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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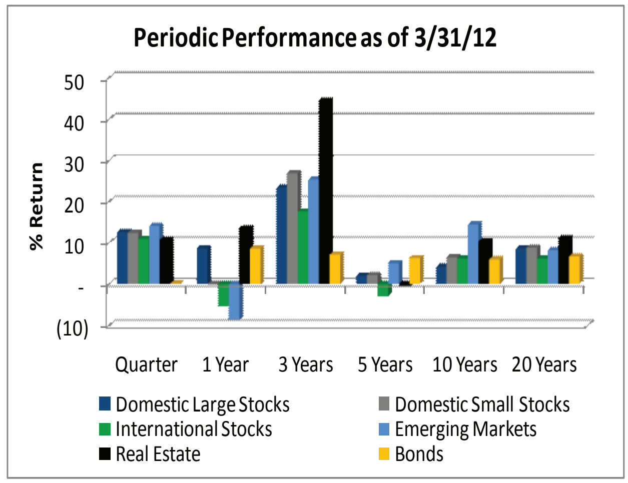
Market Commentary by Craig Buckhout

Equity markets got off to an outstanding start in 2012. Returns for the first three months represented the best yearly start since 1998, as the S&P 500 was up 12.6%. As you can see in the chart, equity markets were generally up 11%-13% with emerging markets up 14%. The broad bond market essentially broke even for the quarter, while riskier bonds, like high-yield corporates, were up as much as 5%.



Equity returns exceeding 10% would be welcome for the year, say nothing of the quarter. Some fear that we are now due for a correction, as the markets have risen too rapidly. We try never to predict future market movements, but it is worth noting that the S&P 500 index, ignoring dividends, reached 1530 back in March 2000. It got back to 1560 in the fall of 2007 before retreating, and it is now hovering around 1400, meaning that the value of the 500 largest U.S. companies is still well below the level first attained twelve years ago, and earnings continue to improve. So while a correction is always possible, there seems equal opportunity for further upside.

It is also interesting to note how much less volatile markets have been in the last

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What About Bonds? by Anthony Farella

Bonds will be a terrible investment over the next 10 years. That is the conventional wisdom in the investment community lately.

> "Bonds are the worst asset class for investors," says Professor Burton Malkiel, the author of A Random Walk Down Wall Street, in an opinion piece published in late March in *The Wall Street Journal*. "Usually thought of as the safest of investments, they are anything but safe today. At a yield of 2.25%, the 10-year U.S. Treasury note is a sure loser."

This prediction may or may not be correct; however it is important to review the reasons why investors should hold bonds in a diversified portfolio.

What Are The Risks of Owning Bonds?
There are 3 components of risk in owning bonds. Issuers of bonds (corporate or government) can default and not repay you. Default risk can be very low (U.S. Treasuries) or quite high (corporate junk bonds). As interest rates rise, the market value of your bond holdings will go down (interest rate risk). Over the past ten years bond returns have been very good due in large part to the increase in market value as rates went lower and lower. Inflation is a source of risk that greatly impacts an investor's purchasing power in retirement.

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Market Commentary (cont.)

quarter as the debt crisis in Europe generates fewer alarming headlines, and other economic news has taken on a positive tone. The European debt crisis seems far from solved, and yet just the absence of bad news has had a surprisingly positive effect on global equity markets.

Should Passive Investors Feel Bad About Getting a Free Ride?
The efficient market allows passive investors to get a free ride – market returns at minimal cost while others do the work. Diligent, hard working analysts and active managers are determining the true value of individual stocks and bonds, and driving prices toward those values in an auction market. Meanwhile, index funds come along and buy a market basket of securities at the market price without doing the work to determine if the prices are fair.

But What Happens When Everyone Buys the Index? Who Keeps the Market Efficient?
As a believer in the advantages of index funds, I have been asking these questions since before we started an investment advisory firm in 1991. By that time, index funds had been available to institutional investors for a few years, but they were just beginning to take off with smaller investors using mutual funds. The new products allowed us to utilize institutional money management strategies for small investors, and it seemed clear that everyone should adopt the new innovation that allowed anyone to get market returns at low cost. Alas, not everyone saw the world as we did, and they probably never will.

