

INVESTMENT UPDATE

THE MUNCY BANK & TRUST COMPANY

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Points of interest:

- Dollar-cost averaging seeks to avoid putting everything into the market just before a decline.
- Averaging works well in retirement plans where small sums are invested regularly.
- When investors are handed a lump sum to invest, they may do better by investing the entire sum at once.

DOLLAR-COST AVERAGING VS. A LUMP SUM: WHICH CREATES MORE WEALTH?

One of the oldest tricks in the investment book is dollar-cost averaging (DCA). This technique suggests that investors will do well over time by slowly investing fixed sums of money into the markets at regular periods.

By doing so they will take advantage of the low buying points while not putting too much money in at any one market top.

This is how many employees end up investing through their employers’ savings plans - a specific percentage is deducted from each of their paychecks and invested into their accounts.

Although many investors have been taught to invest this way over the years, its value is now being questioned by research conducted by the Vanguard Group, which runs the nation’s second largest mutual fund company.

Let it all ride
Vanguard says its simulations of lump-sum vs. dollar-cost averaging in the U.S., British, and Australian stock markets since 1926 give the edge to lump-sum investing.

It looked at two cases: one in which an individual received a \$1 million inheritance, and another where a charitable foundation received a \$20 million cash gift.

Vanguard said that on average investing the lump sums immediately would have resulted in bigger portfolios two-thirds of the time.



The tendency of stocks and bonds to rise more often than they fall gives lump-sum investing an edge over averaging into the market.

This seems to work because stock and bond markets rise on more days than they fall, it said.

“We conclude that if an investor expects such trends to continue, is satisfied with his or her target asset allocation... the prudent action is investing the lump sum immediately to gain exposure to the markets as soon as possible,” the study’s authors wrote.

The study compared two methods of investing. In one, the lump sum is immediately invested into a portfolio of stocks and bonds.

In the second, the money is invested in equal incre-

ments monthly over periods ranging from six months to 36 months.

Better over 10 years
When each portfolio’s results over the next 10 years were compared, the lump-sum approach often did better, Vanguard says.

Why did this occur? Vanguard said it seems to be because when dollar-cost averaging a lump sum into the markets, the temporarily non-invested portion is held in cash accounts. Over time stocks and bonds have beaten cash accounts, so holding money out of the market for a

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DESPITE LOWER RETURNS, AVERAGING MAY HELP INVESTORS TO CONTROL EMOTIONS

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period results in lower portfolio returns.

Vanguard noted that these results do not invalidate dollar-cost averaging within an employer savings plan. In that case the other alternative would be accumulating the small regular contributions to the plan into cash, and then at some point timing the market and investing it all.

When investing through a retirement plan “investable cash becomes available only

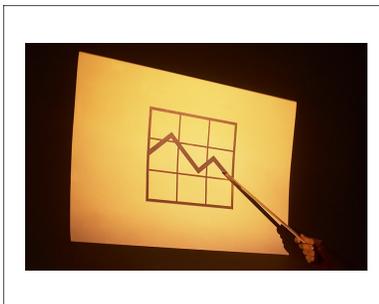
in relatively small amounts over time, which makes DCA a prudent way to invest,” Vanguard says.

Emotional balance

However, it should be remembered that lump-sum investing works best when the investor can maintain an emotional balance for an extended period.

If the investment of a lump sum would entail regrets if it was followed by an immediate market decline, and that regret would make an investor discard his original plan,

then it might be safer to dollar-cost average the money into the market in order to keep the investor comfortable with staying the course.



A sudden crash can unnerve an investor.

REBALANCING: HARD TO DO BUT WORTH IT

Much research has supported the benefits of regularly rebalancing a portfolio.

It suggests that an investor should start with a target asset allocation and then regularly sell or buy individual holdings in order to keep that allocation steady.

For instance, suppose the investor starts with 50 percent in stocks and 50 percent in bonds. A year later the stock market has fallen, and the investor now has 40 percent in stocks and 60 percent in bonds. To rebalance, the investor should sell enough bonds and buy enough stocks to restore the original 50/50 balance.

This forces the investor to sell something that has increased in value and to buy something that is now at a more reasonable price.

Emotional resistance

“Anecdotal evidence suggests that most investors do not rebalance their portfolios,” says Research Affiliates, an investment management firm based in Newport Beach,

Calif.

“Perfectly rational individuals exhibit changing risk aversion that makes it hard for them to rebalance into high-return assets that have had steep price declines,” wrote Jason Hsu, chief investment officer of the firm.

He said it is not just individuals who fail to rebalance, “but also sophisticated institutional investors advised by investment consultants and academics who are also prone to the same behavior.”

This behavior overlooks research that shows the individual investment asset classes exhibit long-term mean reversion in prices. In simpler terms, periods of outperfor-

mance are followed by periods of under-performance, and vice-versa.

Creating opportunities

“So when an asset class falls in price... it’s more likely to experience high subsequent returns,” Hsu wrote. For instance, after extended falls in the Standard & Poor’s 500

Index, subsequent five-year returns have been significantly above average.

