

# The Future of the Economy 2010 and Beyond



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## Inside the numbers...



A 5%\* return...  
That's not a bad  
investment or is it?

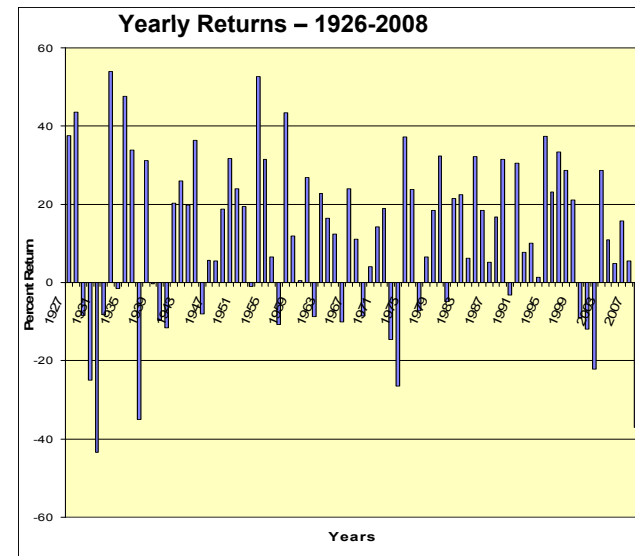
### The truth behind a 5% return on investment

- Rate of return\* 5.00%
- Minus taxes in 25% bracket (25% of 5%=1.25%) (1.25%)
- Minus historic average inflation (3.50%)
- **Net return 0.25%**

**Is your rate of return sufficient to  
achieve your goals?**  
(after you consider inflation and taxation)

\*5% is a hypothetical return, chosen for ease of illustration. Historic average inflation is based on rates from 1935-2008

## Standard & Poor's 500

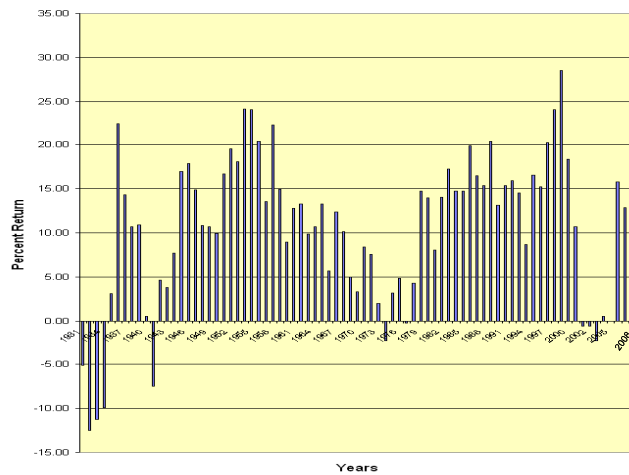


What do you notice about this historical timeline  
when looking at every single year?

Past performance is no guarantee of future results. The S&P 500 is an unmanaged index which can not be invested into directly.

## Standard & Poor's 500

5 Year Periods – 1926-2008

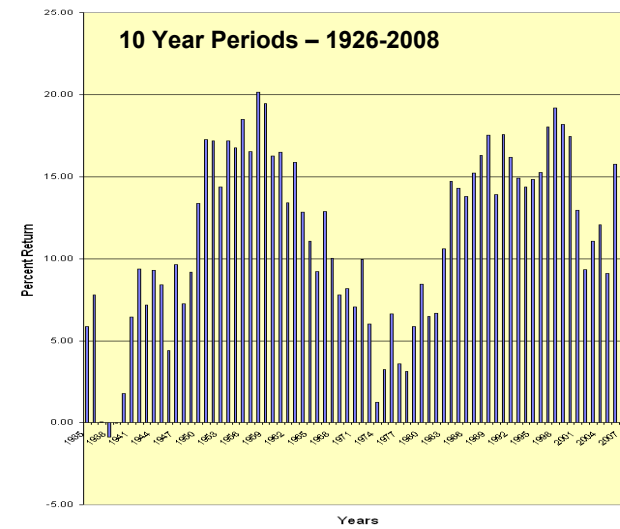


What do you notice about this historical timeline when looking at the results in 5 year increments?

Past performance is no guarantee of future results. The S&P 500 is an unmanaged index which can not be invested into directly.

