Financial Common Sense

ROCKBRIDGE INVESTMENT MANAGEMENT, LLC

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Rockbridge Investment Management is a group of like-minded professionals working with a select group of clients with whom we can have a significant impact. Everything we do is focused on building and preserving wealth for our clients. We help remove complexity so clients can focus on the simple but difficult process of successful investing.

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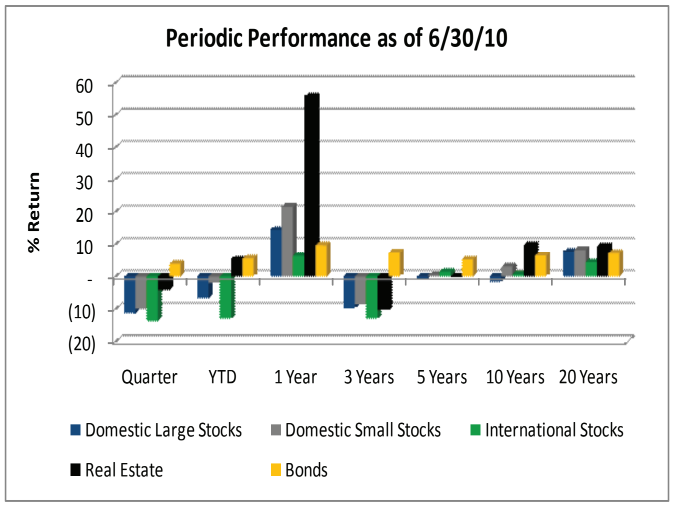
Market Commentary by Craig Buckhout

Fear Returns to the Market – Good for Investors?
First quarter stock market gains were erased during May and June leaving values well below the high water mark reached in the fall of 2007. As the chart shows, large-cap stocks (S&P 500) have lost nearly 10% annually over the past three years. Markets reacted to increasing uncertainty and unfavorable economic news and reversed the trend of the previous four quarters. One-year returns reflect the substantial improvement from the March 2009 trough but year-to-date returns for stocks are in the red. The volatile real estate sector remains in positive territory for the year, and bonds stand out as they provide diversification and stability for investor portfolios. Note how the low but stable bond returns now look very attractive across all trailing periods.



<u>Signs of fear</u>
I love the drama in this paragraph from a recent *Wall Street Journal* article:

> *Volatility returned to global financial markets with a vengeance in the second quarter, sending investors fleeing from stocks worldwide and driving them into defensive investments, especially U.S. Treasurys and gold.*

(Continued on page 2)

Risky Business by Anthony Farella

After a pretty robust recovery in 2009 and 2010, the stock market took a dive in the last two months. The talk of a "double-dip recession" is reaching a fever pitch. A search of the term "double-dip recession" at Google News generates over 7,000 news articles. Media pundits point to the recent market downturn as evidence of a new recession. High unemployment, Europe's debt crisis, a slowdown in China, a teetering housing market and sinking stock prices are all weighing on a fragile U.S. recovery. The news is filled with grim stories and dire predictions. Again.

To be sure, the uncertainty about the domestic and global economy is priced into current stock market valuations. It's important to remember that stock market prices do not fall in a vacuum. For every sale of a security there is a willing buyer on the other side who thinks the security has great growth potential. The interactions between buyers and sellers are what make financial markets efficient.

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Market Commentary (cont.)

Did I miss something? Should I have known enough to get 'defensive' last quarter? First let's think about this quote for a moment. The issuance and redemption of stock for major companies over the past six months has been trivial, so investors collectively did not 'flee' the stock market – the ones who were scared just sold their shares to some other investor…at a much lower price than they could have three months ago.

So what did happen? Well it sounds much less dramatic – events such as the Greek debt crisis, stubborn joblessness, increasing deficits, and the BP oil spill raised concerns about economic recovery and future growth. These concerns, and increasing uncertainty, caused the market's calculation of current stock values to decrease, and the value of Treasury bonds to increase.

Will stocks decline in value further next quarter because the recovery has stalled? Maybe…of course this potential outcome has already been considered by market participants and is built into today's prices. If signs of a double-dip recession become more apparent, then sure, stock values are likely to decline further. But the future is unknowable, and signs of recovery could boost stock prices. Today's market price reflects the value paid by a willing buyer and prices reflect uncertainty.

"Be fearful when others are greedy, and be greedy when others are fearful."