Nonetheless, we now see growing talk of passive management dominating markets, and having a detrimental effect on market function. In fact it has become the topic of serious research.

The latest issue of the *Financial Analyst Journal* includes an article, "How Index Trading Increases Market Vulnerability" (Sullivan and Xiong, March/April 2012). It reports that, "the authors found that the rise in popularity of index trading – assets invested in index funds reached more than $1 trillion at the end of 2010 – contributes to higher systematic equity market risk." The implication is that traders are buying and selling the whole market basket without regard to the merits of individual stocks. I have seen presentation materials from at least one active manager using this argument to help explain why it has been so difficult for them to outperform the market.

On the other hand, Jack Bogle, the founder of Vanguard often credited as the father of index funds, sees the growth of passive investing as a triumph. About 25% of mutual fund assets are now invested in index funds. Also, ETFs (Exchange Traded Funds) which typically track an index but trade throughout the day, now represent about 30% of trade volume in U.S. equity markets, having grown from essentially zero in 12 years. Appearing at a recent conference, Bogle said that in the last five-plus years, index funds have gained $600 billion in assets, while active managers have lost $400 billion. He says that investors have to be persuaded by the growing evidence that index funds work.

So, will the dominance of passive investing destroy the free ride? I am not worried. I believe there will always be plenty of people willing to pay smart analysts to keep the market efficient. My latest evidence of this was published in the *New York Times* on April 1, 2012 in an article entitled, "Public Worker Pensions Find Riskier Funds Fail to Pay Off." The article reports on public workers' pension funds across the country, increasingly turning to riskier investments in private equity, real estate and hedge funds…"but while their fees have soared, their returns have not."

It goes on to explain that the states using more of these alternative, actively managed investments have incurred higher fees and worse performance, compared to the states that stuck with a more traditional mix of stocks and bonds. Yet the Oklahoma Teachers Retirement System, which has done well over the past five years with a mix of stocks and bonds, is putting 10 percent of its fund into private equity and real estate funds. When asked about the higher fees, the fund's executive director said, "We believe the outperformance from moving into these categories can justify the additional fees," demonstrating that hope springs eternal, and that Mr. Bogle is an optimist to think that investors will be persuaded by the facts. I think passive investing has a bright future, and I will be happy to continue taking that free ride.◆

Financial Planning Etiquette: Clients First!
by Patrick Rohe

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"The interests of the client continue to be sidelined in the way the firm operates and thinks about money." This is a direct quotation from Greg Smith's recent op-ed that he penned after stepping down as a senior executive of Goldman Sachs. Holding himself up as a man of integrity, Mr. Smith couldn't stand working there any longer because "the environment now is as toxic and destructive as I have ever seen it," and he no longer had personal beliefs that aligned with the firm he had once so passionately supported.

However, this news should not come as a big shock to everyone. Goldman Sachs, Bear Sterns, Merrill Lynch, Wells Fargo and the many other large financial institutions alike have a priority to their shareholders, and that is to make a profit. Greg Smith stated "if you make enough money for the firm you will be promoted to a position of influence" and later went on to add that the most common question he received from junior analysts was, "how much money did we make off the client?" Mr. Smith claims that clients are referred to as "muppets" by senior staff, suggesting that those clients are oblivious to their sole purpose of providing profit for the firm!

According to a study by Harvard and MIT economists, many financial advisors are often more likely to give advice that will lead to higher fees for them than higher returns for their customers. These economists sent hundreds of actors to financial advisory firms and found that in many cases those advisors steered their clients away from a logical investment and instead into one that produced more fees.

Former Bear Stearns CEO Alan Greenberg once said that he would not hold an M.B.A. against prospective hires, but that he much preferred job candidates with a P.S.D. – his term, which is short for Poor, Smart, with a Desire to be rich. After graduating from Cornell University with a degree in Economics, I was eager to put my newfound love for finance to the test in my first job with a well-known national investment firm. However, much to my surprise, the three-week training that came with the position was spent solely on sales techniques. A few weeks later, after bringing in several clients, I then realized that I had no clue what to do next in regards to investing their money!

