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One Man's Opinions – Fall 2009

SEC Chairman Ben Bernanke opined in mid-September that the economy has hit bottom and is now growing. This confirms my own observation that we had hit bottom between May and July. It is important that we remember we are still feeling the full effects of the worst recession in a generation, perhaps the worst since the Great Depression. While things may be starting to get slightly better, we fell a long way this time, and it might take several years for us to get back to a thriving economy.

In other good news, Treasury Secretary Geithner recently weighed in with a statement that a number of government rescue efforts in place to combat the Wall Street crisis are no longer needed. He anticipates that banks will repay $50 billion in rescue funds over the next eighteen months. Stating the U. S. still has a long way to go before “true recovery takes hold,” Geithner added, “I would not want anyone left with the impression that we are not still facing really substantial and enormous challenges throughout our financial system.” His cautious but upbeat tone is part of a push by the administration to present the government’s financial rescue efforts as a success, and to attribute a large part of the credit to last February’s Obama stimulus bill. In fact, only about 14% of that bill’s funds have been implemented. Most of the credit for the improving economy belongs to the rescue efforts of last fall and, especially, the more than $2 Trillion "printed" and injected into the system by the Federal Reserve over the past year. This, more than Federal spending, is responsible for turning things around.

Mr. Geithner further stated that banks have already paid back $70 billion of the $250 billion that the government had injected in the past year to boost their liquidity. He said the government had earned a $12 billion positive return (17%) from the 23 banks which have paid back the government in full.

I believe that the stock market’s strength over the last six months has now been justified by the improving economy. My opinion is that we actually had two bear markets rolled up in one during the past two years. After Oct. 2007, the market pulled back from an overbought position not justified by the economy. After a year of aimless direction, the sub-prime mortgage circumstances came to light, revealing an extremely over-leveraged financial system. Lending seized up around the country and spread around the world. The entire U.S. financial system was very close to a complete meltdown. The Bush administration and a reluctant Congress came to the rescue. (See my One Man’s Opinions Winter 2009 at www.tommcallister.com for the full story.) The Obama administration, to its credit, continued the massive intervention, which has now been proven successful.

The stock market, as we saw, dropped like a stone when the financial crisis hit a year ago. It began to stabilize after dropping 25-30%, when Obama was elected. In the face of uncertainty as to the plans and abilities of the new administration, it continued to drop further in the weeks between the election and Congress' passing of the Obama stimulus package in late February. It hit bottom on March 9, 2009. As I stated at the time, I thought the stimulus package was vitally necessary for psychological reasons, but would probably do more harm than good when fully implemented. I still believe that will prove to be the case.

I remain optimistic about the stock market twelve to eighteen months ahead as the economy recovers modestly from the depths of the recession. Earnings should rebound nicely, and many stocks remain at historically low price/earnings ratios. Careful stock selection, as is normally the case, remains the key. But inflation protection will be necessary and there are few sectors in the economy other than stocks in which to place one's money. Real estate will recover, but mortgage money will almost certainly continue to be scarce, although reasonably priced. Energy stocks and other commodity investments will also offer inflation protection. I recommend you remain or become fully invested for the intermediate future.

Bond yields should increase significantly in the next two years as inflation kicks in. If this does happen, prices of existing bonds will decline. I recommend keeping bond maturities at five years or less for safety of principal.

Beginning on Jan.1 2010, Roth IRAs are open to all taxpayers. For the first time, those earning a modified adjusted gross income of over $100,000 will be able to contribute to these hybrid accounts. More importantly, all taxpayers will now be able to convert any amount of assets currently held in regular IRA accounts into Roth IRAs. Regular federal income taxes must be paid on such transfers (tax spread over two years), but subsequent accumulations will not be taxable when withdrawn from such accounts after age 59½. The main attraction to Roth IRAs has always been this tax free withdrawal factor. Even more tempting, Roth IRAs can be passed on to one's children or grandchildren and these heirs may subsequently withdraw them, again with no tax on the withdrawals. Such inheritances are, however, a part of one's estate for tax purposes. These accounts from now on are a part of our Certified Financial Planners' toolboxes for our more wealthy clients.

With the stock market still well down from its highs of several years ago, clients have even more incentive to consider switching all, or any part, of their current IRA balances into Roth accounts. The government too, will benefit from getting additional tax payments over the next two years, rather than waiting many years for revenue.

It's interesting that, as the government addresses reforms in the way financial institutions are regulated, an old dispute between Registered Investment Advisors and Registered Representatives who are employees of stock brokerage firms is once again coming to the forefront. RIA's like myself and my colleagues are subject, under securities law, to being held to the legal standard called "fiduciary responsibility." Registered Representatives, by contrast, are held to a lower standard of legal accountability, called "suitability." In earlier decades, this different treatment made sense. Registered representatives acted as stockbrokers, selling investments as commission paid representatives of manufacturers of financial products. Registered Investment Advisors, on the other hand, provided independent valuation and management of investments and offered financial planning advice.

In today's investment world, these differences have faded. Many Registered Representatives of brokerage houses are earning fees on "managed accounts" in addition to doing commission-based sales. For this reason I, and my RIA colleagues, believe all investment advisers should be subject to the same regulatory standards. New SEC Chairman Mary Shapiro agrees, recently speaking in favor of fiduciary standard for all persons involved in the investment management process.

In other statements, Ms. Shapiro has also said that "the public perceives that there is no difference between broker/dealers and registered investment advisors so far as the services they provide." She also opines that both entities should have common regulations. And that is where we in the RIA community part ways with the SEC.

We believe that brokers and advisors do NOT provide the same services. Brokers are paid representatives of manufacturers of financial products. In the last twenty years a major one of those products has become managing investment portfolios. They are marketed by representatives in much the same way that mutual funds and other financial products are sold. They are paid by their broker/dealer employer on much the same compensation terms as mutual fund sales. Registered investment advisors, on the other hand, provide independent evaluation of investment and give personal financial advice and management. They are paid by the investor directly, generally on a percentage (.5-2%) of assets under management or on a mutually agreed hourly fee basis. They offer no products, only service. Our position is that all regulated individuals who participate in any aspect of the investment management process, and are compensated for that participation, should be held to a fiduciary standard. I trust that you, my readers, will find this a reasonable position and support it with your Congressmen and Senators.

My keen interest in the regulation of financial advisors stems from the work I have done for many years in compliance and product research and review. In addition to my work with my own clients, I do compliance reviews and product research for the Morris Group, a FINRA member broker-dealer. I continue to serve as an industry arbitrator several times a year, and I am a volunteer member of a FINRA committee.

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