- Warren Buffett

<u>Why should we expect future returns to be different than the recent past?</u>
Let's start with the bond market where we see an average ten-year return of 6.5%. The bond index today has a yield of about 4% meaning that if all the bonds in the index were held to maturity, the return would be 4%. In order to realize a higher return in the short-run, interest rates need to fall but there is little room to fall from current levels. It seems more likely that interest rates will rise at some point, making bond prices fall, and depressing short-term returns. So, it is unlikely that bond returns over the next ten years will be as high as the past ten years.

Returns from stocks over the past ten years look dismal compared to bonds with small stocks providing 3% and large stocks providing negative 1.6% annual returns. Nonetheless, it is reasonable to expect stocks to provide a risk premium. If the additional return were consistent or predictable, it would no longer be warranted. It is precisely because stock returns are volatile and unpredictable that investors can expect a higher return from stocks than from bonds.

With 20/20 hindsight it is easy to conclude that stocks were overvalued ten years ago. Too little risk and uncertainty was built into stock values as investors paid astronomical prices for the latest technology idea with no earnings in sight. As we approached the cliff of financial collapse in the spring of 2009, fear and uncertainty was priced into everything. As fear abated, stock values jumped. We saw a reversal of this in the past two months.

It is now easy to find predictions that the Dow will fall to 1000, losing 90% of its current value before the world economy straightens out. This is not impossible but seems very unlikely. It is also easy to generate agreement in casual conversation that the outlook for stocks is bad and a poor place for retirement savings – not surprising amidst the current barrage of emotionally presented negative news.

Anecdotally these predictions give me comfort that current prices are reasonable, and capable of providing returns similar to our long-term expectations. As Warren Buffett said, "Be fearful when others are greedy, and be greedy when others are fearful." The fact that fear has returned to stock markets may be good news for investors who take a consistent, long-term approach.◆

Form ADV Notification

Form ADV, Uniform Application for Investment Adviser Registration, for Rockbridge has been filed as appropriate with the Securities and Exchange Commission, and may be reviewed at the offices of Rockbridge Investment, 101 S. Salina St., Suite 400, Syracuse, NY 13202, or may be obtained by mail by requesting same at this address or by phone at 315-671-0588.◆

Following a Fiduciary Standard of Care

Richard A. Schlote

Meeting new people or reconnecting with acquaintances often leads to the question of where I'm working these days. I reply, "I work for Rockbridge Investment Management, which is a 'Registered Investment Advisor' (RIA)." With that response I usually get a nod and a change of subjects. Most don't understand what an RIA is, or how we differ from a broker, bank, insurance company, or anyone else with whom one can invest.

Perhaps the most important difference is that the RIA must follow a *fiduciary standard of care*. A fiduciary must, at all times, act for the sole benefit and interest of the client. It is a relationship of loyalty, trust and confidence. Many advisors or financial consultants only have to follow a *suitability standard*. The investments they sell or recommend only have to be suitable, but not necessarily in the client's best interest. This means that the RIA is expected to manage the client's investments based on what is best for the client, not necessarily what stock, fund, product, or transaction might be suitable, often generating the most income or commission for the advisor.

A fiduciary duty is the highest standard of care. A fiduciary is expected to be loyal to the person/client and must not put his personal interests before the client's. Our clients will never be called to make a purchase or sale of a product to take advantage of some potential gain, market situation, or "hot" product as is often the case with brokers and other financial product salespersons. These products may be suitable, but not necessarily advantageous to the client.

Another difference at Rockbridge is our dedication to determining an appropriate client asset allocation and sticking with it. This is most difficult for individuals who manage their own accounts especially over the past few years when various markets have been so volatile. Their tendency is to sell when the market has gone down and buy when the market has gone back up. It has also been difficult for those with accounts managed by brokers, whose income is dependent on sales of securities or funds; volatility and uncertainty is a great sales tool for them. We don't try to pick stocks or actively managed mutual funds, selling one and buying another in an attempt to increase returns, usually a futile and expensive activity. Our concentration is on monitoring the allocation and rebalancing when appropriate. A close friend (and client) jokingly (I think) accuses us of doing nothing for him, especially when he calls and asks why we didn't sell or buy with market changes. My response is that doing "nothing" was the best thing to do instead of buying or selling based on the emotion of the moment, and often at the wrong time.

> ***"A fiduciary must, at all times, act for the sole benefit and interest of the client. It is a relationship of loyalty, trust and confidence."***

Another friend, Bob, manages his own rollover retirement account. He uses Fidelity funds and talks with an employee there. He pays nothing for the accounts (except for the annual mutual fund expenses inherent in all mutual funds) but gets no advice either. The Fidelity employee explains the funds to him when asked and makes changes as instructed. Bob has no set plan or design for his investments. He may do OK, and may not, but has no real knowledge of how he is doing compared to generally accepted benchmarks. If he were using an RIA he would have a specific investment strategy and someone to talk with about his cash flow needs, his tax situation, his minimum distributions, his investments, and his investment goals. And he wouldn't be worried about market conditions and interest rate changes.

