

## Not All Portfolios Are Created Equal

*Market Commentary by Randy McGill, Branch Manager/Owner – June 30<sup>th</sup>, 2010*

Following a rally that saw the S&P 500 (an index of 500 of the largest U.S. stocks) soar nearly 80% from early March 2009 through late April 2010, the end of the second quarter has witnessed the return of volatility to the markets. In the 42 trading days of May and June, 24 days (57%) saw the intra-day high-low difference of the S&P 500 exceed two percent. Eight days (19%) saw the difference exceed three percent and four days saw *closing price losses* of greater than 3% for the index, including the “flash crash” of May 6<sup>th</sup> and the 3.9% decline of May 20<sup>th</sup>.

Whether it's the result of concerns over the European debt crisis, a “slowdown” of economic activity in China, the timidity of our own economy's recovery, concerns over Washington's legislative agenda, the Gulf oil spill or more than likely, a combination of all of these factors, there can be no doubt; fear is back and a long-due correction is well under way. The old adage “Sell in May and go away” has definitely held true this year. Indeed since the April 23<sup>rd</sup> peak of the S&P 500, the highly watched index has declined 15.69%, and now stands down 6.65% (total return basis) for the year. The NASDAQ Composite has fallen even more dramatically, off 17.27% from its rally peak of the same date.

So what are long-term investors to do in the face of renewed volatility and downward pressure on stock prices? Continue to think long-term? Stay the course? Easier said than done, since for many investors, the meltdown of 2008 and early 2009 remains a fresh and vivid memory. And indeed, the performance of the developed world's major stock indices over the past decade has made the notion of “thinking long term and staying the course” seem naive, if not outdated. Such advice had long been appropriate – and effective - for a period that lasted 25 years (August 1982 - March 2000, March 2003 - October 2007); but the dramatic decline of 2008/2009 changed that. And while stocks are well off their lows since then, many investors find themselves treading water - at best - for the past decade. And so again, what are long-term investors to do?

Today, the portfolios of successful investors must play defense as well as they play offense. My proposition has its roots in the all-pervasive decline of 2008. By the end of that year, I decided that telling our clients to “Think long-term and stay the course” was no longer advice that I could offer without qualification. I became convinced that volatility was likely here to stay and that the emotional toll it takes would make “the long-term” irrelevant for many investors, since many would not remain invested to experience it.

Now I had always recommended that our clients diversify their portfolios across asset classes (in order to reduce volatility and to avoid the temptation of market timing), but I had never recommended a direct hedge to our client's long equity holdings, i.e., a managed short-equity position. I was not willing, and did not believe that our clients would tolerate, an equity position that might decline as traditional equities were rising, thus potentially compromising upside performance. Nevertheless, after carefully researching and testing models back more than a decade, I became convinced that a high-quality, well-managed short-equity position was the missing ingredient in most investor's portfolios.

At my branch, we introduced this strategy to our client's portfolios at the beginning of 2009 and saw immediate results. Our managed short-equity allocation dramatically reduced volatility for our clients as the market fell precipitously through March 9<sup>th</sup> of that year; indeed this period validated my research – it *was* possible for our clients to remain invested and yet not suffer dramatic declines in portfolio value, i.e., play good defense. The rest of 2009 further validated my research as our client's portfolios turned in very competitive returns, even while

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continuing to allocate monies to managed short-equity, i.e., we were able to play pretty good offense as well. (Past performance is no guarantee of future results.)

And now the first and second quarters of 2010 have offered still more validation, if not evidence that our approach to investing works, even in difficult markets. While many long-only investors suffered dramatic declines in May and June, our clients fared quite well. In fact, many of our clients still have gains for 2010 through June 30. Four asset classes have contributed to our success: high-quality bonds, REITs, precious metals and most importantly, managed short-equity - rising nicely as stocks fell in May and June.

What's the lesson? If investors are willing to accept the premise that not all of their equity positions should perform in lockstep with each other, e.g., managed short-equity positions typically, although not necessarily, decline when stock prices rise quickly and dramatically, then volatility can be reduced while returns remain competitive. Again, as I have been stressing in my commentaries and in our branch newsletter, it is indeed possible to play defense and offense at the same time, without timing the market.

The bottom line is that I think our clients will be pleasantly surprised by their performance for the month of June, the second quarter and overall for 2010 to date. And, I hope the fact that our allocations have performed as intended engenders confidence, enough so that our clients remain patient through this current period of volatility and in position to reap the potential long-term rewards of owning investments in many asset classes, including a globally diversified (and hedged) portfolio of equities. Remember, "Not all portfolios are created equal."

Finally, if our advisory efforts and results still leave you with concerns or questions, do not hesitate to contact our office. On behalf of my colleagues Kay Feagles, CFP, Ray Jensen, Registered Principal, Mark Rojek, J.D., CPA, Financial Advisor, Chuck Evans, CLU, ChFC, Financial Advisor, and John Haas, Registered Principal, we remain committed to offering you reasoned financial and investment advice, suited to your needs.

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*Also, diversification does not assure a profit or protect against loss. For example, there are special risks associated with investing in bonds such as interest rate risk, market risk, call risk, prepayment risk, credit risk, and reinvestment risk. Be advised that investments in REITs also carry various risks, including possible lack of liquidity and devaluation based on adverse economic and regulatory changes. Additionally, investments in REITs will fluctuate with the value of the underlying properties, and the price at redemption may be more or less than the original price paid. Further, investing in precious metals is subject to additional risks, including but not limited to: prices may be subject to wide fluctuation; the market is relatively limited; the sources are concentrated in countries that have the potential for instability; and the market is unregulated. Finally, shorting stocks carries a high level of risk. Some of the risks include unlimited loss to the upside and limited gain if the stock falls to zero, hard-to-borrow fees may be charged, and buy-in risk without warning. Please be advised that not all stocks are available for short selling; and margin accounts are required for short selling. Shorting stock is suitable only for the knowledgeable investor who understands all risks, has financial capacity to incur potentially substantial losses, and sufficient liquid assets to meet applicable margin requirements. Consult with your Financial Advisor before investing.*