



March 2012 Newsletter "Skinny Dipping"

From the desk of Matt Brennan

There's good and bad news in this month's newsletter. Let's begin with the positives for a change. The Dow Jones Industrial Average has crossed the 13,000 threshold and dancing has commenced in the streets! After the celebration dies down, we need to remind ourselves as to what the Dow Jones Industrial Average actually represents. The Dow is a price weighted composite index. It's "price" is the weighted average price of the 30 (THIRTY!) underlying stocks that comprise it. Back in 2009, the decision was made to add Cisco Systems (CSCO) to the Dow as opposed to Apple (AAPL). Had they added Apple instead of Cisco, the Dow Jones would be at approximately 14,600 as of February. So does this mean that just by adding Apple instead of Cisco 3 years ago we could have resolved our countries unemployment, housing malaise, sluggish industrial output, and stagnant GDP growth? No. Indexes are in essence, arbitrary.

In his latest shareholder letter to investors, Warren Buffett of Berkshire Hathaway described the risks associated with long-term stock investment as follows:

"The riskiness of an investment is not measured by beta (a Wall Street term encompassing volatility and often used in measuring risk) but rather by the probability - the reasoned probability - of that investment causing its owner a loss of purchasing power over his contemplated holding period. Assets can fluctuate greatly in price and not be risky as long as they are reasonably certain to deliver increased purchasing power over their holding period." (*Berkshire Hathaway Inc. Shareholder Report)

Consider now the following graph showing stocks vs. bonds in terms of performance over the past 15 years.

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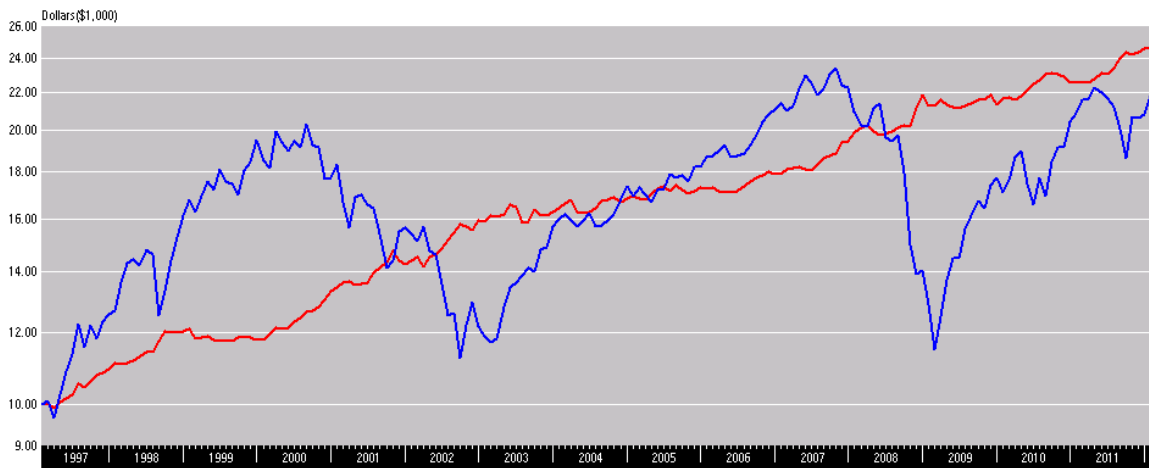
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Growth of \$10,000: from 02-01-1997 to 01-31-2012

Fund/Index	Total Return %	Annualized Return %	Amount at End of Period \$
● Idx: Barcap Government	147.12	6.22	24,712
● Idx: S&P 500 TR	117.99	5.33	21,799



Question: Given this “holding period”, which investment appeals more to you as an investor? Which investment increased your purchasing period by the end of the period? If you were to run this chart back another 15 years (for 30 years total), you would have the same result of bonds outperforming stocks over the period. This is obviously not to say that in the entire history of the market, bonds have been the right choice over stocks, but I *would* contend that 30 years for a person living in retirement can be a pretty significant sample size.

Dominion Wealth holds a significant amount of short to intermediate-term bonds in most client portfolios at the present. This is done because we continue to perceive more risk than reward in stocks. Taking it one step further, we see an environment where investors are being improperly incentivized to take unnecessary risk and that this is contributing to the price increase of stocks. The Federal Reserve Board is essentially taxing savers by holding interest rates at historical lows (and committing to do so through 2014). When an investor receives next to nothing for keeping money in the bank, they will turn to stocks for appreciation purposes. They will also buy longer and longer

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term bonds in order to try and *chase yield*. The interest rate risk investors are exposing themselves to when they buy 20 and 30 year treasury bonds is not at all worth the 3-4% return they earn for their lending. Even a 1% change in interest rates could cause the value of a long-term bond to decrease by as much 12-15% depending on when it was purchased.

Our rationale for avoiding unnecessary risk at this time remains unchanged. Consumption is going off a cliff with the baby boomer's move out of their peak spending years and no amount of stimulus can grease the wheels of the economy enough to make up for it. We continue to be supported in our belief by what is a grim global macroeconomic outlook based on:

- Sovereign Debt Concerns in the Euro Zone expanding past Greece and spreading to Italy, Spain and Portugal
- Slowing Growth in China and here in the US
- Risk of Default in Japan
- Rising Oil Prices
- US Housing malaise and high unemployment

These risks lead us to believe that there is a fundamental disconnect between the global market and the global economies. Here in the United States we have the negative indicator of rising stock prices on falling market volume. The average trading volume on the New York Stock Exchange is around 700 million a day, compared to approximately 1 billion at this time a year ago (Source: Bloomberg). We have more buyers than sellers and this serves to gradually "bid up" prices.

We remain defensive for the time being and our research supports that the risk for a new recession remains high. We cannot ignore the economic data and dive headfirst into what may be a retreating ocean of stocks. Recall that it was Buffett himself who once famously said, "It's only when the tide goes out that you can see who is swimming naked."

Best Regards,

A handwritten signature in cursive script, appearing to read "Matt".

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