## Standard & Poor's 500

10 Year Periods – 1926-2008

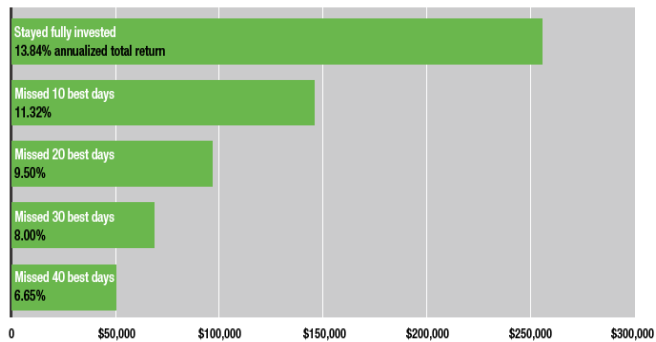


What do you notice about this historical timeline when looking at the results in 10 year increments?

Past performance is no guarantee of future results. The S&P 500 is an unmanaged index which can not be invested into directly.

## Fluctuation is going to happen, don't panic!

\$10,000 INVESTED IN THE DOW JONES INDUSTRIAL AVERAGE (12/31/82-12/31/07)



*Data is historical. Past performance is not a guarantee of future results.  
The best time to invest assumes shares are bought when market prices are low.*

Only by staying fully invested can one potentially reap the rewards of the best days of the market.

Indices are unmanaged and cannot be invested into directly.

## Balance mitigates volatility

1926 – 2008: Totals and Averages

	<u>S&amp;P</u> <u>500</u>	<u>LT</u> <u>GovBds</u>	<u>SmStks</u>	<u>S&amp;P/Bds</u>	<u>40S&amp;P/</u> <u>40Bds/</u> <u>20SmStks</u>
<b>Average</b>	9.6	5.6	11.2	8.2	9.3
<b>Std Dev</b>	20.6	9.2	32.7	11.5	14.6
<b>Highest return</b>	54.0	40.4	142.9	34.1	50.1
<b>Lowest return</b>	-43.3	-9.2	-58.0	-24.3	-19.9
<b>Spread High/Low</b>	97.3	49.5	200.9	58.4	70.0

How does the portfolio mix impact overall performance and risk?

Stocks are subject to market fluctuation. Average annual returns from 1926-2008

Sources: Standard & Poor's and Lehman Brothers, MYSE & DFA. Refer to disclosures on preceding page. Past performance is no guarantee of future results. Indices cannot be invested into directly.

## And now let's remove the anomaly of the Great Depression...

1946 – 2008: Totals and Averages

Year	S&P 500	LT GovBds	SmStks	50/50 S&P/Bds	40S&P/40Bds/20SmStks
<b>Average</b>	10.3	5.8	11.5	8.5	9.4
<b>Std Dev</b>	17.7	10.2	24.6	10.4	12.0
<b>Highest return</b>	52.6	40.4	83.6	34.1	36.0
<b>Lowest return</b>	-37.0	-9.2	-33.8	-11.1	-12.8
<b>Spread High/Low</b>	89.6	49.5	117.4	45.1	48.9

What's different about the results during this time period?

Stocks are subject to market fluctuation. Average annual returns from 1946-2008

Sources: Standard & Poor's and Lehman Brothers, NYSE & DFA. Refer to disclosures on preceding page. Past performance is no guarantee of future results. Indices cannot be invested into directly.

## Notes Regarding Pages on Asset Categories

Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly.

- Small Company Stocks are represented by the fifth capitalized quintile of stocks on the NYSE for 1926-1981 and by performance of the Dimensional Fund Advisors (DFA) Small Company Fund thereafter.
- Standard & Poor's 500 is an unmanaged group of securities and is considered to be representative of the stock market in general.
- Government Bonds are 20-year US Government Bonds.
- Stocks, unlike Government Bonds, are not backed by the full faith and credit of the United States government. Furthermore, small company stocks may be subject to a higher degree of market risk than large company stocks.

## Learn from the past & prepare for the future

“The more things change the more they remain the same”

- Human nature does not change (fear & greed)
- Economic laws cannot be repealed (supply & demand)
- Market behavior does not change (booms and busts)

### Specific circumstances do change:

- Tomorrow's leaders may be different than today's
- Objects of infatuation are never the same
- Investors' specific objectives change and evolve

### Portfolio design must:

- Respect fundamental economic principles
- Be forward looking
- Reflect and adapt to investors' unique objectives

*“plus ça change, plus c'est la même chose”*—Jean-Baptiste Alphonse Karr – French novelist

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## Did circumstances change?



