



Quarterly Memo

July 2009

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Predicting the Next Train Wreck



Recalling the events that caused our current recession and financial pain is like replaying a disaster movie. Only now with hindsight can we

begin to see the multiple causes and effects. At the time, we observed home sales far above their long term trend, home prices skyrocketing in many locales, mortgages being securitized like never before, and the predominance of subprime mortgages made to questionable credit risks. This was worrisome to most and alarming to many. Yet practically no observers foresaw the complete

impact of the escalating madness: severe recession, the near-meltdown of financial markets, massive investor losses, the demise of huge institutions, and government takeovers of others – truly an economic train wreck. If we saw signs of a similar scenario developing, should we try to prepare more effectively next time?

Is it possible another train
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Bonds Beat Stocks For The Long Term

No, that is not a misprint. With the whipping stocks took in the bear market, bond returns actually exceed stock returns over both short and long term periods as of March 31, according to Ibbotson numbers shown below. Does this effectively end the notion of “Stocks for

the Long Run”? Should this data convince you that, going forward, stocks are just not worth the risk for no additional return? Not really.

The bull market in bonds. A bear market in stocks is only half the story. Bonds experienced

a bull market not likely to be repeated. Bond yields are now historically low, meaning that some capital appreciation occurred in addition to the relatively high income yields of the past. Ibbotson calculates that the 40 year return on

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	S&P 500	IA SBBI Int-Term Gov't Bond	IIA SBBI Long-Term Gov't Bond
1 Year: Starting April 2008	-38.09	6.24	14.32
5 Year: Starting April 2004	-4.77	5.17	7.79
10 Year: Starting April 1999	-3.00	6.31	8.20
20 Year: Starting April 1989	7.42	7.39	9.61
30 Year: Starting April 1979	10.30	8.57	9.93
40 Year: Starting April 1969	8.70	8.03	8.79
Jan 1926-March 2009	9.44	5.40	5.60

Source: Ibbotson

Predicting the Next Train Wreck (continued from page 1)

“Italy and Belgium have fairly high debt levels but are relatively prosperous economies.”

wreck is in its early stages right under our noses? That frightful possibility cannot be ignored. What worrisome signs are indicating possible serious trouble ahead?

A market driven economy bears some resemblance to a living organism – it goes through various cycles and when injured has a natural tendency to repair or heal itself. This is based on observing millennia of economic progress – with many diversions (Marxism, e.g.) and occasional steps backward (world wars) along the way. In modern times, most economic problems can be traced to inept governmental attempts at managing the economy with monetary policy, fiscal policy, tax policy, currency controls, trade protectionism, or all of the above. Keynesian economic theory holds that government fiscal stimulus can ameliorate the severity of natural cycles by “priming the pump” of the economy

through temporary deficit spending. Real world experience tends to validate that measured stimulus has worked on many occasions. Others have brought countries to their knees. Unless fiscal policy changes from its current track, we could be headed for the latter.

The US does have an historical example of huge deficit spending. In WWII, the Federal government borrowed huge sums to fund the war effort. In 1939, the Federal debt stood at \$50.5B and escalated to \$271B by 1945. However, beginning in 1946, the Federal government ran a surplus and the debt grew very little in the next decades. The debt as a percentage of gross domestic product (GDP) exceeded 110% in 1946 but fell steadily into the 1970's, when it reached a low of 24%. Vibrant economic growth made the size of the debt less significant over time. In recent years, this ratio has increased to 55%.

Where it appears to be going in the next ten years is truly frightening.

What has been the experience of other nations that amass huge public debts through deficit spending? The outcome seems to be largely influenced by the **rate of increase**. Debt created by a one-time event, such as a war, and otherwise contained seems to result in no long-term harm. Witness the huge debts of Great Britain after defeating Napoleon in 1815. Some countries carry relatively high levels of debt but manage to control the rate of increase. For example, Italy and Belgium have fairly high debt levels but are relatively prosperous economies. However, Japan has one of the world's highest debt levels that continues to increase and has seen little economic growth. The most troubling scenarios are where debt increases
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Matrix Team Named to Five Star List Again

For the second year in a row, Giles Almond and the Matrix team have been named one of Charlotte's FIVE STAR: Best in Client Satisfaction Wealth ManagersSM by *Charlotte* magazine. Crescendo Business Services, an independent research company, administered a

rigorous “Best in Client Satisfaction” research process. More than 84,000 high net worth individuals and 8,500 financial services professionals were asked to evaluate wealth managers in the Charlotte area. The final list was reviewed by a blue ribbon

panel of local financial services industry experts. Fewer than seven percent of the wealth managers in the Charlotte area were selected.

