ISSUE
02
May
2011

JOURNAL OF
INVESTMENT
INSIGHTS

investor edge

this issue

Brian G. Carrington, CFA

Solutions for a New Economy

Our goal is to provide confidence in guiding complex decisions, provide oversight based on wisdom, and offer extensive knowledge, backed with formal educations.

Our services include retirement plan consulting, endowment & foundation consulting, along with individual investment & retirement management services.

By always acting in a fiduciary capacity, we provide objective and unbiased investment advisory services to our clients.

The Silent Thief

The silent thief comes at the gas station, hits you in the supermarket, and deteriorates your income. This thief does not discriminate and is corrosive like rust. This silent thief is known as inflation.

The textbook definition of inflation typically is outlined as the rise in prices that causes purchasing power to fall. Inflation tends to fall into two categories. Low to moderate inflation is attributed to fluctuations in demand and supply for goods and services. The most corrosive form of inflation is when governments increase the supply of money in the economy too quickly.

In earlier centuries, money supply inflation was caused when governments increased the mix of non-precious to precious metals in coins. The “cost” of money declined for governments by substituting cheaper metals for gold and silver in the coinage. As the population recognized the diminished purity of the coins, they would expect more coins as payment for the same product. In the United States, the Federal Reserve has increased the supply of money by about 5% over the last twelve months, causing renewed concerns of further price increases. Another significant form of inflation can result from a nation expanding its use of debt. A country’s borrowing can cause domestic interest rates to rise.

Investors ask how they can protect themselves from inflation. Central banks need to keep the money supply appropriate to the level of growth in the economy. Second, national debt must be managed with a great deal of wisdom.

Investments that have historically outperformed during inflationary periods have included large cap dividend paying stocks, commodities, precious metals, and real estate. However, each inflationary period is different. Although the inflation rate is currently relatively low, gold is at an all time high and real estate is going through a significant correction. Should inflation move higher in the United States, gold and real estate may not provide the desired protection. However large cap stocks, oil, and foreign securities might have a fighting chance.

perceptiveedge
INVESTMENT MANAGEMENT, INC.

This Issue's Trivia Questions

Q: What is the highest inflation rate ever recorded in the US?

A: In 1980 the inflation rate hit the high water mark at 13.58%.

Q: In the last 80 years, three administrations have seen years with deflation. What years and administrations are they?

A: 1949 / Truman -0.95%, 1955 / Eisenhower -0.28%, and 2009 / Obama -0.34%.

Contact Information

Brian G. Carrington, CFA
Principal

O 952 476 2770

brian.carrington@perceptive-edge.com

Perceptive Edge Investment Management, Inc.

PO Box 604
Wayzata, MN 55391

perceptive-edge.com

The Active Thief

Working with plan sponsors for over a decade has provided some insights that have been confirmed by a recent Robert W. Baird research report. Investors and plan fiduciaries are making critical mistakes by fleeing investment managers based on short-term performance.

Baird's research report – "The Truth About Top-Performing Money Managers – Why investors should expect – and accept periods of poor relative performance" outlines that top performing managers all experience underperformance over three year periods.

The research report screened a universe of managers that outperformed by more than 1 percentage point and had lower volatility over a 10-year period. This resulted in 370 managers.

Of this group of managers, almost all underperformed at some point in time. Over the 10 year period, 85% had a least one three-year period of underperformance. These top performing managers, on average, had six separate rolling three-year periods of underperformance. Over the shorter-term, 91% of these managers underperformed by more than 5 percentage points during at least one 12-month period. The main conclusion is that top performing managers achieve their performance over longer periods of time.

> Changing investment managers based on short term performance can create an active thief.

Although changing a manager can rob performance, an even larger thief comes in the form of chasing performance of individual asset classes. Human nature is driven towards success and outperformance. As a result, many investors do not develop a strategic asset allocation. Unfortunately, in attempting to call the market, errors are magnified. Individuals may be good at timing when to get out of the market. Individuals may be good at timing when to get into the market. More often than not, getting both decisions correct is next to impossible. Getting only half the equation right may result in poor overall performance.

Examples of market sentiment changing abound. For example, small cap growth stocks were the worst performing sector in 2002 and the best sector in 2003. International had a good year in 2007, but was one of the worst sectors in 2008.

The active thief generally loses to strategic asset allocations and staying in top managers through their down periods of performance. Fortunately, the clarity of this course of action is becoming more commonplace.