

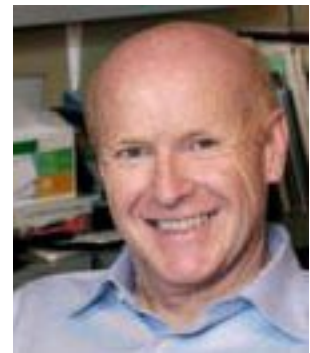
Template for a Year-End Client Letter 2012 in Review: Learning from the Past, Looking to the Future

By Dan Richards
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Proactive communication with clients is always important – but never more than when uncertainty dominates media headlines.

Client concerns about whether you're on top of things can be reduced by sending regular overviews of what's happened in the immediate past and the outlook for the period ahead. That's why each year since 2008, I have posted templates to serve as a starting point for advisors looking to send clients an overview of the year that just ended and the outlook for the period ahead.



Advisors have told me they've received a great response to these letters, and the templates always rank among my most popular articles.

This letter has four components:

- 1. An update on performance*
- 2. Perspective on today's macro challenges*
- 3. Where stock valuations stand today*
- 4. Your recommendations for the period ahead*

This template is only a starting point – use as much or as little of the content as is appropriate. Be sure to take the time to customize this letter and put it into your own words, particularly the last section on recommendations, so that it truly does represent your own point of view.

Where we stand in 2013: Learning from the past, looking to the future

As we enter 2013, I'm writing to summarize what happened in markets last year and to share my thoughts on positioning portfolios for the year ahead.

Last year saw a continuation of the uncertainty that's characterized markets since the global financial crisis, which will be marking its fifth anniversary in September. At the same time, the U.S., Europe and emerging markets all showed strong gains in the mid-teens,



despite concerns about Europe’s finances and worries that the US would fall off the “fiscal cliff” and go back into recession.

Much of 2012’s volatility was driven by the ebb and flow of good and bad news about Europe. Positive indications for Europe’s economy in the first quarter led to the strongest start for markets in recent memory, which was promptly given back as concerns rose in the second quarter. Markets then rallied in the second half of the year when the European Central Bank announced that it would provide liquidity to governments and financial institutions – to the point that for 2012 as a whole, Europe’s stock market actually outperformed the U.S.

The chart below shows returns for the past five years, all in local currency. Including dividends, the United States and emerging markets ended 2012 above where they were five years ago, shortly after global markets hit all-time highs in the fall of 2007.

Annual Returns - Local Currency	US	Europe	Emerging Markets	World Markets
2012	16.2%	16.4%	17.2%	16.6%
2011	2.0%	-8.8%	-12.6%	-6.1%
2010	15.5%	7.5%	14.7%	11.1%
2009	27.1%	28.6%	60.6%	30.1%
2008	- 37.1%	-38.5%	-45.7%	-39.2%
Average annual return: 5 years*	1.8%	-2.0%	0.3%	-0.8%
Average annual return: 10 years*	7.3%	7.0%	14.9%	7.2%

Returns to December 31, 2012, all in local currency, including dividends

Putting big picture problems in perspective

It’s easy to feel discouraged by all the bad news and problems facing the world. Recently, though, I came across a December 1990 article from the Knight-Ridder newspaper chain that helped provide some interesting perspective on today’s issues.

Here’s what was going on at the end of 1990:

1. In August of that year, Iraq invaded Kuwait; it was not until January of 1991 that a coalition of Western and Arab nations led by the United States responded. In the



meantime, there was huge uncertainty about what would happen and oil prices doubled as a result.

2. Starting early that year, Western economies went into a significant recession, which hit its peak in the fourth quarter of that year. In the four months from July to October, the stock market was off 15% – for the year as a whole the market was down almost 7%.
3. In the aftermath of \$500 billion in write-offs in the savings-and-loan sector, there was a widespread view that the U.S. was on the threshold of a full-fledged banking crisis. Loan defaults were up and bank profits down, 900 US banks had failed in the past five years and another 1000 were on the problem list. In response banks were cutting back on loans, even to credit-worthy borrowers.

Prices of bank stocks such as Citibank and Chase Manhattan Bank dropped by half from July to December. An editorial in *Business Week* had a typical view: “The banking sector is under enormous strain. Should it begin to unravel, recession could become an economic disaster.”

Of course, we now know that the period that followed saw strong growth in the economy and a buoyant stock market. This is not to suggest that the same will happen today – but it is to say that we have worked through significant challenges before, whether the issues in the early 1990s, the shock in oil prices that led to a global recession in the 1970s or numerous other big-picture problems.