Watch for the September issue of *Charlotte* magazine in local hotels and establishments.

The Role of a Trust Protector

Trust protectors have been commonly used in offshore trusts, but are a recent innovation in US trust drafting. A trust protector is a person with specific, limited duties and supervises the actions of the trustee, and is an additional layer of protection for the rights of trust beneficiaries. The role of the trust protector is specified in the trust document, but can include such duties as:

1. Ability to remove or replace the trustee.
2. Ability to change the trust's situs if unforeseen law changes occur.
3. Ability to resolve

disputes between beneficiaries and co-trustees.

4. Ability to approve trust expenses exceeding a specified amount.
5. Ability to withhold distributions to beneficiaries.
6. Ability to approve the investment policy of the trust or veto investment decisions.
7. Ability to join in defending a lawsuit against the trust.
8. Ability to terminate the trust. At some point, trust assets may become insufficient to justify the cost of trust administration.

Who should be considered

as a trust protector? It should be someone who can be trusted to independently act in the long-term best interests of the beneficiaries and who is familiar with the grantor's financial and personal goals and values. Clearly, it should not be a beneficiary or close relative.

If you have worked with your CPA for many years, he/she may be qualified for this role. Your CPA should have your family's confidence, the right business skill set, a tax background, and an understanding of your family's dynamics.

“A trust protector...is an additional layer of protection for the rights of trust beneficiaries.”

Pope Benedict XVI Calls for World Economic Authority

In a recent papal encyclical *Caritas in Veritate* (Love in Truth), Pope Benedict stated his case for a global authority to take a dominant role in managing the world economy. The encyclical states this is “necessary in order to arrive at a political, juridical and economic order which can increase and give direction to international cooperation for the development of all peoples in solidarity. To manage the global economy; to revive economies hit by the crisis; to avoid any deterioration of the present crisis and the

greater imbalances that would result; to bring about integral and timely disarmament, food security and peace; to guarantee the protection of the environment and to regulate migration: for all this, there is urgent need of a true world political authority...Such an authority would need to be regulated by law, to observe consistently the principles of subsidiarity and solidarity, to seek to establish the common good, and to make a commitment to securing authentic integral human development inspired by the values of charity in truth. Furthermore, such

an authority would need to be universally recognized and to be vested with the effective power to ensure security for all, regard for justice, and respect for rights. Obviously it would have to have the authority to ensure compliance with its decisions from all parties, and also with the coordinated measures adopted in various international forums.”

This encyclical continues and expands themes set forth by previous pontiffs and is an interesting expression of current Catholic economic theory and social doctrine.



Predicting the Next Train Wreck (continued from page 2)

“If our political leaders...continue to focus on the redistribution rather than the creation of wealth, and stifle business growth, our economic future is very much in doubt.”

due to some economic shock and then rapidly escalates. These seem to be the “banana republic” stories that end badly, with high inflation or outright default. The direction of the debt to GDP ratio trajectory seems to be the key.

According to Congressional Budget Office (CBO) projections, the deficit for the current year will reach \$1.85T, but improving to “only” \$658B in 2012, before deteriorating to \$1.2T by 2019. The total deficits projected between now and 2019 total \$9.3T – again not including the cost of health care reform.

While total Federal debt owed to the public was \$5.8T last year, the projected debt in 2019 is \$17.3T. This means the debt is projected to grow at an annual rate exceeding 10%.

As mentioned earlier, the current debt to GDP ratio for the US is 55% according to the CBO. Its estimates show the Administration’s current budget taking the ratio to 82% by 2019. However, this does not include the cost of whatever health care reform bill passes Congress. Neither does it include debt owed to the Social Security trust fund. Some projections see the total ratio pushing easily through 100% - with no end in sight.

It’s also important to note that the debt to GDP ratio also must include an estimate of GDP. The CBO projects real GDP growth of 2.9% in 2010, 4% in 2011, 3.6% in 2012-2015, and 2.3% thereafter. Obviously, if the CBO’s growth estimates prove optimistic, the ratio will be far worse than the baseline case.

