

# Schultz Financial Mgmt Corp - Investment Commentary Volume 10

**10/26/2009**

**Dear Investors,**

Since my last investment commentary on July 18th, stocks, oil, and gold have continued to forge higher while the US dollar has become weaker. Long term US Treasury bonds have continued to trade sideways, showing little concern of future inflation, while corporate bonds have continued to climb higher as credit risk appears to be lessening.

The Volatility Index ("VIX), a widely used gauge of stock market fear among investors has continued to decline as fear continues to abate, encouraging more investors to take cash off the sidelines and invest in stocks.



## **Current Market Perspective:**

### *Stocks:*

In anticipation of an economic recovery, investors have been buying "junk" stocks with poor balance sheets and poor income statements. These are the stocks that plunged in price the most during the bear market, but now help propel the market averages higher. This provides a challenge for equity managers like us, who select stocks largely based upon fundamentals (e.g. earnings growth), to keep pace with the averages. Once the economy has proven its recovery, we expect that investing

in companies with the best fundamentals will work best.

World Economic Growth has turned positive, led by Asian countries. The Leading Economic Indicators has shown five straight monthly increases. Consumer confidence has improved, reflecting a more upbeat consumer attitude. Inflation is expected to be very low for the next several years as agricultural commodity prices have plunged and wage inflation is expected to remain non-existent.

According to Valuing.com only the healthcare sector is undervalued, while technology and utility sectors are fairly valued. All other sectors are overvalued with energy, basic material, and industrial goods sectors over valued by about 20%. This makes sense, considering investors are betting on an economic recovery.

*Bonds:*

Treasury bonds have moved mostly sideways over the few months. Corporate bonds have risen in value as yields have declined. From a historical point of view, the excess yield in the high-yield and high-grade corporate bonds are still attractive relative to US treasury bonds or govt. agency bonds (e.g, Fannie Maes). California municipal bonds are now starting to look reasonably attractive relative to corporate bonds. The Barclays Capital Managed Money Municipal California Index, based upon a basket of CA municipal bonds with a 9.7 year average weighted maturity has a current distribution yield of 4.6% which is a tax equivalent yield of 7.26%.

**Our Investment Styles:**

*Core - Dividend Income Stocks:*

Our core basket of twenty dividend income paying stocks is managed with the intention of staying fully invested throughout a full business cycle. Relative to the Dow Jones Industrial Average, we are currently overweight in consumer staples and telecom utilities. The average annual dividend yield of our basket of stocks is 3.7%. Six of our 20 holdings are foreign company stocks. The year-to-date return for this basket of stocks is 13.8%, roughly 3% behind our benchmark, the *Dow Jones Industrials Average*.

*Trend Following Large Cap Stocks:*

With our trend following large cap investment style, we may overweight and underweight sectors slightly, but normally keep a close correlation to the S&P 500 so that any hedging that we do with SDS (exchange traded fund that performs inversely to the S&P 500) will be effective.

Since the March lows, there have been small "corrections" that have occurred. The first was a 5 percent drop between May 8 and May 15, followed by a 7.1 percent slump between June 12 and July 10, and a decline of 4.3 percent between Sept. 22 and Oct. 2. On each of those occasions we temporarily reduced our equity exposure, only to reinvest at higher levels, causing us to gradually lose ground relative to our benchmarks. This kind of close monitoring and responsive action is required to protect against substantial market declines as we did in 2008 and earlier this year. Nevertheless, year-to-date, our basket of large cap stocks is still up 25% which is 3% better than the *S&P 500 Index*, our performance benchmark.

*Trend Following Global ETFs:*

Our largest country allocations are China, Australia, Austria, and India respectively. We have reduce our overall equity exposure and volatility and are slightly hedged with short position in US small cap stocks and REITs which have started to trend lower. This global basket of ETFs is up 34% year-to-date, 4% above our benchmark, the *All Country World Index ("ACWI")*. The ACWI is a global stock market index that includes stocks of U.S., foreign developed and emerging market countries.

*Trend Following Bonds:*

We remain fully invested in high yield corporate bond funds that we have held since March. Yields on the various bond funds range from 8.0-8.5%. This investment style is up 31% year-to-date compared to 5.7% for our benchmark, the *Barclays Aggregate Bond Index*.

**Our Current Outlook:**

We believe a new bull market began in March of this year. US equity markets have begun a sustainable, bullish trend. Powered by global economic recovery and sustainable corporate earnings growth, stocks should now rise for several years. However, Australia, Asia, and Latin America offer more attractive growth potential than the US, Japan, and most European countries which have accrued a lot of public and private debt.

From a technical perspective, the S&P 500 has been gradually losing upward momentum, with trading volume more prevalent on down days than up days. The S&P 500 Index's 62 percent rally from its March low has brought it close to 1,121.4 which represents a 50 percent Fibonacci retracement of the market decline from the peak in October 2007 to the March 2009 low. Based upon historical tendencies of secular bear markets, a 15-25% correction within the context of this new bull market is quite likely.

High yield corporate bond funds have appreciated considerably, but we expect them to hold these current levels while throwing off about an 8% yield. Corporate BBB paper with 4-7 year maturities look the most attractive with some bond yields in the 5-7% range. Also, with the increase in supply of California municipals bonds, we are seeing some attractive yields in CA municipal bonds with 10 year maturities.

Please give me a call if you have questions or comments about this investment commentary or if you would like to discuss your investment allocations.

Sincerely,

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