

in Context

WEALTH STRATEGY FROM A DIFFERENT PERSPECTIVE



THE COST OF CASH

During times of investment crisis, some investors flee to safer investments. This past crisis was no exception. For the period 2008–2009, equity funds experienced \$243 billion of outflows.

Many investors feel safer staying in cash. In late March, *The Wall Street Journal* reported these figures: “As of March 16, assets stood at \$2.99 trillion, according to money-market fund tracker iMoneyNet, the first time they ended a week below \$3 trillion since passing that mark on Nov. 20, 2007.”

However, investors sitting in cash run the risk of inflation eroding their spending power. A November 2009 article on cash on CBS’s *MoneyWatch* noted, “All inflation is not created equal. Some things go up a lot, even when most prices remain stable or even decline. One is college tuition, and another is health care, a major concern for retirees. Even stocks may not keep pace with health care inflation (currently in the double digits, according to Buck Consultants) — and cash has no chance.”

In the majority of years, cash accounts can keep up with or slightly outpace inflation. Once taxes are figured into the equation, the figures look worse. The *MoneyWatch* article cited this data from Morningstar: Cash holdings earned an average of 3.7 percent per year from 1926 through 2008, while inflation averaged about 3 percent per year. The after-tax returns of cash accounts were about 2.3 percent.

When investor confidence is shaken, sitting in cash can feel comfortable. That comfort comes at a price, and investors may not realize how steep that price can be. It is important to realize the costs associated with comfort and safety.

THE ELUSIVE SURE THING

As we began 2010, it seemed there were three sure things: The price of gold would rise, bond yields would rise and inflation would show up uninvited. The year began with gold at \$1,121 and the 10-year Treasury note yielding 3.82 percent.

At the end of the first quarter, gold is at \$1,113, and the yield on the 10-year Treasury is 3.83 percent (as of 03/31/10). The U.S. Consumer Price Index, which tracks inflation, rose just 0.3 percent and 0 percent in January and February, respectively.

Despite the economic and political issues (domestic and international) that we have faced so far this year, equity markets around the globe have turned in solid performances. Unfortunately, again this quarter, so many investors made the same mistake they did in 2009: They poured money into short-term cash equivalents such as money market funds and savings accounts. In March, there was more than \$8 trillion in cash equivalents with nearly \$3 trillion in money market funds.

In their fixed income allocation, it has been difficult for many investors to take at least some term risk. This is frustrating because the yield curve has been very steep, providing a large risk premium.

Investors have been reluctant to extend maturities beyond the very shortest term because the conventional wisdom is that interest rates are sure to rise. This fear has caused them to try to insulate themselves from the negative impact of rising rates.

At some point this year, the Federal Reserve may begin raising its target for short-term rates to stay ahead of inflationary pressures. However, investors fail to recognize that given the steep yield curve, it is quite possible they could actually be exposing themselves to the greatest risk by staying short. That’s because that is where rates could rise the most, and those investors could miss the opportunity to capture the better rates that currently exist not much further out on the yield curve.

While a Fed tightening will certainly lead to a rise in short-term rates (driving down the prices of short-term bonds), that doesn’t mean that long-term rates will have to rise. In fact, if the Fed raises short-term rates more than expected, long-term rates might actually fall. The reason: An unexpectedly large increase would be perceived as a tightening of monetary policy, which has positive implications for longer-term bonds.

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SHELF LIFE

Knowledge is power, but too much information can be destructive. Studies have shown that investors who tune out the majority of financial news fare better than those who subject themselves to an endless stream of information, much of it meaningless.

—Gary Belsky and Thomas Gilovich, *Why Smart People Make Big Money Mistakes ... And How to Correct Them* (revised and updated, 2009)

IS TECHNICAL ANALYSIS PROFITABLE IN EQUITY INDEXES?

By Ben Marshall

Technical analysis uses historical price and volume movements to generate buy-and-sell signals. This investment technique continues to be popular with the investment community, yet there is much debate over whether it can add value. In a recent paper, we tested the profitability of more than 5,000 trading rules on the 49 MSCI-EAFE developed and emerging market equity indexes. Such rules are often used by investors when they are deciding whether to enter or exit a market.

There are a huge number of possible trading rules, which raises the possibility that a given rule will appear profitable on a particular data series due to chance. The possibility of such a chance finding needs to be accounted for using statistical techniques, so we adopted these in our paper.