With the debt growing at a 10% rate and an economy capable of growing at a maximum sustained rate of 3-4%, the implications are obvious. Our fiscal policy must change. We will not be Zimbabwe by 2019 but you might be able to see it from there.

Is change even possible? For many years, we have heard warnings of the impending budget crisis due to Medicare. Yet neither political party put forth any credible proposals to deal with it. Now it may be nearly impossible to assemble the political consensus to deal with the impending crisis. A large and increasing percentage of US households depend on government benefits in some form (Social Security recipients, Medicaid and Medicare beneficiaries, earned income credit recipients, etc.) and they are not likely to tolerate any representative that seeks to reduce them – no matter if a reduction is in our national best interest. Some cynical observers

now compare our democracy to six wolves and four sheep voting on what’s for dinner. Did historian Alexis de Tocqueville foresee our day when he said “The American Republic will endure until the day Congress discovers that it can bribe the public with the public’s money”?

Lately, the health care debate indicates that most Americans believe health care is an entitlement – that any person needing open heart surgery, MRI procedures, or other expensive treatment should be able to obtain it regardless of insurance or financial resources. We find it difficult to contemplate denying or rationing health care to anyone. Yet how can we continue on the unsustainable path where healthcare consumes a greater and greater share of GDP, projected to be 31% by 2035? It will be interesting political theatre to see how legislation is worked out in the next few weeks that balances the conflicting goals of expanded access, improved quality of care, and reduced costs.

Even if the political will existed, the tax burden to pay for promised entitlements is simply inconceivable. While our national savings rate is (thankfully) increasing, it cannot match the outlays projected. We must continue to import the

capital we need. How is our major capital supplier feeling about our prospects? It is a sad fact that we must go begging other countries to finance our profligacy. The percentage of US Treasury obligations owned by foreigners has risen from 12% in 1978 to 61% now. The Japanese remain our largest creditors with 22% of the foreign debt. However, the Chinese share has been growing and now stands at 19%. The Chinese have expressed concern about the lack of fiscal restraint and have made rumblings about replacing the dollar as the world's reserve currency. Some worry that the Chinese will cut off our credit line but that seems unlikely. Whether we or they like it or not, the Chinese economy needs American exports and they will not knowingly destroy a major export market. However, as the perceived economic risks in the US grow, lenders will demand higher rates or choose to deploy capital elsewhere – not that a default is a realistic possibility, but a falling dollar due to inflation is.

At this point, is there a good scenario for our economy? Perhaps - de Tocqueville also said "The greatness of America lies not in being more enlightened than any other nation, but rather in her ability to repair her faults." Escaping the

consequences of our deficit spending will amount to threading a fiscal needle. There must be a more disciplined approach to controlling Federal spending, especially entitlements – and it must happen soon. The tax base must be expanded rather than focusing on raising rates. And, most importantly, sound and sustained economic growth must be seen as the only feasible solution. We can neither cut spending enough (though it must be cut) nor tax our way out of this (though we must broaden the tax base). As our parents' generation successfully did following WWII, we must primarily **grow** our way out through policies to promote higher productivity and workforce growth. If our political leaders fail to recognize this, continue to focus on the redistribution rather than the creation of wealth, and stifle business growth, our economic future is very much in doubt.

If our course does not change and we are in the early stages of a new train wreck, what are the implications? In keeping with a well-diversified, strategic asset allocation approach, we see these general themes:

1. Don't assume the US equity market will come to your rescue. In many past periods, all you needed to be was in an equity index fund to produce excellent long-term returns. As you

know, equity returns are produced by earnings multiplied by a multiple (P/E ratio). While we may see a traditional bull market run following the 2007-2009 bear, both factors can be challenged in a slow growth, high inflation environment down the road.

2. Increasing foreign equity allocations. Many other economies are not facing the same challenges and may offer better growth opportunities. We must be willing to put aside our "home country" bias and invest more globally.

3. Factor higher inflation in the portfolio's risk profile. We believe investors piling into CD's, Treasury bonds, and fixed annuities may be fighting the last war. Instead, anticipating the potential effects of inflation three to five years out should be shaping asset allocations.

