

## Horizon Notes

**We are not moving.** We (prematurely) announced in our last newsletter that we were moving our office. Our plans did not come to fruition, so we are still in the same convenient location as we have been – now going on 18 years.

**New website released.** We have launched a new version of our website. It's a pretty radical overhaul in terms of layout and presentation, but we think you will find that the new site contains useful information about Horizon as well as easy-to-understand descriptions of our planning and investment management services. We have also added a blog, which will help us share our periodic thoughts about financial matters. Our address remains [www.horizon-advisors.com](http://www.horizon-advisors.com) and we hope you will visit the new site and share your thoughts.

## Investing in Uncertain Times

### The Political Battlefield

After the pitched battle to raise the debt limit ceiling and the follow on downgrading of U.S. Government debt by Standard and Poors, it is no wonder that August brought such volatile markets. Our chattering political class and their media handmaidens were quick to assign the blame for the arguments and the downgrade. Indeed, there is plenty of blame to go around and it belongs to Washington D.C., and to us fellow citizens for allowing the deficit spending culture of Washington to continue for so long. The battle to control federal spending pits the congressional impulse to continue to spend more of the public's money against a difficult economic scenario, reluctant taxpayers, and confused citizens trying to make sense of it all.

For too long, our elected officials have made it a policy to give their constituents pretty much anything they wanted. Then and after the spending was committed, the bill would come and they would either (rarely) raise taxes or (more often) borrow to the make payment. This has

resulted over time in massive deficit spending. However, our current fiscal and economic conditions conspire to reverse this spending impulse, calling to mind the old maxim, "You can have *anything* you want, but you can't have *everything* you want." It has become obvious to all involved that we cannot continue on the present path, and difficult choices must be made.

The nascent course reversal was not pretty to watch. While we are thankful that an agreement to raise the debt ceiling was reached, we are not handing out awards for getting along well with others. This was one of the most rancorous and politically charged legislative efforts in memory and we would prefer not to see it repeated. In fact, we think that the very nature of the debate contributed greatly to the early August market swoon by crushing investor confidence and providing Standard and Poors with their final argument to proceed with their downgrade of U.S. debt.

In spite of this rancor, we think that the result of the debate has created a much needed change in trajectory. Much has been made about how little the budget ceiling legislation has changed the future of our deficits. While this may be true in the short-term, it may miss the bigger point, which is that it has changed the future of our debates. There was actually a serious agreement and a new approach to reducing spending. At least we now know that this can be done. It will be up to future legislators and presidents to determine the level of follow-through, but for now, folks are focusing on the issue and we can at least acknowledge that this is progress.

### Our Slow Path to Recovery

We are constantly reminded that the current economic recovery has been sluggish thus far, and very different from what economists ordinarily expect. GDP growth has been unusually slow, unemployment remains high, and government debt has swelled. This has been a disappointing outcome, especially given the multiple stimulus programs that were intended to help the recovery. It has caused concern and frustration among policy makers,

employers, and investors alike.

However, we believe that most have mischaracterized our current recovery by comparing it to recoveries that follow ordinary recessions. Typically, an economic cycle consists of normal contractions and expansions, where a contraction (recession) is followed by a recovery that rapidly reclaims progress lost during the contraction. This type of normal recovery has been the experience and expectation for every recovery in the post-WWII era, but clearly, this has not happened this time.

The difference is that the recent recession was not caused by an ordinary set of circumstances; but by a financial crisis on a global scale. Gross over-indebtedness by consumers and financial institutions around the world, most notably in U.S. subprime mortgages, was the proximate cause of this crisis. The inability of consumers to keep up with these high-risk loans as we entered into a recession led to a crisis in the financial sector. This ultimately led to the financial crisis and market panic that reached its crescendo in the fall of 2008. Multiple government bailouts proved necessary to arrest the panic and the excessive debt eventually became the responsibility of the government, effectively migrating the debt from the private sector to the public sector.

In the recent economic text *This Time is Different – Eight Centuries of Financial Folly*, economists Carmen Reinhart and Kenneth Rogoff lay out with stunning accuracy the type of recovery that we are now experiencing. They make the point that this sort of recovery scenario: slow growth, high unemployment and swollen government debt – has typically followed past financial crises.

