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MANAGEMENT

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YOUR BIGGEST LONG-TERM FINANCIAL ENEMY IS INFLATION

A silent killer of wealth is once again stalking the land, and it isn't Bernie Madoff: it is the old enemy of investors and savers, inflation.

Inflation has been remarkably subdued since 2001, running at a 2.3 percent annualized rate as measured by the Consumer Price Index. Since the recession that began in Dec. 2007 (and ended in June 2009) inflation has been even more subdued at only 1.4 percent per year.

But recent months have seen ominous double digit increases in energy costs, along with rising food costs. The CPI increased by one-half of one percent in February. It is currently rising at an annual rate of 2.1 percent, higher than the 1.5 percent increase during the 2010 calendar year.

Savers get hurt

Inflation eats at every financial instrument, but no one is hurt more than those who have fixed rate investments, such as bonds or savings instruments like certificates of deposit and bank savings accounts.

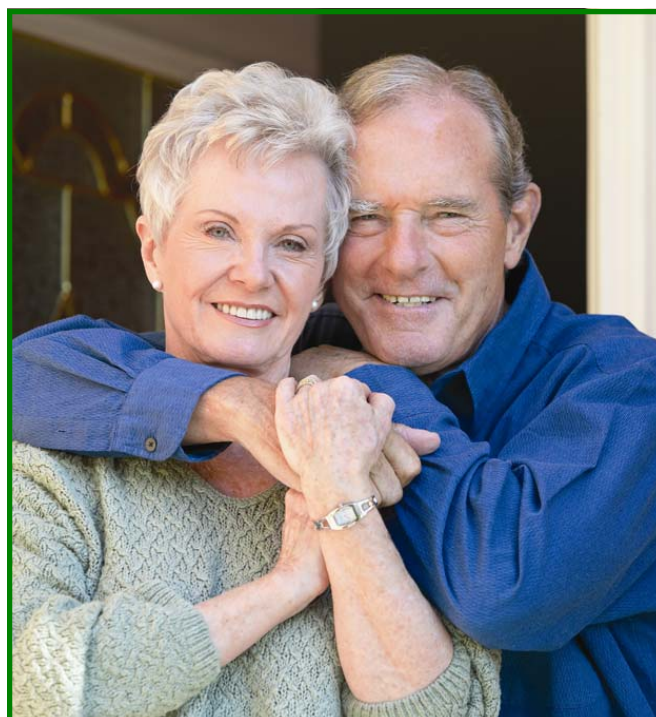
The Federal Reserve continues to hold short-term interest rates at artificially low levels as it waits for the lagging job market to recover from the recession. Millions of jobs were lost and the recovery has been agonizingly slow.

But savers who are getting 0.5 percent on their savings accounts or 1 percent (if they are lucky) on their one-year CDs are literally watching a portion of their savings go up in smoke day after day.

Once they are done paying income taxes on their paltry interest earnings, their savings accounts are shrinking in terms of real buying power.

No recovery

This is a real, permanent loss. If their money was invested in the stock market and the market lost ground, they could wait out the decline and see their principal recover and



Inflation may be subdued but it is not dead. When it comes back, fixed income investments won't be your best bet.

grow again as the market recovers. But fixed income purchasing power losses are real and can only be made up if a period of deflation ensues.

In deflation, prices fall and a dollar doesn't even have to earn interest in order to grow in terms of purchasing power.

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Savers should not hold their breath, however: Aside from two tiny annual declines in the CPI in 1954 and 1949, prices have not fallen on a consistent basis since the Great Depression of the late 1920s and early 1930s.

Retirees often seem to fear the stock market due to its large fluctuations. But inflation is a far greater risk for them, says William Goetzmann, a finance professor at Yale University.

“If you put all your money into bonds when you retire because you think they are safe, but then the governments of the world decide that inflation is the only way out of their current predicament, that will come right out of your savings,” he says.

Stocks are one instrument that offer long-term inflation protection. In the short-term they may not work as inflation hedges: The Standard & Poor’s 500 Index lost 0.5 percent annually on an inflation adjusted basis from 1999 through 2010. However, short-term savings didn’t do so well either: One-month U.S. Treasury bills gained only 0.2 percent annually after inflation.

But the S&P did a much better job over longer periods. For instance, it gained 6.5 percent a year after inflation from 1989 through 2010, and 7.5 percent a year from 1979 through 2010, after adjusting for inflation.

NICK MURRAY INTERACTIVE CLIENT’S CORNER: ALL THAT GLITTERS

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DON'T PUT YOUR RETIREMENT IN JEOPARDY OVER COLLEGE EXPENSES



Middle-aged parents face two huge expenses: college costs for their children and the even larger eventual cost of retirement.

Many find it hard to juggle the two and get confused over priorities and where to allocate resources.

A recent Gallup survey done for Sallie Mae, the large student lender, found that 6 percent of parents in 2010 had withdrawn money from an employer retirement savings plan or an IRA to cover college costs for a child.