Perhaps the most important question investors should ask any financial professional is "How do you invest your own money?" Our employees' investments are managed exactly the same as those of our clients.

It appears that these volatile market and economic conditions may continue. We suggest that our clients call or visit us to discuss their investments at any time. It is important that the client be comfortable with their investment advisor and their important investments.◆

Risky Business (cont.)

I don't know if the economy is headed for another recession; however, there are some economists who see light at the end of the tunnel. In its biannual report on the global economy, released in May 2010, the international Organization for Economic Co-operation and Development ("OECD") said the economy is recovering faster than expected.* The OECD lifted it's projections for global economic growth to 4.6% in 2010 and 4.5% in 2011. The OECD did caution about risks including overheating emerging markets and international debt crisis; however, the overall message was one of cautious optimism.

Additionally, the U.S. and other developed countries are introducing legislation to improve transparency in financial markets with an eye on reducing systemic risks in the current system. That's a fancy way of saying these excesses have a way of working themselves out. Once investor confidence increases, markets should be poised to rebound.

As investors we understand the risks of investing in the stock market. We may not like the volatility and uncertainty, but we expect to be compensated for the risk we are taking. And we take this risk for a very good reason: to accumulate enough money to maintain our purchasing power when we quit getting a paycheck. A well thought-out investment strategy may not have great outcomes in the short run, but maintaining discipline in down markets will lead to long-term investment success.

You can't change your feelings about what's going on in the world. You can only change your actions. For younger investors in the accumulation stage, you are in a great position to benefit from the market declines. Keep contributing to your investment accounts and buy "low." It's actually a great time to increase your regular investments if your budget allows it. For retirees who rely on their portfolio for income, there are fewer options. The most obvious is to scale back and lower expenses during periods of uncertainty. If your withdrawal rate is low enough (3%-4% of your portfolio), then you should be confident that you have time for your portfolio to recover.

Be prudent and conscious of what is going on, but don't let the news distract you from living your life. Having trust in your investment plan will allow you to ignore the noise in the financial markets and focus on long-term success. ◆

**OECD Economic Outlook, May 2010*

Returns from Various Markets

The following table shows the returns from various markets over periods ending June 30, 2010:

Market/Asset Class	Quarter	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
Money market	0.0%	0.0%	0.2%	1.6%	2.8%	2.7%	3.9%
Bond market	3.9%	5.5%	9.7%	7.4%	5.3%	6.5%	7.2%
Large-cap stock market	-11.4%	-6.7%	14.4%	-9.8%	-0.8%	-1.6%	7.7%
Small-cap stock market	-9.9%	-2.0%	21.5%	-8.6%	0.4%	3.0%	8.2%
International equity market	-13.7%	-12.9%	6.4%	-12.9%	1.4%	0.6%	4.4%
Inflation	0.7%	1.0%	2.0%	1.6%	2.3%	2.5%	2.7%

Market Benchmark Portfolios

The following table shows returns from our market benchmarks over periods ending June 30, 2010:

Benchmark	Quarter	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
Capital preservation	0.7%	1.9%	6.1%	3.0%	3.7%	4.1%	5.5%
Conservative	-1.7%	0.3%	8.9%	1.1%	3.3%	3.9%	6.7%
Moderate	-4.1%	-1.3%	11.6%	-1.3%	2.8%	3.4%	7.4%
Aggressive	-7.3%	-4.1%	12.1%	-5.0%	1.7%	2.1%	7.3%
All equity	-11.7%	-7.9%	12.3%	-10.3%	0.0%	0.4%	6.8%

Note: These results were developed by simulating past returns in the various markets included in each benchmark, assuming the reinvestment of dividends and other earnings and deductions of costs totaling 0.20%. The money market is represented by 90-Day Treasury Bills; the bond market by the Barclays Capital Government/Credit Bond Index; the domestic large cap market by the S&P 500; the domestic small cap market by the Russell 2000 Index; and the international equity market by the EAFE Index. This data is presented to show the long-term relationship between returns at various levels of investment risk. It is not intended to present performance results experienced by clients of Rockbridge Investment Management, but is intended to provide a benchmark against which actual performance might be judged. Also, readers should recognize that future investments would be made under different economic conditions. It should not be assumed that future investors would experience returns, if any, comparable to those shown above. The information given is historic and should not be taken as any indication of future investment results.