We believe that we are now in the midst of the final stage of the financial crisis, where consumers and financial institutions have been “bailed out,” and governments are struggling under the weight of a greatly increased debt load. Naturally, the weakest nations, such as Greece, are showing the clearest signs of strain. But by and large, almost every country around the globe is feeling the lingering effects of the financial crisis.

The final remedy to resolve a financial crisis, once and for all, is to get rid of the excessive debt. This typically happens in one or more of three ways: default, fiscal austerity, or debasement (inflation). Default can come in many

forms, but most commonly as a restructuring in which lenders are repaid only partially. Austerity involves cutting spending and benefits coupled with higher taxes on the populace, making way for accelerated debt repayment. Debasement, or more commonly inflation, allows borrowers to repay existing debts with currency that is less valuable than the amounts that were initially borrowed, making the debt less expensive. The final resolution for the U.S. is likely to be some combination of austerity and inflation. The resolution for some countries in the embattled euro-zone may come through a combination of all three measures.

The good news is that there is a path to recovery, and once there, the global economy will be much leaner and healthier. The bad news is that the path is long and involves a steep uphill climb to get out of the deep hole in which we currently reside.

Having said that, on the investment side, things may not actually be as bad as they seem. Stock valuations are attractive and there are a number of economic indicators that imply that the recovery should continue. Our banking system is much stronger now and we are beginning to see an increase in lending. There are also record amounts of cash on company balance sheets which should eventually lead to hiring and investment once some of the lingering uncertainties are resolved. This may happen more slowly than we would like, but it appears to be underway. See our further thoughts in our “market review” section, below.

### Investing in Uncertain Times

We are reminded of an old saying, “now is always the most difficult time to invest.” Although this is always true, it is particularly difficult to be comfortable investing when we have been through a period of drastic market declines like 2007-09. While markets have had a tremendous recovery over the past couple of years, it is hard to shake the memory of the declines we experienced.

How investors feel about their portfolios is greatly influenced by what behavioral scientists call the “recency effect.” That is, whether market activity is good or bad, and especially when it has been particularly good or bad, we expect the recent trend to continue. Our human nature sets our expectations for things to remain the same. As

one commentator recently (and wryly) observed, “past performance is a great indicator of future expectations.” This really speaks to the short-term focus that we live our lives by. Rather than accepting and planning for uncertainty, which is really what we should expect, we use the “rearview mirror approach” and plan for things to be as they have most recently been.

Many investors have a tendency to become unnerved by uncertainty and are involuntarily drawn to extrapolate the most negative (and usually improbable) possibilities. This emotional response can often lead to poor decisions in the short-term that can have very real and negative consequences in the long-term. The best ways an investor can fight this urge is to maintain a broad perspective, focus on long-term goals, and remain committed to a long-term strategy as a means of reaching those goals. Following these simple (but not necessarily easy) principles will help you to avoid the emotional trappings that high levels of uncertainty can create.

Looking at the pros and cons and the array of uncertainties, we remain inclined to pursue a long-term approach to investing and planning. The cornerstone to a well developed financial plan is a disciplined and well diversified strategy that is built with the expectation that in the long-term, markets will return to equilibrium, no matter how volatile and disruptive they appear to be in the short-term. ~ *Larry Maddox*

## Market Review

The following table shows market index returns through August 31st, trailing 3-mos., 12-mos., and 3 years.

Index (Through 8/31/11)	YTD	1-Year	3-Year
S&P 500 TR (Large Stocks)	-1.77%	18.50%	0.54%
EAFE TR (Int'l Stocks)	-6.02%	10.01%	-2.96%
Barclay's Bond Aggregate	5.88%	4.62%	7.23%

Given the volatility in the capital markets over the past few weeks, it is easy to forget that the market was just a hair from its 52-week high as recently as July. Then, a flurry of events has made the once happy days of spring feel like a distant memory. With the debt ceiling debate going into the eleventh hour, Standard and Poors an-

nouncing a debt downgrade, and the euro-zone debt crisis seemingly reaching a crescendo, confidence has been severely impacted and concerns over the durability of our recovery have been raised.

At the end of April, the S&P 500 was up 9.1% for the year. But in the following four months, the market has declined by -9.9%. Most of this decline occurred in just 10 trading days surrounding the conclusion of the debt debate. What has followed in the past month has been a see-saw, back and forth battle between the bulls and the bears, which has yet to subside.