**Economic Growth**

**1978 to 2008**

### 1. De-regulation

- Carter – airline deregulation act of 1978
- Reagan / Thatcher – privatization era

### 2. Globalization:

- Berlin Wall goes down - new market economies are formed
- Growth of trade – rise of China, India et al

### 3. Interest rate in secular decline:

- Stimulated financial leverage
- Helped push asset prices higher

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## Stability is ultimately destabilizing

- Long period of stability encouraged too much risk taking



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## Circumstances did change

After  
2008



### 1. Re-regulation

- Financial crisis precipitates regulatory changes
- Government plays a bigger role

### 2. Global trade is under pressure

- Protectionist tendencies in face of high unemployment

### 3. Financial system is deleveraging:

- Banks keep more capital (lend less)
- Non-bank lending vanished (replaced by govt.)

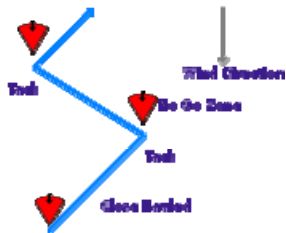
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## How does change impact your goals ?

- We cannot control the wind
- But we control how we sail towards our goals



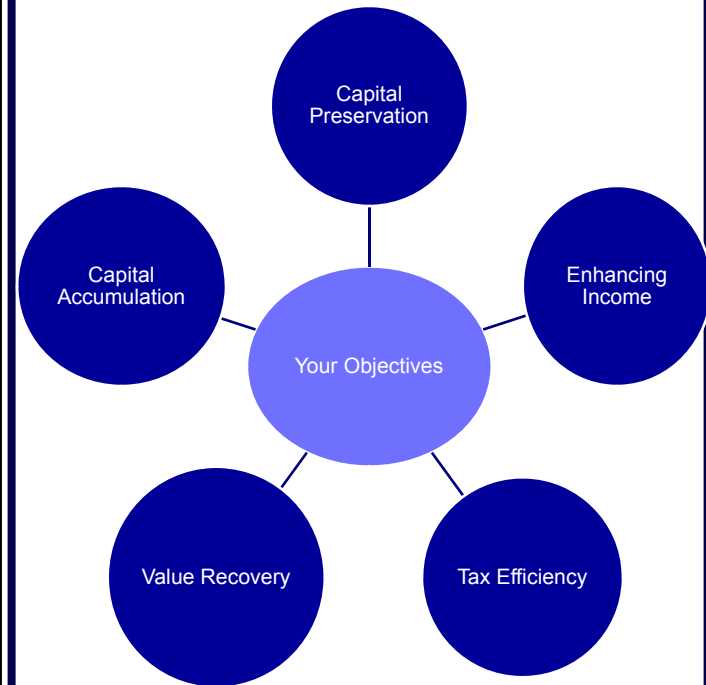
**Your Goals**



**Portfolio Design**

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## How does change impact your goals ?



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## What is our starting point?

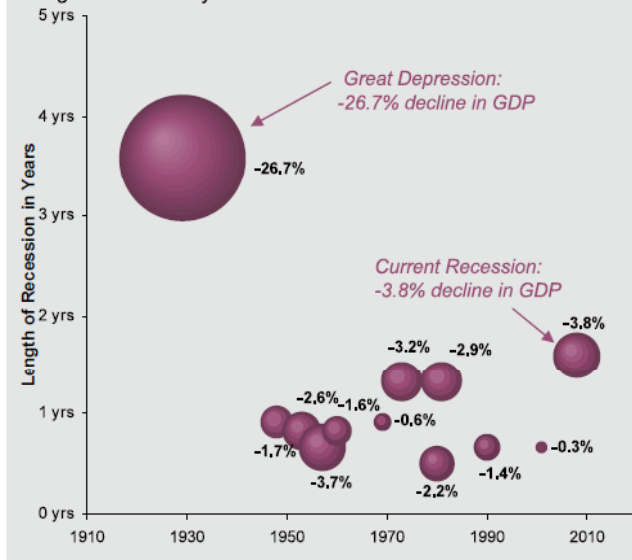


The Bloomberg Financial Conditions Index combines yield spreads and indices from the Money Markets, Equity Markets, and Bond Markets into a normalized index. The values of this index are z-scores, which represent the number of standard deviations that current financial conditions lie above or below the average of the 1992-June 2008 period.

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## The effect of the crisis

### The Great Depression and Post-War Recessions Length and Severity of Recession



Source: NBER, BEA, J.P. Morgan Asset Management.

Bubble size reflects the severity of the recession, which is calculated as the decline in real GDP from the peak quarter to the trough quarter except in the case of the Great Depression, where it is calculated from the peak year (1929) to the trough year (1933), due to a lack of available quarterly data. Data are as of 9/30/09.