4. Employ more skill-based strategies. Sources of portfolio return need to be more diversified in a more challenging future investment environment. This means employing more "absolute return" strategies that may be unfamiliar. Investors will need an open mind and be willing to learn.

Looking back ten years from now, maybe the train wreck was somehow avoided – we can only pray for that miracle.

"The greatness of America lies not in being more enlightened than any other nation, but rather in her ability to repair her faults."

Alexis de Tocqueville

Bonds – Not As Safe As You May Think

“The most significant and least understood risk faced by bond investors is interest rate risk.”

“When the financial history of this decade is written, it will surely speak of the Internet bubble of the late 1990s and the housing bubble of the early 2000s. But the U.S. Treasury bond bubble of late 2008 may be regarded as almost equally extraordinary.”

Warren Buffett

How would you like to own an investment with a reputation for safety, stability, and absolute security, only to see your principal value drop by 9% in a year? On another occasion, this investment posted losses for **four consecutive years**. No, this is not some recent Wall Street manufactured derivative product – this is what can happen to investors owning US Treasury bonds!

Bonds are not risk-free investments. They have principal risk, which is the risk of not getting your principal repaid. One would hope that this would be nonexistent with US Treasury bonds, however, the credit default swap market indicated otherwise earlier this year when it priced insurance on US Treasury debt higher than Exxon Mobil or Johnson & Johnson. Any bond issued by an entity that does not “own the printing press” can default (absent a US Treasury guarantee), and many have as we have seen in recent years.

Unless they are inflation indexed, bonds have inflation risk, which occurs when the inflation rate is greater than the bond’s return, leading to negative “real” returns. This has happened in 30% of rolling ten year periods since 1926 and as recently as the 1980’s.

A very real risk that was

seen in recent months is liquidity risk. You may have a bond that is sound but if there are no buyers, the price will fall, often dramatically. Treasury Inflation Protected Securities (TIPS) prices were affected in last fall’s panic simply because the market for them is small relative to the very liquid market for traditional Treasury bonds.

The most significant and least understood risk faced by bond investors is interest rate risk. For example, let’s say you purchase a 30 year Treasury bond at today’s rate of 4.5% that pays \$45 on a \$1,000 bond. One year from now, due to any number of reasons, the 30 year Treasury bonds sold then are yielding 6.5%, i.e. paying \$65 on a \$1,000 bond. What will your 29 year bond paying \$45 of annual interest be worth in this new higher interest rate environment? Answer: about \$785 – a loss of over 20%. How can that be? That’s the principal value that would cause your bond (that only pays \$45 of annual interest) to yield the new current rate of 6.5%. This possibility is Warren Buffett’s predicted Treasury bond bubble.

The longer it takes to receive the cash flows from a bond, the more pronounced the principal change when interest rates fluctuate. Longer term bonds have more

sensitivity to interest rate changes. The level of sensitivity is approximated by a measure known as *duration*, which measures the weighted average point in time where a bond will have paid one-half of its total cash flows (principal and interest). The duration in years will approximate the percentage change in principal value given a one percent change in interest rates. For example, the duration of a 29 year bond with a 4.5% coupon rate calculates to 12.3 years, indicating very high interest rate sensitivity. A similar bond maturing in ten years would have a duration of 8.1 years and a five year bond would be 4.6 years. Bonds with similar maturities but higher or lower coupon rates will have different durations. The key to controlling interest rate risk in a portfolio is duration management. This issue is addressed in each client’s *Investment Strategy Summary*.

Some may question whether duration matters: if a bond is held to maturity, the investor will receive the yield expected when the bond was purchased. That is true, however, bonds may need to be unexpectedly liquidated before maturity. Buying long duration bonds at the wrong time means it will take decades for the mistake to “mature”.

Natural Gas Prices – How Low Can They Go?

In some ways, it is difficult to understand – in this world that is moving to green energy, a clean, largely domestic fuel now selling for 75% less than a year ago. The current spot price (the so-called Henry Hub price) is \$3.41 per million BTU's, down from a peak of \$13.50 last summer, easily making natural gas the worst performing commodity. As is almost always the case, price can be explained by supply and demand factors.

