



Clients First Transparent Accessible

Quarterly Newsletter

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Market Overview

The U.S. equity markets rebounded over the past three months reversing much of the decline seen in the third quarter. (see table below). Political events, economic data and corporate earnings all came in better than the consensus expected back in September. All ten Standard & Poor's economic sectors participated in this quarter's advance, which was led by the more cyclically sensitive sectors; Energy, Industrials, and Materials. Nevertheless, despite generally better than expected news, investors' preferences for safety and yield persisted resulting in favoring larger companies with stable and/or growing dividends as evidenced by the year-to-date performance of the Dow Jones relative to the broader indices.

The Federal Reserve retained their outlook for slow but improving economic growth and thus did not make any meaningful changes in monetary policy. Interest rates remained at low levels throughout the quarter. (see table below).

The U.S. dollar advanced over the quarter as the flight to safety from Europe continued, resulting in stronger demand for dollar denominated assets. While a stronger U.S. dollar can suppress the prices of many global commodities, wheat, corn, oil and copper prices advanced over the quarter, even as cocoa, cotton, natural gas, silver and gold prices declined. Therefore, the particular supply and demand conditions of each commodity overwhelmed the effect of currencies. (see table below).

Developed international equity markets and emerging market equities also rebounded, but to a lesser extent than the U.S., resulting in decidedly negative returns for the year. (see table below). The consensus expects a recession in Europe to negatively impact growth in China which in turn would dampen the demand for many commodities produced in the export based economies of Australia, Canada, and South America. The U.S. economy is more dependent upon the U.S. consumer than global exports (or European politicians) which helped the U.S. equity markets to out-perform.

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U.S. Equity Returns Table

Source: Thompson Reuters

Index	Q4 2011 Returns	YTD 2011 Returns
Dow Jones	+12.6%	+8.0%
S&P 500	+11.8%	+2.1%
NASDAQ	+8.9%	-0.8%
Russell 2000	+15.5%	-4.2%

U.S. Treasury Yield Table

Source: Bloomberg

	1/2012	10/2011	1/2011
3 month	0.01%	0.01%	0.13%
2 year	0.26%	0.24%	0.62%
5 year	0.88%	0.88%	2.01%
10 year	1.95%	1.79%	3.34%
30 year	2.97%	2.77%	4.43%

Broad Indices Table

Source: Thompson Reuters

	Q4 2011 Returns	YTD 2011 Returns
Gold (GLD)	-3.8%	+9.6%
Crude Oil	+24.8%	+8.2%
U.S. Dollar Index	+1.8%	+1.5%
International Equity Markets (EFA)	+4.9%	-12.0%
Emerging Equity Markets (EEM)	+9.1%	-18.7%

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Improving Investment Results

Behavioral finance studies human behavior and cognitive reasoning as they apply to investing. Over the years, this field has identified numerous psychological biases innate to humans that tend to frustrate the achievement of investment goals. We can **learn the lessons identified by behavioral finance to become better investors** and thus improve investment results.

Last quarter we explored how **“myopic loss aversion”** can negatively impact investment decision making. Myopic loss aversion is the **tendency to evaluate results over short time periods** which can lead to detractive decisions made during time of adversity to reduce the fear and pain associated with loss. Often times, when a decision to sell has its roots in relieving the pain of loss or the fear of additional loss, long term results suffer because **many such short term losses are only temporary**.

This quarter we will discuss forecasting. Despite the difficulties in prediction, investing entails expectations of the future. Behavioral finance has identified psychological biases that can influence forecasting in irrational and erroneous ways, which can lead to detrimental decision making.

In one study, participants were asked to imagine two urns filled with a million poker chips. In one of the urns, 70% of the chips are red and 30% are blue. In the other urn, 70% of the chips are blue and 30% red. Participants are then asked, “if 12 chips are drawn from one of the urns: 8 red chips and 4 blue chips, what are the chances that the chips came from the urn with mostly red chips?” Most participants estimated 70% to 80%. However, mathematically, the correct answer is actually 97%. Behavioral finance calls this **tendency to under-estimate, “Conservatism.”** While the term “conservatism” may have many positive connotations, when it comes to forecasting, conservatism is a bias that can skew expectations.

Another psychological bias that can hinder investment decision making is called **“Anchoring.”** Anchoring is our **tendency to cling to a number**, which often happens subconsciously. One study asked 600 participants to write down the last four digits of their phone number, and then to estimate the number of physicians that work in London. The study showed that those with phone numbers ending with 7000 or higher thought there were around 8,000 doctors working in London, while those with phone numbers ending in 3000 or lower thought there were around 4,000 doctors working in London. While, the number of doctors in London has nothing to do with one’s phone number, nevertheless, the **irrelevant variable affected the estimates**.

The **combination of conservatism and anchoring** can lead to **estimating the future based upon a scaled back projection of the recent past**. Given the historical variability of annual rates of return in stocks, expecting next year’s return to be a moderated version of last year’s return is highly suspect. **Next year’s return will depend more upon what transpires in the future rather than on what occurred last year**. Nevertheless, investors typically make the mistake of becoming more aggressive after a strong advance in the market, and more defensive after weaker periods. One’s asset allocation and equity strategy should be based upon one’s particular objectives and personal willingness and ability to accept risk rather than recent market results.

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Inherited IRAs

Inheriting an IRA is a bit more complex than one might originally assume.

If you inherit an IRA from anyone other than your spouse, you can not simply roll it over into your own IRA. Instead, you have to re-title the IRA so that it is clear that the owner has passed and that you are the beneficiary.

If the IRA owner passed after age 70.5, (when required minimum distributions begin), and the owner had not yet distributed in that year, the heir must do

so prior to December 31st of that year to avoid a 50% penalty on the amount that should be withdrawn.

Furthermore, the way one calculates the required minimum distribution in an inherited IRA is different from the calculation from their own IRA account.

If you are moving the IRA account to a new custodian, make sure you do a “trustee to trustee” transfer. If a check is made out to you (and you

are not a surviving spouse), the IRS will consider it a “total distribution” subject to tax, thus effectively ending the IRA.

It is important to meet all the particular requirements in order to retain the tax-deferred status of an inherited IRA and avoid any penalties, (which can be severe).

If you are an IRA owner, or IRA beneficiary, and have questions, please feel free to contact us.

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