Most researchers have found that technical trading rules do not add value in the U.S. equity market, but the historical evidence is more favorable to technical analysis in emerging markets. However, it is difficult to compare the results from previous studies across countries, as they use different time periods, different trading rules and different statistical techniques.

We compared more than 5,000 of the most common rules (different variations of moving average, filter, support and resistance and channel breakout rules) across 49 markets from January 2001 through December 2007. We chose MSCI-EAFE indexes because these benchmarks are frequently used by fund managers.

Although we found evidence of some trading rules generating returns in excess of the average buy-and-hold market return in each of the 49 market indexes, these returns were not statistically significant once we accounted for the possibility they could be due to random chance.

We can conclude from our research that there is no evidence that the technical trading rules we tested added value over the seven-year period we considered, beyond what may be attributed to random data variation. It appears that investors using these rules would not have consistently earned better returns than a simple buy-and-hold strategy.

About This Commentary: A summary of the working paper "Technical Analysis Around the World" by Ben Marshall and co-authors Rochester Cahan (Deutsche Bank, N.Y.) and Jared Cahan (Macquarie Energy, Houston). This is available at <http://ssrn.com/abstract=1181367>.

Ben Marshall is an associate professor of finance at Massey University in New Zealand. His research has been discussed in *Barron's*, the *CFA Digest*, *Technical Analyst*, *Sydney Morning Herald*, *thetstreet.com*, *New Zealand Herald* and *National Business Review*. He has written more than 20 articles for professional and academic journals.

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What is really unfortunate is that recent history provides an example of this very point, evidence that investors either don't know their history or they don't learn from their mistakes. From 2004–2007, as the Fed was tightening monetary policy, one-month T-bill rates rose from less than 1 percent to more than 5 percent. During this period, one-year Treasury bills returned 3.3 percent per year, and five-year Treasury notes returned 4.2 percent per year. Thus, despite a sharp rise in rates, long-term bonds were the best place to be.

Given that there is no evidence suggesting that professionals have the ability to forecast interest rates, it seems prudent for investors with fixed income allocations to at least consider extending maturities and earn the term premium within the context of their Investment Policy Statement. As research has shown, for the best estimate of tomorrow's yield curve, one should look to the yield curve today.



Four Estate Planning Steps to Consider

By Chris Erblich

Review and Update Existing Estate Planning Documents — It is essential to have core estate planning documents in place (living will and health care power of attorney, financial durable power of attorney, will and revocable trust). Estate planning is a journey rather than a one-time destination, meaning these documents should be reviewed every few years. Laws change, family situations change and attitudes toward wealth and charity change. Estate planning documents should change to keep pace.

Review Beneficiary Designations — A beneficiary designation — such as a "transfer on death" designation on a savings account, or a beneficiary named on a life insurance policy or retirement plan account — controls where these assets pass on death, **regardless of where an individual's will or revocable trust directs assets to pass**. It is critical that beneficiary designations be properly coordinated with the overall estate plan.

Implement a Revocable Trust Rather Than a Will — Most people would identify a will as the document that controls where an individual's assets pass on death. A revocable trust (also called a living trust) is a "will substitute" with several advantages. With a properly funded revocable trust, an individual may avoid the need to probate assets upon death (a slow, costly and public process) and may plan for periods of lifetime incapacity.

Pass Assets to Future Generations in Trust Rather Than Outright — An individual's will or revocable trust commonly directs assets to be distributed outright to children or grandchildren at a certain age, such as 25 or 30. Outright distributions to beneficiaries can have significant drawbacks. Assets distributed outright to a beneficiary may be exposed to a beneficiary's creditors, divorce claims and estate taxes. If assets are instead held for a beneficiary in a lifetime trust, it may be possible to avoid creditor and divorce claims and also to minimize estate taxes, all while maintaining flexibility for the beneficiary.

Chris Erblich is a partner with Husch Blackwell Sanders LLP. He practices in the areas of tax and estate planning with a focus on high net worth individuals. He has been an adjunct professor of law, teaching estate planning at St. Louis University School of Law. Chris is listed in the 2007–2010 editions of *Best Lawyers in America*® in the area of trusts and estates.



Buckingham Asset Management, LLC
8182 Maryland Ave., Ste. 900
St. Louis, MO 63105

phone	314.725.0455
toll-free	800.711.2027
fax	314.725.7022
web	www.investmentadvisornow.com
email	bamservices@bamstl.com

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