The demand story. While residential use has remained constant from one year ago, commercial use is down slightly, as is electric power use. Most of the country is experiencing a moderate summer, which has dampened demand, with forecasts calling for temperatures to remain below normal. However, the big drop has been in industrial use, down 11.5%. Due to the recession, demand for gas in the petrochemicals, plastics, wood products, metals, motor vehicles, and fertilizer industries is off sharply.

There's not much additional space to store gas at this point. Stockpiles have grown to 2.95 trillion cubic feet, which is 18% higher than the five year average and approaching 75% of capacity.

The supply side. While

the debate about "peak oil" rages on, we are not there yet with natural gas. We are now producing roughly 4.3% more gas than in 2001. There have been a number of new discoveries: Granite Wash in the Texas panhandle and western Oklahoma, Eagle Ford in south Texas, and Horn River Basin in northern British Columbia. These finds appear especially prolific, with claimed average initial well production rates of 16-22 million cubic feet per day. Add these to the recent finds in the Marcellus, Haynesville, and Barnett Shale and it is not surprising some pundits predict \$2 gas.

The rest of the story. It should be no shock that prices have fallen sharply with lower demand and increased supply. The key to future prices is the sustainability of the current conditions. According to HIS Energy Group, over 50% of natural gas consumed in the US today comes from wells drilled in the last three years and 25% comes from wells drilled in the last year. We are producing more gas now than in 2001 due to drilling 33,000 successful gas wells per year since then. While imports have added marginally to our supply, the main reason supplies have been so abundant is because we have (to use an old phrase) drilled, drilled, drilled. Yet currently there are only

665 gas drilling rigs operating, the lowest number since May 2002 and down 59% from last September. Given many wells need \$6-\$8 gas prices to justify drilling and completion costs, fewer wells being drilled at today's prices is logical.

Combine fewer wells being drilled with high decline rates in some of the new discoveries and the supply picture could change substantially in a few years, if not sooner.

Implications for investors. The last time we checked, the rule was "buy low, sell high." With less demand for drilling services, drilling costs have materially dropped. Now seems to be a good time to become an owner of this clean natural resource. By most measures, gas prices appear to be unsustainably low. With the recession (hopefully) running its course and growth expected to return in 2010, the demand for natural gas should return to a more normal level, even without an especially cold winter or hot summer. With fewer new wells being drilled, the supply situation should firm and prices along with it.

Hedging has helped. Our clients with existing gas well investments have benefited by hedging one-half of production. This has helped cushion the effect of recent low prices.

"Now seems to be a good time to become an owner of this clean natural resource."



Natural gas prices

Bonds Beat Stocks For The Long Term (continued from page 1)

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long term government bonds was 7.75% income yield and 1.14% capital gain. Falling rates have given bonds a tail wind since 1982.

A future head wind? As explained in another article in this edition, rising interest rates depress bond total returns. With the 30 year bond currently yielding 4.5%, it seems more likely that rates will increase rather than drop in the future. By contrast, rates peaked in 1982 at 14.2%, leaving plenty of room for rates to fall.

Historical odds still favor stocks for the long run – by a mile. Stocks versus long term

government bonds over rolling ten and twenty year periods since 1926 show that stocks outperformed 91 and 97 percent of the time, respectively.

What's past is not prologue. Whenever bonds have outperformed stocks for a ten or twenty year period in the past, the subsequent ten or twenty year period heavily favored stocks. For example, bonds outperformed stocks in the two decade period ending in 1948 (3.91% vs. 3.11% annual returns). In the subsequent two decades, stocks outperformed bonds with an annualized return of 14.92% versus 1.27%. In similar ten year

periods, stocks outperformed 100% of the time by 6.6% on average in the subsequent decade.

No guarantees. As always, "past performance is not a guarantee of future results." So while history greatly favors the stock investor for the long term, one can always find arguments that the next decade will be different. Bonds of appropriate duration will continue to have a place in portfolios where cash flows will be needed in the short to intermediate term.

Fleeting glory? By June 30, stocks had rebounded and may soon again rule for the long term.

About Matrix Wealth Advisors, Inc.

Planning is the process of allocating limited resources among unlimited alternatives according to a system of values to achieve life goals.

Founded in 1990, Matrix uses a very personalized, principle-centered process to offer comprehensive financial planning and investment management services that help clients

close the gap between where they are now and where they want to be. Matrix is a fee-only, fiduciary firm and is compensated solely by our clients.



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