

Quarterly Perspective

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ECONOMICS 101

A guest commentator on CNBC's morning program, "Squawk Box," recently made a statement about economics being a difficult subject to master. For one thing, understanding economics requires the student to accept that all manner of opposites – supply and demand, inflation and deflation, gains and losses – are inter-related and ultimately join to form one big, never-ending circle of life. I have always found all this yin and yang challenging and was relieved to hear that at least one "expert" agreed with me.

The Study of Risk

I do know that no study of the economy and the markets can take place without a discussion of risk – in its many and varied forms, such as:

Loss of principal risk –

Can I lose what I invested?

Liquidity risk –

Can I liquidate this asset quickly without much risk of loss?

Risk/return trade-off –

Am I being paid enough to take on the risk associated with this asset?

Purchasing power risk –

Will this asset allow me to maintain my standard of living in the future?

With today's constant barrage of bad news, it is easy for people of all ages to seek ways to eliminate

risk from their lives. It has created an almost irrepressible response on the part of investors to get out of the markets and grab hold of the "sure thing," even though the return is paltry. Some have done just that, resulting in a flood of cash to treasury securities, money market accounts and FDIC-insured deposits. They have, therefore, eliminated one risk – the risk of loss of principal. They have also generally eliminated a second risk – liquidity risk – and have accepted the low return for the low risk of the trade-off. But what if investors want or need more return? And have they really thought about the risk of loss of purchasing power?



The question du jour is, "Should I get out of or stay in the markets?" While this is a question that, ultimately, can only be answered by each individual or organization for themselves, we thought sharing some additional "risk-related" thoughts might be beneficial.

Did You Say Deflation?

There is a great deal of attention being directed towards the risk of inflation right now. However, according to WMG Chief Investment Officer Andrew Douglas, "The greatest concern of Fed Chairman Ben Bernanke and the markets is that of sustained *deflation*." During a deflationary cycle both the price of goods and services and the value of assets decline. Obviously, decreasing asset values equate to a negative wealth effect. But declining prices would seem to offset shrinking balance sheets and help consumers, so why the concern?

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“Contrary to what you might think, falling prices lead to less spending, not more,” says Douglas. “Individuals and businesses delay purchases, hoping those goods and services will be cheaper at a later date.” And we need spending to get the economy moving again. Deflation also takes the air out of the tires for anyone in debt. No one wants a \$40,000 auto loan when that same car could be purchased for \$37,000 today. Borrowers are forced to pay back lenders with dollars that are worth more now.

This cycle of less spending and shrinking dollars feeds on itself and creates a downward spiral for the economy. Portfolio Manager Brian Jackson points out that “Barclay’s Capital recently stated household housing and equity wealth has fallen by \$16.4 trillion since the second quarter of 2007. Assuming a spending impact of \$.04 per \$1.00 of wealth lost, the level of consumption falls by \$650 billion.”

Inflation might be a *forthcoming* problem; deflation is a *contemporary* problem. This explains why Bernanke is flooding the system with liquidity. Douglas also points out that Bernanke is doing precisely what he said he would in a speech in 2002. “He has not wavered from his intrinsic theory of how to address today’s economic problems. He has been keeping rates low and now he is working to get money in motion again.”

Back to Econ 101. Every action has a counter-action. In this case, the effect of sidestepping deflation may be to cause inflation. The Fed’s actions are examples of monetary policy. Congress and the White House are responsible for fiscal policy and the various stimulus packages recently enacted are increasing the federal debt.

Government has three alternatives when it comes to debt:

- Reduce it by spending less.
- Reduce it by increasing income – also known as raising taxes.
- Let it ride.

Since “government” in this case refers to elected officials, bullet points one and two are about as popular to them as rap music is to my mother. That leaves living with the debt. In order to do that, the Treasury will be in the business of issuing loads of bills, notes and bonds for years to come. According to Investment Officer Kim Grant, “If necessary, the Treasury will raise interest rates to keep investors buying its securities. It’s referred to as ‘crowding out’ and it will force other companies to pay more on their bonds as well.”

When a company’s costs increase (like higher interest on loans), it charges more for the goods or services it provides. The vicious cycle begins again; only this time it is an *inflationary* cycle. Wealth grows as earnings increase. Individuals and businesses rush to buy before prices go up. Problem is today’s dollars don’t buy as much as yesterday’s dollars used to. This is the risk of the loss of purchasing power

Stay In or Get Out?

So...returning to the original question...stay in the market or get out? Although there are many variations on the theme, we offer four basic choices:

1 Be Ultra-Conservative. Sell all stocks and bonds and purchase treasuries or FDIC-insured deposits eliminating loss of principal risk, but incurring sizable purchasing power risk.

2 Be Moderately Conservative. Sell stocks and reinvest in all fixed income assets (such as bonds and treasuries) reducing – not eliminating – market risk, but maintaining purchasing power risk.

3 Be Moderately Aggressive. Own both stocks and bonds retaining some market risk, but reducing most purchasing power risk.

4 Be Aggressive. Initiate or maintain an all-stock portfolio incurring sizable principal risk, but having the best opportunity for reducing purchasing power risk.

