



Financial Planning Notes
Client Newsletter
July, 2010

"I love to go to Washington, if only to be nearer my money."

Bob Hope

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Bubble, Bubble, Toil and Trouble

The global capital markets seem to have become markets driven by bubbles. In the last decade we've seen three bubbles burst with adverse affects to market prices all over the globe. We had the great tech stock bubble that burst in 2000, the speculative run-up of housing prices that burst in 2007 and the China driven commodities bubble that burst in 2008.

Bubbles are nothing new. Speculative bubbles have been around and recorded for hundreds of years. Yet investors never seem to learn as one bubble bursts and they get sucked into another.

How do we recognize the next big bubble? One way is to look for stories that sound exaggerated and that promise new paradigms that will break with historic patterns of price relationships. Recent stories like:

- Inflation will skyrocket due to increased government borrowing and investors will flee to the safety of gold.
- The dollar will collapse as the US economy disintegrates, providing healthy returns to those invested outside the US.
- China, India, Russia and Brazil will continue their rapid growth independent of trends in the United States and their stock markets will rise accordingly.

Another way might be to take the internet shortcut and just ask Google, since, as my teenage children have taught me, that is where all of the wealth of information known to modern man is catalogued. Type into the Google search window "the next big market bubble" and see what happens. It may scare you if you don't know better.

Upon reading the pages and pages of information provided you realize that the next big bubble is... well, just about anything and everything you can imagine. Here's a short list of actual predictions I pulled from Google of where the next big bubble is certain to happen: The Chinese Yen, Diamonds, Banks, Higher Education, Blue Chip Stocks, Lithium, Rare Earth Metals, Carbon, Asia, US Government, China, *Sub-Prime* Carbon, Alternative Energy, Biotech, Emerging Markets and Commodities. I got tired of reading after that.

If there is one thing you can count on investors doing, it's chasing performance. As strong performance in any of the above list pushes prices higher you can bet investors will be jumping on, committing far more than they should, oblivious to what lies ahead. Then when the bubble bursts, down they go, desperately trying to get out. When they do, with whatever is left, off they go to look for the next great opportunity.

What a horrible way to invest.

After going through the above Google list, if I were an investor new to the market or maybe with just a rudimentary understanding of how markets really work, I'm afraid I might be inclined to stay out of the market all together. Surely one of these bubble predictions is correct... maybe all of them are!

In hindsight, bubbles always seem so obvious. Looking back at the housing crisis now, it seems painfully obvious that real estate prices were overpriced and that a far too large number of people were buying homes that simply couldn't afford them, due of course to easy lending and sub-prime mortgage products. It's so obvious... now.

However, in 2005 or 2006 when real estate was peaking there was very little discussion about the potential devastation to prices that was about to occur. And there was even less discussion about the potential that a failing real estate market had on every other aspect of the economy.

Obvious now, not so obvious back then.

So it's probably safe to say that the next big bubble bursting will be blatantly obvious *after* it occurs. We'll be asking ourselves, "Why didn't we make money off of this?" or "How could we have missed that... it was staring us right in the face!"

But I ask you now, where is it going to occur? And when? Very difficult to answer... and if you *think* you know, would you bet all your money on it?

So what are we investors to do?

We remind ourselves that bubbles are just a natural part of the whole process. We realize that capital markets are unpredictable over the short term but over the long-haul investing in capital markets has been a wonderful way to grow wealth. We realize that, since capital markets are unpredictable we must be highly diversified and remain so throughout our investment lives. In essence, we must never own any one thing (or group of "like" things) enough to make a killing on it or be killed by it.

And we must never panic.

One thing I can virtually assure you is that there will be the opportunity to panic again... maybe soon. Market swings wide enough to cause the timid investor to panic have been a regular part of the history of capital markets since the beginning. A rational person would expect it to continue. I have no idea where the next downturn is going to come from, when it will come or what the circumstances will be. I do know, however, that historically after every single market downturn the market made a recovery... every single time. So again, the rational investor would expect the result to continue.

