying some terms:

Immediate annuities, where you exchange cash for a stream of future monthly income payments, are among the safest financial vehicles around. We believe they can be an excellent choice for retired individuals who are looking for safe and predictable income.

Variable annuities are regulated as securities. Variable annuity sub-accounts are separately-trusted. Even if the sponsoring insurance company fails, assets in the sub-accounts would remain intact. We have concerns about the use of variable annuities as the sole or primary vehicle to build funds for retirement, and we have not invested new client funds in a variable annuity in a decade, but we do know several smart and ethical advisors who include variable annuities as part of their accumulation plans.

Equity indexed annuities, despite their link to the stock market, are not regulated as securities. Their guarantees are secured only by the general funds of the insurance company. They combine different types of benefits (market-linked growth, guaranteed principal, lifetime income) in ways very difficult to understand. Why are they sold so aggressively? Because they pay higher commissions than almost any other financial product — as much as 12% of the dollars invested.

We are not yet persuaded that it is a good idea to combine something insurance companies have done well for more than a century (project mortality outcomes and pay

lifetime income) with something they have done badly for only a few years (predict market risks and manage portfolio volatility). As *Chief Investment Strategist*, Jim Hemphill says, "Think of AIG's credit-default swaps unit in London, which got risk wrong by two orders of magnitude, lost \$150 billion, and almost crippled the world financial system."

If there's one thing that we should have learned over the past two years, it is that we should be skeptical of any claim of a high-return, risk-free investment. There is always a risk-reward relationship. In order to achieve a higher rate of return, you have to be willing to incur greater risk.

If you're considering an investment product that promises guaranteed returns or low to no risk, please bring it to our attention. We are here to help you make decisions that will best benefit your financial well-being. *We believe that there are meaningful options available depending on your specific situation and need. However, as we've said again and again, in the current market environment there is an enormous amount of noise.*

Signs of a potentially deceptive practice or product, beware if a salesperson:¹

- Encourages you to borrow money or cash in retirement funds to invest.
- Pressures you to invest immediately.
- Promises quick profits.
- Says that the disclosure documents required by federal law are just a formality.
- Sends materials with typos or misspellings, or are not printed on letterhead.
- Use of words or statements such as: "guarantee," "high return," "limited offer," or "safe as a CD."

¹ *Consumer Action website (www.consumeraction.gov)*

Goings on About Town

Financial advisor Vincent Barbera and his wife Jill are excited to announce that they are expecting their second child in November.

Tom Rylko, our Director of Financial Planning, completed the *Media 5 Mile Race* on June 18th. He was happy to shave several minutes off last year's time.

TGS clients Michael and Joanne Christopher are proud of their son Brian's recent accomplishment. Brian completed a five month trek up the Appalachian Trail. His journey began on February 28th in Georgia and ended in Maine. Retrace his steps at: www.trailjournals.com/brianchristopher

TGS Financial Advisors was named a *Top Wealth Manager* by *Wealth Manager magazine* for the fifth year in a row.

The firm was also named by *Financial Advisor* magazine as one of the *Top RIA Firms* nationally. This is the fourth consecutive year the firm has been recognized.

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by TGS Financial Advisors), or any non-investment related content (financial planning, estate planning, insurance, etc.), made reference to directly or indirectly in this newsletter, will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from TGS Financial Advisors. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. A copy of our current written disclosure statement discussing our advisory services and fees is available for review upon request.

Please remember to contact TGS Financial Advisors if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services. Please also advise us if you would like to impose, add or modify any reasonable restrictions to our investment advisory services. TGS is neither an attorney nor accountant and no portion of the newsletter content should be construed as legal or accounting advice.

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Book Recommendation

The How of Happiness

A Scientific Approach to Getting the Life You Want

by Sonja Lyubomirsky | Reviewed by Marvin Barron

Most self-help books base their advice on a foundation of philosophy, religion, or personal experience. The How of Happiness is the first general-audience book to base its advice on clinical research. That research comes to us from the new field of "positive psychology," whose founding father – Marty Seligman – works at the University of Pennsylvania.

Positive psychology has taken the research tools of traditional psychology and turned them toward the question of "What is it that nurtures our minds?" instead of the traditional question of "What causes our minds to break?"

What researchers have found is that about 50% of our happiness is genetic (thanks, Mom!), 10% is environmental, and 40% lies within our conscious control. This book is a great place to start if you'd like to learn methods for controlling that 40%.