So what can individual investors do to avoid being a "muppet" for the firm they decide to work with?

Here are a few qualities to seek:

Fiduciary. They act only in your best interest; a fiduciary relationship means we're legally obligated to do so. Registered Investment Advisory firms are held to a fiduciary standard. This is not the case with others such as insurance companies or broker/dealers.

Fee-only. Their compensation is fully disclosed, fairly priced, and paid strictly by you, their client. Fee-only advisors accept no commissions or other types of incentives from outside sources to distract them from serving as your fiduciary.

Having worked at a brokerage firm prior to my time here at Rockbridge, I personally understand Mr. Smith's frustration. This is one of the reasons that I am so passionate about our firm's investment philosophy and the fiduciary standard that we hold ourselves to as investment advisors. At Rockbridge, we have a strong desire to do right by our clients and carry forward the belief that the "Golden Rule" applies to all that we do, including financial planning!◆

What About Bonds? (cont.)

For retired investors, interest and dividends are an important source of income. If inflation outpaces interest rates, the bond investor's purchasing power decreases.

It is likely that bond returns will not be nearly as good as they have been over the past ten years. So what should an investor do about it?

1) **Sell bonds and move into cash or CDs, waiting for interest rates to rise.**
While it seems like a good strategy, it's very difficult to predict when rates will rise. They may stay low for several more years. Inflation is likely to outpace interest payments from cash reducing their real value and purchasing power.

2) **Sell bonds and re-invest in the stock market.**
In addition to expected return, high quality government bonds are a low-risk way to diversify a stock portfolio. An investor would greatly increase portfolio risk using this strategy. Ask yourself if you can stomach the volatility of a 100% stock portfolio during a period like 2008. Most investors would be unable to ride out that storm.

3) **Reach for higher dividends by reallocating to longer-term or corporate bonds.**
This strategy will also increase risk in a portfolio. Longer-term bonds are more volatile and sensitive to interest rate changes. Corporate bonds increase default risk if the business offering the bond fails.

4) **Do nothing.**
Bonds are in a portfolio for good and valid reasons. Over the long term, interest income – and the reinvestment of that income – 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.

I don't recommend selling bonds and buying either cash or stocks. However, there is merit in adding longer-term Treasury Inflation-Protected Securities, or TIPS, and short-term corporate bonds into a portfolio for investors willing to accept the additional risk. There is no way to reliably predict future interest rates or inflation, so most investors will fare very well by leaving their bond allocation alone and riding out the market cycle.◆

Returns from Various Markets

The following table shows the returns from various markets over periods ending March 31, 2012:

Market/Asset Class	Quarter	1 Year	3 Years	5 Years	10 Years	20 Years
Money Market	0.0%	0.1%	0.1%	1.2%	1.9%	3.4%
Bond Market	0.1%	8.5%	7.1%	6.3%	5.9%	6.6%
Large-Cap Stock Market	12.6%	8.5%	23.4%	2.0%	4.1%	8.6%
Small-Cap Stock Market	12.4%	-0.2%	26.9%	2.1%	6.4%	8.8%
International Equity Market	11.0%	-5.3%	17.7%	-3.0%	6.2%	6.2%
Real Estate	10.8%	13.5%	44.5%	-0.8%	10.4%	11.2%
Inflation	0.6%	2.9%	2.4%	2.3%	2.5%	2.5%

Market Benchmark Portfolios

The following table shows returns from our market benchmarks over periods ending March 31, 2012:

Benchmark	Quarter	1 Year	3 Years	5 Years	10 Years	20 Years
Capital Preservation	1.2%	4.5%	5.6%	3.6%	4.1%	5.2%
Conservative	3.6%	5.1%	10.1%	3.9%	5.0%	6.6%
Moderate	6.0%	5.4%	14.5%	3.8%	5.7%	7.6%
Aggressive	8.3%	3.7%	17.3%	2.5%	5.4%	7.8%
All Equity	11.5%	0.8%	20.9%	0.1%	5.0%	7.7%

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.