That compared with 3 percent who took retirement withdrawals for college expenses the previous year, Sallie Mae said. The average withdrawals also grew, to \$8,554 from \$5,318.

Three percent of parents also said they took a 401k loan for college costs.

Robbing Peter

This can cause big problems later in retirement, says New York's College Savings Plan.

Parents who rob from their retirement accounts to pay college bills are probably doing so during the ages of 40 to 60. That gives them little time to make up for the hit to their retirement accounts.

The 529 plan sponsor noted that while an \$8,554 withdrawal doesn't sound big, it adds up if done for all four

years of college, and gets worse if done for a second or third child. Also, it said building up debt in a 401k plan before retirement adds to a potential retiree's financial burden.

It also notes that parents must pay income tax on withdrawals from an employer savings plan or an IRA. If done before age 59.5 from an employer plan, an additional 10 percent tax penalty is assessed (the penalty is waived on IRA withdrawals for college.) The withdrawals, taxes, and penalties leave parents with less money in their retirement plans to compound and grow for the future.

Limited expense

Parents should realize that as expensive as college seems to be, it is limited to the years a child is in college. Retirement, however, can last for many years and the overall expense can be hundreds of thousands of dollars higher.

In the end it may be better to have children borrow for their own education than to endanger your retirement.

INTERNATIONAL STOCKS STILL OFFER DIVERSIFICATION BENEFITS

A long-held axiom among professional investors says that diversifying a portfolio by adding international stocks helps to reduce risk and enhance returns.

But as the world's developed economies in Asia and Europe have become more tightly entwined, critics have argued that global investing's allure has declined because stock market patterns in major markets have converged.

Rex Sinquefeld, who helped develop the first long-term analysis of stock market returns, concluded in 1996 that these arguments were both right and wrong.

Big stocks in sync

He demonstrated that the returns on large stocks in Europe, Asia, and the United States had figuratively united as one, after discounting the effects of local currency fluctuations.

However, he still found some diversification benefit because there is enough difference in return patterns between markets that investing in several at once helps to reduce volatility (for instance, Japan's market may be rising during a year when Germany's is falling).



Investing in international small and value stocks can juice up your portfolio.

Sinquefeld's big conclusion, however, was that investors can get a lot of diversification and return bang for their bucks by concentrating in international small stocks and international value stocks.

Fama and French

Professors Eugene Fama and Kenneth French had already demonstrated in the early 1990s that stocks of small companies and so-called value stocks (those whose prices were low in relation to their company's book values) offered high returns and diversification benefits in the United

States. Sinquefeld, Fama, and French argued that the phenomenon was international as well.

An update of Sinquefeld's work by Dimensional Fund Advisors, the firm he founded, has provided support for this theory.

Since 1970, the annual average returns of small and value stocks both here and abroad have exceeded large stocks by anywhere from three to six percentage points. However, small and value stocks also are more volatile than large stocks.

For that reason, investors should maintain modest allocations to the risky asset classes in order to improve their returns without adding additional overall risk, DFA says.

MARKET HISTORIANS SAY THIS BULL MARKET IS FOR REAL AND WILL LAST

Stock markets worldwide have been rallying for nearly two years now. The Standard & Poor's 500 Index hit a low of 676 on March 9, 2009 and has risen ever since. In late February it was in the 1330 range. Yet the average investor doesn't seem to trust the trend, and plenty of professionals are skeptical as well. Worries over the growth in U.S. debt, cynicism over the Federal Reserve's stimulus strategy, and talk of a short-term cyclical bull market within a long-term secular bear market abound.

Yet two of the most eminent historians of Wall Street are saying that not only does this bull market have a long way to go, but that it could be as historic as the market's rise from the early 1980s through the late 1990s.

Wharton's wizard

Jeremy Siegel, the Wharton School professor and author of "Stocks for the Long Run," has studied stock market returns going back to 1802. He says this market is at least 20 percent below the long-term trend line in stocks. Other bull markets have risen well above the long term trend line before they were over, he says.

In the end, predictions are educated guesses. Investors should concentrate on sticking with stocks no matter what the short term outlook.



UPBEAT THIRD YEAR

This is the third year of President Obama's term, and, traditionally, the best year for investors in the four-year presidential cycle.

Market historians at the Leuthold group say that since 1942 the 200 days after midterm elections have produced consistent upturns, regardless of which party is in power and which party wins the midterm elections.

In all 17 previous instances the U.S. market gained 18 percent on average, the firm says. Theories have abounded but no academic proof has been offered of why this pattern occurs.



FINANCIAL LITERACY

More than two-thirds of Americans failed a simple financial literacy test commissioned by Northwestern Mutual Life, the company said.

Only one-third could accurately peg the long-term rate of inflation at 3 percent, rather than 6 or 9 percent, while only another third knew that index mutual funds aim to match the returns of stock or bond benchmarks. However, 79 percent understood asset allocation.

Part of our financial services includes educating our clients about their investments, risk management and estate and financial planning.

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