For the year-to-date through August 31<sup>st</sup>, the S&P 500 is down -1.8%. With the still unresolved euro-zone crisis, international markets have had an even tougher time as the MSCI EAFE is down -6.0%. There remains a significant “flight to safety” trade, however, and the bond market has rallied significantly in recent months returning 5.9% on a year-to-date basis.

Economic growth began to weaken in the spring due to manufacturing disruptions caused by the disaster in Japan and an extremely harsh winter in the northeast. A rapid rise in gasoline prices following widespread political upheaval in the Middle East added pressure to consumers and caused economic growth to slow even further. More recently, the chaotic conclusion of the debt ceiling debate, the subsequent downgrade of U.S. debt, and the ongoing crisis in Europe have added to investor pessimism and sparked extreme volatility in the capital markets.

With this recent convergence of events, significant concerns have emerged that economic growth will continue to decelerate and that another recession could occur. A recent report showed that GDP grew at the discouraging pace of 1.0% in the second quarter. In the wake of all of the recent market volatility, growth is likely to be weak in the 3<sup>rd</sup> quarter as well.

Along with the slowdown in economic activity, there has also been a notable decline in job growth. The recent August employment report revealed that zero jobs were added for the month. For the first four months of the year, jobs were added at an average pace of 179,000 per month. For the last four months, the pace has declined to 40,000 per month. President Obama has taken note and

recently proposed a \$450 billion stimulus package intended specifically to encourage hiring.

A clear bright spot in our economy has been the rapid improvement in corporate profits. Companies continue to post better than expected gains in profits driven largely by increases in efficiency and profit margins. Earnings are expected to exceed peak levels this year with no slowdown in sight. Companies have also built massive stockpiles of cash, which can protect them in the event of an economic downturn and fuel hiring and investment activities once confidence returns.

Earlier in the year, commodity prices posted steep increases. This stirred fears that inflation was becoming a serious problem. However, as economic concerns have increased, the speculative interest in commodities has rapidly declined. Since their highs in April, commodities prices have declined significantly, with the exception of precious metals. As measured by the S&P GSCI, commodities are down -11.4% since the end of April and have posted a year-to-date return of 3.2%. Gold has returned 28.3% so far this year, with most of those gains coming in just the past few months. Overall, inflation concerns have quieted considerably as confidence in the economy has eroded.

With the end of the Federal Reserve's Quantitative Easing program and the subsequent (but unrelated) credit downgrade of U.S. debt, many assumed that interest rates for U.S. Treasury bonds would head higher. That assumption proved incorrect as interest rates moved rapidly lower. U.S. Treasury securities have again asserted themselves as the primary safe haven asset for investors looking to avoid risk. Recently, benchmark 10-year Treasury bond yields were as low as 1.9%, which matched a multi-

generational low. However, interest rates for most other types of bonds have risen.

While we do not expect a repeat of the dramatic market slide that began in the fall of 2008, it is impossible to deny that the mood among investors has darkened. The rancorous debate surrounding the debt ceiling, the subsequent downgrade of U.S. debt by Standard and Poors, and the ongoing crisis in Europe have all played a role in contributing to the dour mood in the capital markets. However, stocks appear to be attractively priced, corporate results are very strong, and U.S. banks are much better prepared to deal with financial uncertainties than they were in 2008. We continue to believe that patient investors, with portfolios properly situated for the long-term, are well positioned to benefit from an eventual return of confidence in the economy and the capital markets.

Thank you very much for your continued confidence in our service and advice. If you would like to discuss our opinions, outlook, or your portfolio in greater detail, we would be happy to schedule a meeting or a conference call at your convenience. ~ Owen Murray

### Making Cents

A recent WSJ article described research by Philip Tetlock, a psychologist at the University of California, Berkeley. In experiments with noted experts, he quantified more than 80,000 predictions. He then compared predictions to outcomes and discovered that the majority of these experts performed worse than random chance – they would have performed better by pulling their answers out of a hat! This just validates the comment of Bertrand Russell, who said that “even when all the experts agree, they may well be mistaken.”



Financial Planning

Investment Management

5851 San Felipe  
Suite 700

Houston, Texas 77057  
713.748.7000

[www.horizon-advisors.com](http://www.horizon-advisors.com)

Estate Planning

Retirement Planning