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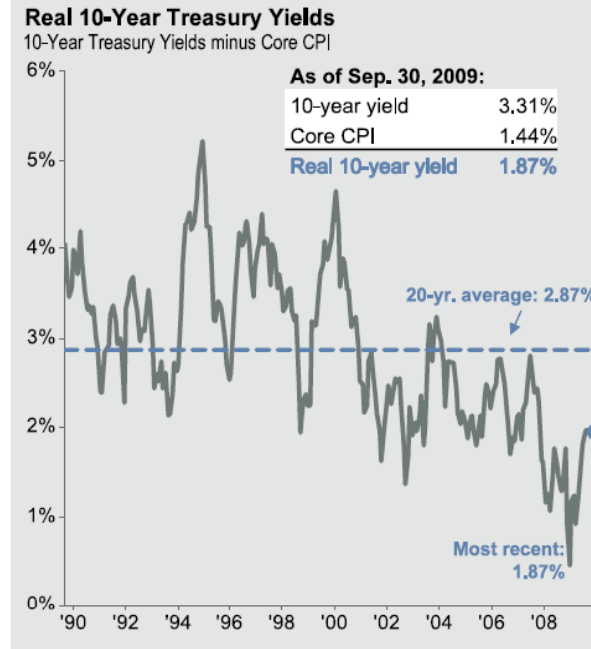
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## Strong Stock Market Recovery in 2009



Source: Russell Investment Group, Standard & Poor's, FactSet, J.P. Morgan Asset Management.  
 All calculations are cumulative total return, including dividends reinvested for the stated period. Since Market Peak represents period 10/9/07 - 9/30/09 illustrating market returns since the most recent S&P 500 Index high on October 9, 2007. Since Market Low represents period 3/9/09 - 9/30/09, illustrating market returns since the S&P 500 Index low on March 9, 2009. Returns are cumulative returns, not annualized. For all time periods, total return is based on Russell-style indexes with the exception of the large blend category, which is reflected by the S&P 500 Index. Past performance is not indicative of future returns.

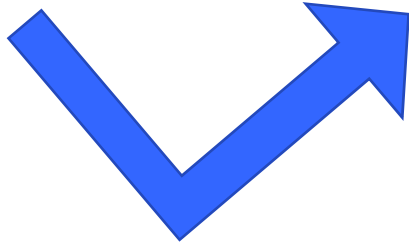
## Strong bond markets as well (higher prices, lower yields)



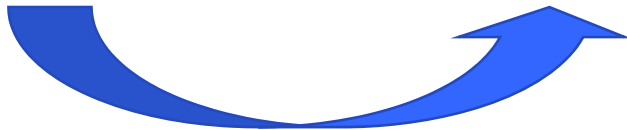
Source: FRB, BLS, J.P. Morgan Asset Management. Chart is the 10-year Treasury yield less Core CPI (inflation excluding food and energy, year-over-year).  
 Data are as of 9/30/09.

## Which market is right?




**Stock markets seem to say :**  
Strong economic recovery



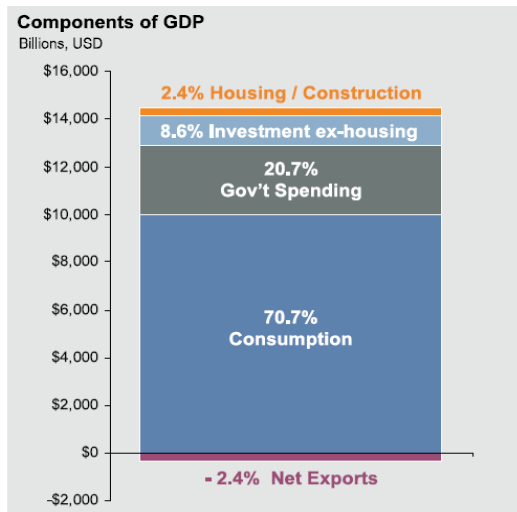
**Bond markets seem to say:**  
Slow economic recovery



## Ingredients of a sustained recovery

1. Monetary & fiscal stimulus 
2. Inventory cycle rebuilt 
3. Private consumption pickup 

## Most likely scenario: slow economic recovery



Source: BEA, J.P. Morgan Asset Management.  
Data reflects most recently available as of 9/30/09. GDP values shown in legend are % change vs. prior quarter annualized and reflect revised 2Q 2009 GDP.