Human behavior is still going to dominate and most people will still instinctively want to flee, even when they know logically that it makes no sense. Herein lies the value of a good investment advisor; to remind you, if you are that person, that to flee will be going against every piece of historical evidence we have and to tell you not to do it.

The longer we are in this business the more conviction we have for what I just said. I'm going on 20 years now as an advisor and over that time I have amassed (unfortunately) multiple examples of where I gave up and agreed with my client that perhaps it would be better for them to do the thing that I know is wrong. Guess what? It was the wrong thing to do EVERY TIME. I'm learning and getting tougher in my old age.

The next big bubble is out there, somewhere. It's probably staring us right in our face, even as we speak. Laughing at and intimidating the weaker investors. But not us... and not you.

Allen

Academic Research Improves Small Cap Portfolio (This Gets a Little Techy)

Small company investing is one of the strategies that we employ in our equity portfolios. We know from the academic work of Gene Fama, Ken French and others that exposure to small company stocks has an advantageous effect, or premium, to returns over time. It also adds a dimension of diversification to the portfolio which benefits volatility as well as return.

Research has recently identified a subset of US small cap stocks that *does not* appear to capture the small cap premium and has consistently underperformed the small cap universe. This set of stocks has growth characteristics in the form of low valuation ratios such as book price-to-market.

Research by the academic community into the performance of small cap growth has not isolated a specific reason why these stocks perform poorly over the long term. But the effect is clearly observable and measurable. Given the poor performance in small cap growth stocks one has to wonder if it is possible to improve the long-term performance in a US strategy by isolating and excluding small cap growth stocks.

Step One: Defining Small Cap Growth

The first step is to identify the small caps that are growth stocks. The academic definition of small cap growth would be the small cap stocks that, based on having the lowest book-to-market ratios, comprise

the lowest 25% of book-to-market ratios. However, we don't necessarily want to exclude that entire 25% of the small cap market from eligibility. Instead, we want to refine and intensify the most extreme small cap growth stocks: we could call these "the worst of the worst." So in addition to book-to-market ratios we additionally sort based on earnings-to-price ratios and cash flow-to-price ratios.

There are approximately 2,500 eligible stocks in the US small cap market. After sorting we find that roughly 10% fall into the above criteria, which we could term "extreme" growth.

After Exclusions: The Impact on Performance

Next we can look at the exclusion's effect on long-term performance (from 1979 to 2009). The US small cap strategy¹ (before exclusions) had an annual return of 11.91%. The set of extreme small cap growth stocks had a return of -1.63%. The strategy after exclusions had a return of 13.30%, an improvement of nearly 1.4%. For comparison, the Russell 2000 index of small cap stocks is shown, and the data extends back to the beginning date of the index.

1979-2009	US Small Cap Strategy ¹	Extreme Sm Cap Growth Stocks	US Sm Cap Strategy excluding extreme	Russell 2000 Index
Annual Return	11.91%	-1.63%	13.30%	11.26%

¹DFA US Small Cap Portfolio, DFSTX

Implementation

Research has found consistent underperformance in US small cap growth stocks, and holding these stocks in a diversified strategy can be detrimental to long-term performance. Simply attempting to exclude all small cap growth stocks, as defined by a broad measure, could diminish the potential for diversification in the small cap buy universe. Instead, academics recommend developing a refined definition to focus on excluding only the extreme small cap growth stocks.