The outlook for 2013

Even in the face of all the global problems, many analysts entered the new year cautiously optimistic about the outlook for stocks. The reason is not because there is any expectation of an easy resolution to the developed world’s debt woes, unemployment or slow economic growth; there is universal agreement that it will take years to work through them.

The reason for optimism arises from the fact that around the world companies are generally in very good condition, with strong operating margins and solid balance sheets. An October interview in *Barron’s* magazine was a good example of the positive mood on stocks, in which 45-year industry veteran and former Morgan Stanley strategist Byron Wien explained the reasons for his cautiously optimistic forecast for the US:

- The US housing market has hit bottom and will be a positive force in 2013.
- Growth in the middle class in emerging markets will continue to provide opportunities for investors and for companies selling into those markets (Wien was especially positive about agricultural commodities.).



- Dramatic new oil discoveries will put a cap on the price of oil and help buoy the US economy.
- Large multinational stocks offer predictable growth, solid balance sheets, and attractive yields at reasonable valuations.
- Even in the face of challenges on budget deficits and debt levels, Wien pointed to the resilience of the US and its history of repeatedly working through what he referred to as “disasters.”

Here’s a [link](#) to the interview with Byron Wien, should you wish to read more.

The other hot topic in markets is the direction for bond prices. There is growing concern among many leading strategists about the prospect for bonds based on current record low interest rates, despite their “flight to safety” appeal; indeed, a recent *New York Times* article titled “*Bond craze could run its course in new year*” pointed to research from Morningstar that bonds have grown from 14% of US investor portfolios five years ago to 26% today. This is at a time when Warren Buffett in his annual letter to investors last spring said that due to today’s low rates and inflation “*bonds are among the most dangerous of assets.*”

What this means for your portfolio

In my email at the end of last year, I outlined some guiding principles in my approach to building client portfolios, four of which I repeat here. Should you be interested in doing so, I’d be pleased to discuss these guidelines at our next meeting.

1. Taking the right level of risk

My starting point with clients is to identify the rate-of-return they need in order to achieve their retirement goals and then to construct a portfolio based on that return objective. My goal is to take the right level of risk for each client – enough that we can be fairly confident that over time you’ll achieve your objectives, without taking more risk than is necessary. For retired clients, I believe in maintaining secure, liquid funds to cover three years of expenses – having that buffer means that we reduce the risk of having to sell holdings at depressed levels.

2. Adhering to your plan

Regardless of what happens to markets in the short term, barring a significant change in your circumstances, we should stick to our agreed upon investment parameters. Some of you may recall my advice in early 2009, as we faced what appeared to be an end-of-the-world scenario and some stocks hit lows they hadn’t



seen in 20 years. At that time, I urged clients to maintain a core level of equity exposure, something that ended up working out well.

In light of stock valuations and the risk in bonds earlier in 2012, for some clients we increased equity weights to the upper end of their range. Given strong stock performance in the last half of the year, for clients at the top of their range last spring we recently rebalanced holdings to bring the equity weight back down within portfolio guidelines. Of course market reversals from current levels are always possible; however, taking a long-term view, at current levels there is still a strong case for stocks over bonds

3. Diversifying portfolios

When building equity portfolios, I've always advocated strong diversification outside the U.S. This helped my clients through most of the 2000's and has hurt them in other periods such as the 1990s and 2010 and 2011, when the US outperformed.

Going forward, I have no idea whether the dollar and our market will do better or worse than global markets, but do know that the U.S. represents less than half of investing opportunities around the world and we need to stay geographically diversified as a result.

4. Focus on cash flow

The final principle relates to the role of cash flow from investments. In an uncertain environment for immediate economic growth and equity returns, I continue to place priority on the cash yield from investments.

In my view, the returns on some REITs, master limited partnerships, investment-grade corporate bonds, the better rated high-yield bonds and dividend stocks in some sectors continue to make these attractive. When it comes to equities, we do have to be increasingly selective, however, as some stocks that pay steady dividends now look expensive by historical standards and show signs of stretched valuations – this is because investor appetite for yield has bid up prices of those dividend-paying stocks.

I hope you found this overview helpful. Should you have questions about anything in this note or about any other issue, please feel free to give me or one of the members of my team a call.

And as always, thank you for the opportunity to serve as your financial advisor.



[Dan Richards](#) conducts programs to help advisors gain and retain clients and is an award winning faculty member in the MBA program at the University of Toronto. To see more of his written and video commentaries, go to www.clientinsights.ca. Use A555A for the rep and dealer code to register for website access.

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