ROCKBRIDGE INVESTMENT MANAGEMENT, LLC

Financial Common Sense

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Rockbridge Investment Management is a group of like-minded professionals working with a select group of clients with whom we can have a significant impact. Everything we do is focused on building and preserving wealth for our clients. We help remove complexity so clients can focus on the simple but difficult process of successful investing.

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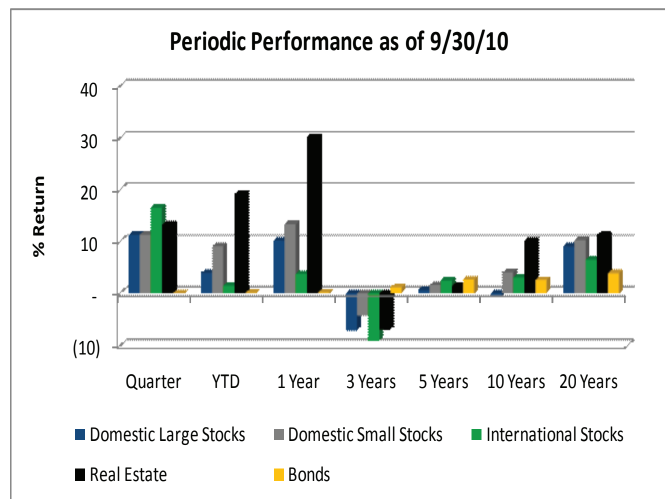
Market Commentary by Craig Buckhout

Equity Markets

Equity markets finished the third quarter with a very strong performance in September, bringing all major categories into positive territory for the year to date (YTD). With returns less than 4%, large-cap US and international markets are below our long-term expectations while small company stocks (+13% YTD) and real estate (+20% YTD) are above their long-term averages and making very positive contributions to diversified portfolios.



After a summer of doom and gloom reports about chances of a double-dip recession and the government debt crisis in Europe, it is a bit of a surprise to see all markets in positive territory, proving once again the value of diversification and a consistent discipline.

The Irony of Bonds

Falling interest rates have bolstered bond returns in 2010. When rates fall, bond prices rise. The increase in price provides an immediate boost to returns, but the lower rates mean expected future returns are lower. So total returns for 2010 are over 7% for a bond market index fund but yield to maturity is down to 2.3%.

Is Now the Time to Buy Dividend Paying Stocks?

I keep reading articles that present dividend paying stocks as an alternative to low fixed income returns. One author recently noted that a number of companies have a dividend rate (as a percentage of the stock price) that is half a percentage point or more higher than their ten-year bond yields. He specifically mentioned Johnson & Johnson with a dividend yield of about 3.6% and ten-year bonds yielding about 2.9%. "And, of course, that dividend is going to rise over time, whereas that bond payment is fixed."

That may be true, and consistent with long-term expectations, but stocks and bonds have very different risk characteristics, and dividend paying stocks are still stocks. (See Inset on page 2 "How Volatile Are Stocks?")

For the past five years, and even the past ten years, bonds have outperformed stocks. We expect the opposite over the long term. With interest rates near historically low levels, the expected returns from stocks, dividend paying or otherwise, are an appealing part of a well-diversified portfolio but not a substitute for bonds.

(Continued on page 2)

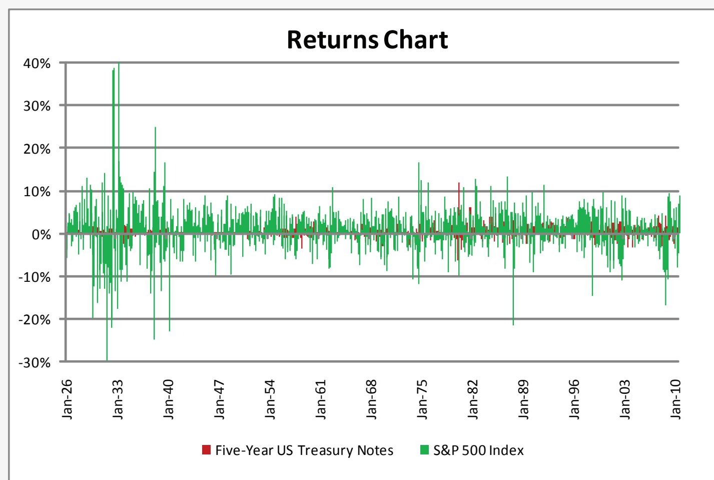
Market Commentary (cont.)

What Should We Expect From Here?
Markets have been relatively volatile and we can expect more of the same, as markets react to good and bad news about economic events. We tend to observe less volatility when everyone agrees the economy is growing and debate centers on the rate of global economic growth. The current debate however, about inflation or deflation, recovery or a double-dip recession, reflects a greater level of uncertainty, which is naturally reflected in greater market volatility. (See Inset "How Volatile Are Stocks?")