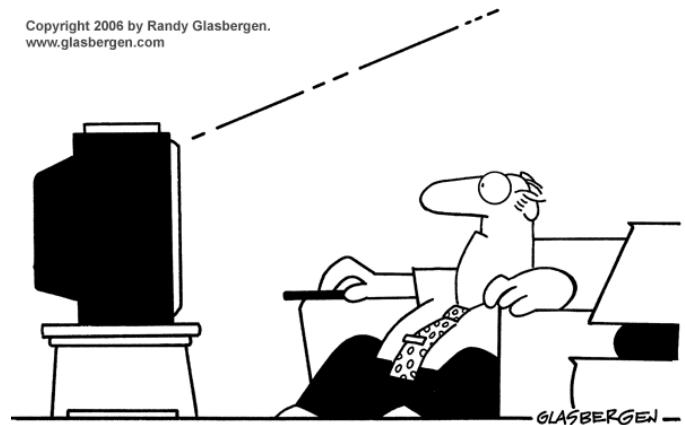
We have seen our primary developer of equity product (Dimensional Fund Advisors, or DFA) begin to implement this exclusion of extreme small cap growth stocks in all of their US strategies. We are

seeing them sell off opportunistically extreme growth small cap stocks where they have held them.

Researchers are currently studying markets outside the US, focusing initially on the largest developed and emerging markets, to see if the same poor underperformance in small cap growth exists.

Academic Conduit

Having this conduit, through asset managers like DFA, continues to be valuable to clients of Northstar. You can be assured that as new research in the academic community develops we will pass that valuable information on and implement wherever possible.



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"Stocks were down today, but bounced back after someone drove down Wall Street throwing Prozac from the back of a truck."

On Stock Picking and the World Cup

A couple of newsletters ago, I compared stock picking to the NCAA Basketball championship tournament. Perhaps this prompted you to think... could I draw analogies to other sports? Professional sports? International sports? Or perhaps you just went on living your life.

Either way, events at the World Cup serve to highlight the difficult, maybe impossible task we undertake when we attempt to pick winners. As with stock performance, we can only take into account known information in trying to determine how our favorite team will perform in the future, and all of the known information is already considered, or "priced

in” when it comes time to put up our money and bet on the games.

There were a number of teams considered “elite” going into this summer’s tournament in South Africa: Five-time champions Brazil, along with Portugal and Spain are always among the top ranked teams. Also among the top tier were the 2006 champs Italy, and runners-up France.

As a result of their heavily favored status, bets on Italy and France in the opening round games provided you with very low odds, or a very small payoff if they won. Yes, they were favorites to do well, but the oddsmakers accounted for that and offered you a small return for a successful bet on those teams.

In the world of stocks, Italy and France would be “blue chip” companies. Strong balance sheets, proven record of success, and an expectation of good earnings in the future. Because the risk of failure was less than the risk for low-ranked teams like North Korea and New Zealand, the expected return was small.

It would have been difficult to predict what came next: In the opening round, Italy failed to beat lowly New Zealand. In fact, they managed only two ties and a loss, and failed to advance to the second round. France’s failure could be described as “epic.” Their star striker was sent home after tussling with coaches, and the rest of the team boycotted practice. They scored just one point, and closed out their World Cup experience with a humiliating loss to the host team, ranked 83rd in the world.

Yes, sometimes the favorites fall. If there were no chance of losing, you wouldn’t be able to place a bet, and you wouldn’t want to, because your \$1 bet would return you \$1.

It’s worth keeping in mind the unpredictability of sports and the difficulty of beating the oddsmakers when you see media stories recommending concentrated financial portfolios to get you through volatile times. Often those recommendations are the blue chips, or even “safer” assets like US Treasuries.

It is easy to recognize the two significant problems with that kind of investing: 1) The market already knows those investments are safe, and so their securities are priced at a premium to the market; and 2) there’s no guarantee a top ranked company will perform up to its previous standards (or better) in the future.

Steve

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Thanks for Your Recommendations!

We are continually honored with the highest praise we can imagine... your recommendation to your family, friends and neighbors.

Like any business, we thrive on word of mouth recommendations from our friends and clients. We love helping new friends that are sent our way and we strive to do everything possible to provide them the same great client experience you receive. Thanks!

Congratulations, Steve!

Our own Steve Tepper is now a CERTIFIED FINANCIAL PLANNER[™] practitioner, having completed all of the education, experience and examination requirements of the CFP Board of Standards.