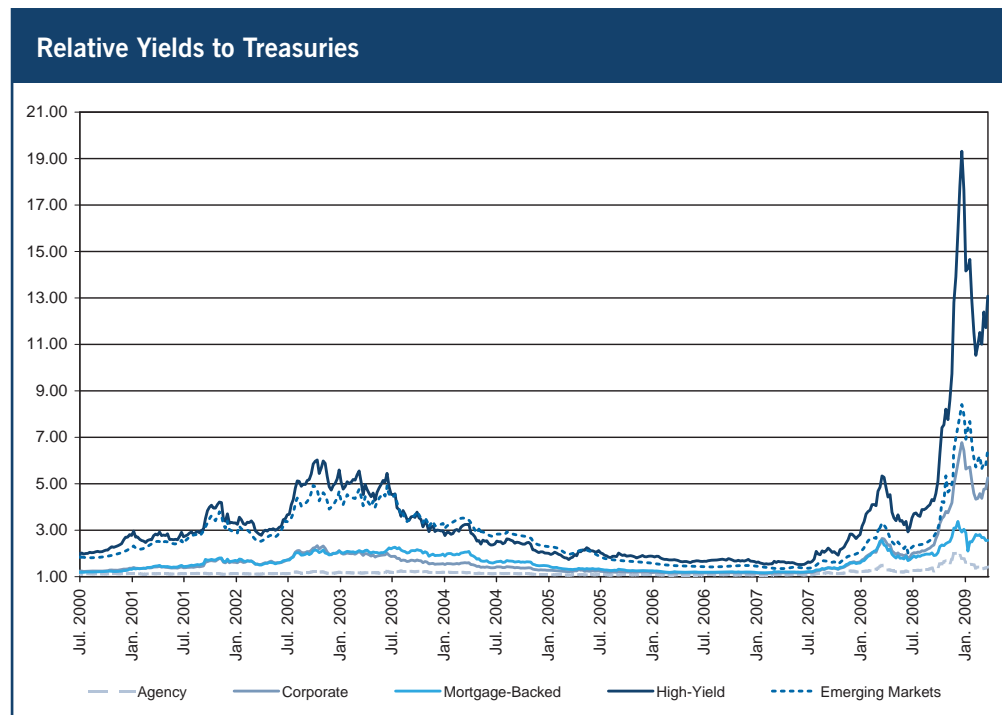
Investment Officer Sarah Reicks makes a great point when she says, “Investors have to keep in mind the difference between long-term individual investor strategies and short-term investment manager strategies. For example, we have made a strategic call to minimize equities and maximize fixed income within our asset allocation ranges. The last thing we want is for our clients to interpret that as a call to exit the stock market.” Douglas concurs, adding, “We feel fixed income offers the best risk/return trade-off for the next twelve to eighteen months. We are constantly monitoring the markets and, during that time, our probabilities could change and we would make adjustments. But the average investor should be very careful implementing large swings in asset allocation.”

Tom Peckosh, our Head of Equities, reminds investors, “Long-term inflation concerns are very real and an all fixed-income portfolio offers little or no protection from rising prices.” Even TIPS (Treasury Inflation-Protected Securities) will likely result in the spending of some principal should inflation

take off in a couple of years. Only ‘risky’ assets like stocks and commodities provide the necessary balance. Peckosh says, “The long-term average P/E ratio for stocks is around 16 and the average right now is slightly below 10. On average, stocks are cheap and there are still many good companies out there.”

Douglas was quick to chime in that the risk/return trade-off for non-treasury bonds is favorable right now, also. The chart below shows how narrow the spreads have been between treasuries and other fixed income assets since the start of 2000. “Now, though, the spreads have widened so investors are being paid for taking some prudent risk, such as investment grade corporate bonds.”

Even considering the bashing most investors have taken at the hands of the markets recently, our economics professor would probably advise us to take heart and remain diversified, granting the markets time to come full circle. We would agree. Class dismissed.





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AN ERROR MADE RIGHT

Is it good news to find out one of the mutual funds you owned had a pricing error that occurred over a period of five months, affecting the net asset value of units of the fund? When the fund company discovers the error, goes back to the date of the initial problem and reverses and re-posts all of the transactions that occurred since then, it really kind of is. Restores your faith that companies will step up and do what's right, doesn't it?

And it's even better when the fund contacts an institutional manager who invested in it – like Heartland's Wealth Management Group – and that manager goes back to when it purchased the shares, reverses and re-posts all of its transactions, and re-balances its books to make sure its clients are not adversely affected in any way. Top those efforts off with full disclosure and we think you have an example of how the system works properly – even when an error is made. You are probably way ahead of me when I say that's what happened with the Principal High Yield Institutional II Fund.

In late February, we received notification from Principal that a pricing error had occurred last August. In March, they told us they had completed their corrections and, thanks to the diligent efforts of our tireless Operations staff, we concluded our re-posting, verifying and re-balancing prior to quarter-end.

The best news is that your account incurred no loss as a result of this unfortunate situation. The dividends you received were correct and your proportionate share of the fund has been adjusted. You may notice numerous transactions related to the fund in your statement. At this time, we continue to hold a small position in the fund in many of our accounts.

Please feel free to contact your Wealth Advisor if you have any further questions and know that we will keep you apprised of information that affects your assets and our relationship.

On the Flap...

NMB&T Economic & Market Forecast



Andrew Douglas and Brian Jackson shared the WMG 2009 Forecast with clients and guests in Albuquerque and Santa Fe in February. The presentations were followed by social time.

Happy Retirement!



We offer "Congratulations!" and our best wishes to Ron Spielman as he embarks upon a new adventure – retirement. Many thanks to Ron for his years of dedicated service to Heartland WMG.

Ron Spielman, *Vice President - Wealth Advisor*



New WMG Advisors

Welcome to Kim Keuter, Kim Larson and Ron Brosius who have joined WMG since the first of the year. We are excited to have you joining our Team of Professionals.



Kim Keuter
Wealth Advisor



Kim Larson
Wealth Advisor



Ron Brosius
Wealth Advisor