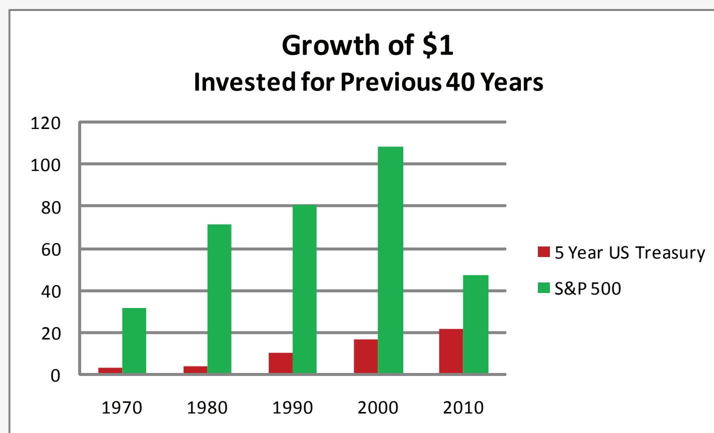
So, investor fear remains high amid the volatility and uncertainty. One indication is the measure of cash flowing from stock to bond mutual funds. Morningstar reported that bond funds grew by $168.5 billion while domestic stock funds shrank by $42.2 billion, year to date through August. This data supports the statement of Gus Sauter, Chief Investment Officer for Vanguard. When asked what is the greatest risk investors face today, he replied, "Not participating (in equity markets)."

The formula for success remains unchanged: understand risk, diversify, and follow a consistent discipline. ◆

How Volatile are Stock Returns?
It is important to remember that stock markets have always been volatile. Looking at the S&P 500 since 1926 we observe the average monthly return at a bit less than 1% per month, but the chart below shows how much returns gyrate. The chart also shows the much less volatile monthly returns on five-year Treasury bonds, which have an average monthly return of nearly 0.50%.



Month to month, or even for a year or two, the additional risk of stocks seems unappealing compared to the meager half percent additional return. Indeed, short-term investors have no business investing in stocks. However, if we step back and look over a 40-year period of accumulation or retirement distribution, the extra risk is expected to pay off handsomely as illustrated in the chart below showing the growth of $1 over a 40-year period ending in each of the past five decades.



Historically, stock prices have been volatile, and we should expect that to continue.

Fixed Income Risk in Your Portfolio by Anthony Farella

With interest rates near historical lows, some investors may be anxious about a possible rate climb and its potential impact on their fixed income investments. Rising interest rates typically cause existing bonds to lose value. While investors might hold short-term instruments to manage this risk, an interest rate decline could spoil this strategy by forcing investors to reinvest in lower yields when their short-term instruments mature.

Rate movements in either direction affect portfolio returns. This is true in any market environment, regardless of the current rate level. The larger question is how to manage the risk. As you read the financial headlines and evaluate your current fixed income exposure, it may be helpful to consider these principles about fixed income investing:

Interest rate movements are unpredictable.
Academic research offers strong evidence that the bond market is efficient, and that bond prices and interest rates are not predictable over the short term. This uncertainty is reflected in the often-contradictory interest rate forecasts offered by economists, analysts, and other market watchers.

Even when the experts share similar views on the direction of the economy and credit markets, reality often proves them wrong. Last year's *Wall Street Journal* forecasting survey offers a recent example. Among 50 economic forecasters surveyed in 2009, 43 expected the ten-year US Treasury note yield to move higher over the next year, with an average estimate of a 4.13% yield. Only two respondents predicted rates to fall below 3.00%. The ten-year Treasury yield slumped to 2.95% on June 30, 2010, and rates on thirty-year mortgages fell to their lowest level since Fannie Mae began tracking them in 1971.

Today's bond prices already reflect expectations for tomorrow's business conditions and inflation, and these expectations can change quickly in response to new information. This new information is unknowable. Investors who accept market efficiency should not be surprised when the credit markets foil the experts. If prices were easy to forecast, you would find a host of fixed income managers with market-beating returns. But most of them underperform their respective benchmarks over longer time periods.

Since no one has a reliable method for determining whether interest rates will rise or fall in the near future, investors should avoid making fixed income decisions based on a forecast, media coverage, or their own hunches.

Pursuing higher expected returns requires more risk taking.
The strong link between risk and return appears in all properly functioning capital markets. When investing in stocks, bonds, or other assets, investors must accept more risk to pursue a higher potential return.

In the fixed income markets, earning a return above short-term government instruments is usually a function of assuming more term and credit risk. Term risk refers to a bond's maturity, and credit risk refers to the creditworthiness or default potential of the borrower. Bonds with longer maturities and lower credit quality are usually considered riskier and have offered higher yields and returns to compensate investors for higher risk.