1. High unemployment (around 10%)
2. Credit continues to shrink at fast pace
3. Homes & investments have lower values  
= Consumer bound to save more and spend less

## Which market is right? They both are!

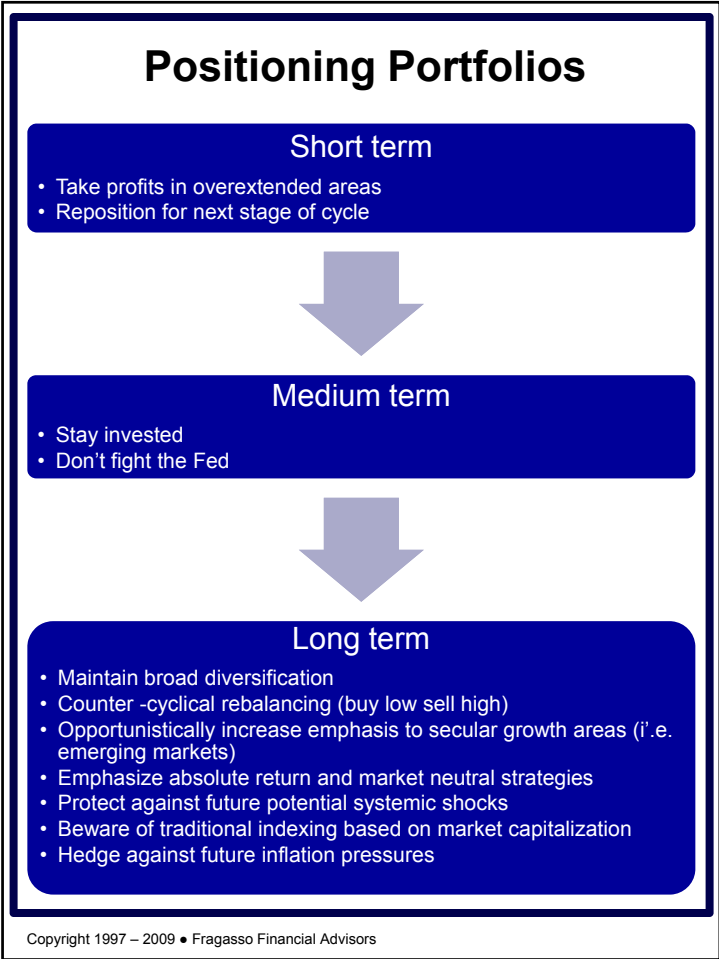
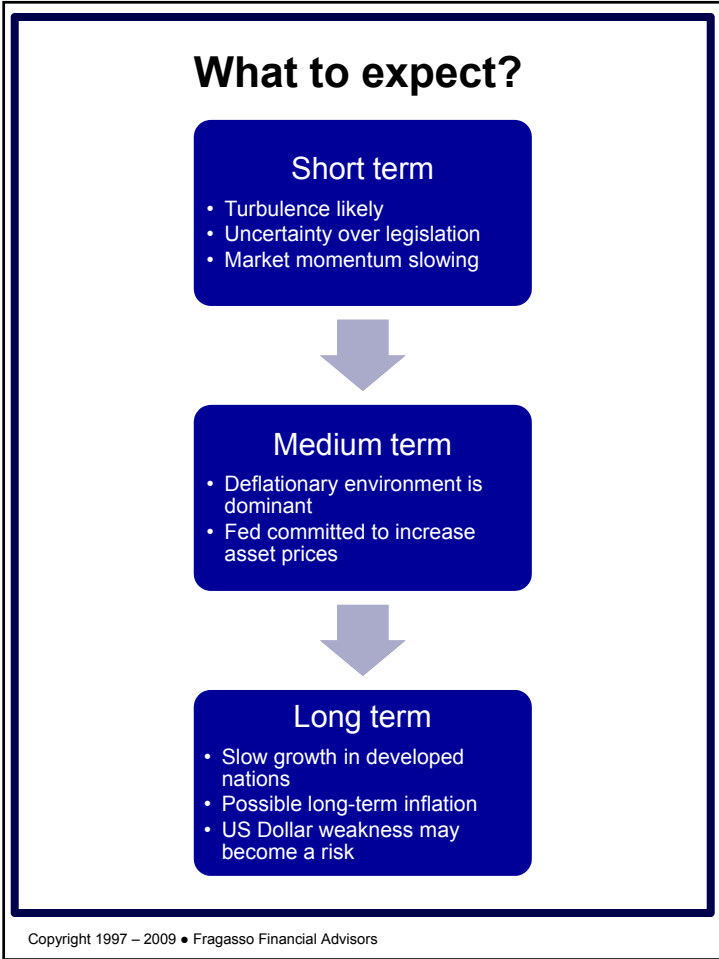
- **Stock market rallied because**

Financial system back from the brink

Slow economy => low interest rates

- **Bond market rallied because**

Slow economy => low interest rates



**This concludes our  
prepared remarks**

**Questions?**



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