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An Evening With John Langdon – October 28, 2010

Join us for "An Evening With John Langdon" on Thursday, October 28, from 5:30 p.m. - 7:30 p.m. at Justin's Grill, near Carrier Circle, on 6400 Yorktown Circle, East Syracuse. Author and Le Moyne professor John Langdon will be discussing the expanding global economy and its impact on investors. John is well known in the Syracuse area, especially by the senior community, for his standing room only presentations on current world affairs for the local chapter of OASIS, a unique educational program for mature adults. His down-to-earth witty conversational style gives him instant rapport with his audiences and helps them to better understand complex world issues. Visit our website for further information on John.

If you would like to attend, please RSVP by Friday, October 22, to Mary Habib at 315-671-0588, ext. 224.◆

Fixed Income Risk in Your Portfolio (cont.)

On the term side, investors who commit their capital for longer periods of time are exposed to the amplified effects of changing interest rates. Bond prices and interest rates move in the opposite direction: When rates rise, the value of an existing bond declines; when rates fall, bond values rise. The market adjusts the price to match the yield available on a new instrument. The longer the bond's maturity, the greater the price adjustment for a particular interest rate change.

On the credit risk side, the Government is considered the strongest borrower in the market, so it has a lower cost of capital relative to other issuers. The most creditworthy companies are considered relatively safe, but they must still offer a higher rate than the Government to compensate investors for taking more default risk. The weaker a corporate borrower's financial condition, the more it must pay in yield to attract investors. Investors seeking higher returns on the credit spectrum must bear a higher risk of default.

Investment strategy should drive fixed income decisions.

Investors may hold fixed income securities for a variety of reasons—for example, to reduce portfolio volatility, generate income, maintain liquidity, pursue higher returns, or meet a future funding obligation. Each objective may involve a different portfolio approach, or a combination of strategies to manage tradeoffs. Regardless of your approach, you should know the difference between controlling risk and avoiding it. You cannot eliminate risk, but you can manage your exposure by diversifying across maturities, industries, countries, and currencies to reduce the impact of rates, inflation, currency fluctuations, and other risks.

Many factors influence the direction of interest rates and performance in the bond markets, and these are too complex for anyone to reliably predict. Rather than placing your faith in the experts or reacting to economic news, manage your fixed income component from a portfolio perspective. Your strategy should reflect your overall investment goals, risk tolerance, and other personal financial considerations. This is a solid approach to managing your portfolio in an uncertain interest rate market.

Over the long term, it's interest income—and the reinvestment of that income—that accounts for the largest portion of total returns for many bond funds. The impact of price fluctuations can be more than offset by staying invested and reinvesting income, even if the future is similar to the rising-rate environment of the late 1970s and early 1980s.◆

Returns from Various Markets

The following table shows the returns from various markets over periods ending September 30, 2010:

Market/Asset Class	Quarter	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
Money market	0.0%	0.1%	0.1%	1.1%	2.6%	2.5%	3.8%
Bond market	3.3%	9.0%	8.7%	7.5%	6.1%	6.5%	7.3%
Large-cap stock market	11.3%	3.9%	10.2%	-7.2%	0.6%	-0.4%	9.1%
Small-cap stock market	11.3%	9.1%	13.3%	-4.3%	1.6%	4.0%	10.3%
International equity market	16.5%	1.5%	3.7%	-9.1%	2.4%	3.0%	6.4%
Inflation	0.1%	1.1%	1.1%	1.6%	2.1%	2.4%	2.6%

Market Benchmark Portfolios

The following table shows returns from our market benchmarks over periods ending September 30, 2010:

Benchmark	Quarter	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
Capital preservation	3.0%	4.9%	5.2%	3.3%	4.2%	4.2%	5.7%
Conservative	5.6%	6.0%	7.1%	2.2%	4.2%	4.3%	7.2%
Moderate	8.3%	6.8%	8.8%	0.7%	4.0%	4.2%	8.3%
Aggressive	10.3%	5.8%	8.6%	-2.3%	3.0%	3.2%	8.6%
All equity	13.0%	4.0%	7.9%	-6.7%	1.3%	1.8%	8.6%

Note: These results were developed by simulating past returns in the various markets included in each benchmark, assuming the reinvestment of dividends and other earnings and deductions of costs totaling 0.20%. The money market is represented by 90-Day Treasury Bills; the bond market by the Barclays Capital Government/Credit Bond Index; the domestic large cap market by the S&P 500; the domestic small cap market by the Russell 2000 Index; and the international equity market by the EAFE Index. This data is presented to show the long-term relationship between returns at various levels of investment risk. It is not intended to present performance results experienced by clients of Rockbridge Investment Management, but is intended to provide a benchmark against which actual performance might be judged. Also, readers should recognize that future investments would be made under different economic conditions. It should not be assumed that future investors would experience returns, if any, comparable to those shown above. The information given is historic and should not be taken as any indication of future investment results.