Investors should consider rebalancing their portfolio annually at the same time of year. That way they won’t be swayed by short-term market movements.

More frequent rebalancing may be counter-productive because assets tend to have momentum when moving in one direction and an investor may end up selling a rising asset too soon to reap the full benefit of its move upwards.



Regular rebalancing among asset classes forces you to sell investments that have gained value to buy those that have become bargains.

“So when an asset class falls in price... it’s more likely to experience high subsequent returns.”

‘ECHO BOOMERS’ COULD GIVE A BIG BOOST TO THE STOCK MARKET

The Baby Boom generation born between 1946 and 1964 has dominated investment markets since the 1980s.

They struggled for an economic start during the repeated recessions between 1973 and 1982, but then helped to propel an 18-year bull market as they reached their peak earnings power in the 1990s.

Now some market observers worry that the Baby Boomers are dragging down the stock market as they near or enter retirement and become more risk averse.

Indeed, the spread between money flowing into conservative bond mutual funds and flowing out of riskier stock mutual funds is at its widest in history, according to research conducted by Charles Schwab & Co.

A new generation

Liz Ann Sonders, chief economist at Schwab, thinks the generation born after 1980, variously referred to as the “millenials” or “echo

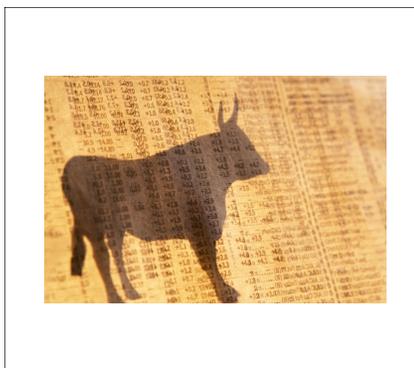
boomers,” could propel stock prices higher in the years to come.

She says the Echo Boomers make up a large cohort of potential investors—85 million vs. 80 million Baby Boomers.

Echo Boomers are struggling with weak job prospects as they try to establish careers and families. This is typical of early adult life and similar to the struggles Baby Boomers faced during the difficult period of 1973-82, Sonders says.

The savings effect

Once they reach their 30s, however, they will have the capacity to save and invest, just as their parents did. And the evidence suggests they are already having an impact: “Millenials are saving and are already investing in stocks,” she says. Workers in their 20s currently have more stocks in their 401k accounts than did their counterparts 10 years ago.



Children of the Baby Boomers may help propel stocks to a new bull market.

Also “millenials tend to be optimists and are more willing to take risks relative to their parents’ generation,” Sonders says. The Kaufman Foundation’s survey shows that Echo Boomers already make up 29 percent of all entrepreneurs.

This generation also is having a worldwide effect on creating a bigger workforce—the ratio of workers to total population in East Asia was 47 percent in 1965, while it reached 64 percent in 2010, Sonders notes.

“Once they reach their 30s, however, they will have the capacity to save and invest.”

RETIREE PERK, MIDDLE CLASS BLUES, & MORE

Say goodbye to another retirement perk that used to be common—health insurance provided by an employer.

Fifteen years ago over 10 percent of private employers gave some form of retiree health insurance to their loyal workers. Recently the percentage offering such coverage has sunk to just 6.1 percent, says the Employee Benefits Research Institute.

What’s more, employers continue to increase the portion of premiums that retirees



must pay for health insurance. Despite the decline, up to a third of active workers think they will get employer coverage in retirement.

Middle class decline

It’s official: the middle class has been in a sharp decline over the past 40 years, says the Pew Research Center.

Middle-income Americans make up 51 percent of the population, down from 61 percent back in 1971, Pew says.

Those who remain in the middle class take in just 45

percent of the nation’s income, down from 62 percent, while median income has dropped 28 percent.

Tuition hikes slow

College-bound seniors have a bit of good news: tuition increases averaged just 3.9 percent for private colleges and universities this school year, the lowest annual increase in 40 years, says the National Association of Independent Colleges and Universities.

Increases averaged 4.5 percent in the previous two years, and 5.7 percent in the 1998 to 2008 period.

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BUYING AND HOLDING STILL WORKS DESPITE STOCK MARKET VOLATILITY

The perception that day-to-day stock market volatility has increased may convince some investors that they should be trading within their portfolios frequently.

Indeed, lots of stock market commentators love to talk about “the action this afternoon” and “what investors should be doing right now.”

How about just sitting on their hands? It may come as a surprise but some of the savviest investors buy and hold portfolios for years without responding to the market’s daily fluctuations.

Mark Hulbert, whose newsletter tracks the performance of the investment newsletter industry, says the top newsletters don’t trade much at all.

He recently analyzed the performance of 200 invest-



Daily market fluctuations should not make an investor deviate from a long-term plan.

ment advisors who publish their trading and found that the top three newsletters, based on performance over 25 years, held stocks for an average of 3.2 to 7 years.

“Their holding periods are about as far away from high-frequency trading as you can imagine,” Hulbert wrote in the Hulbert Financial Digest.

Another argument against not getting swept up

in trading trends is compelling: investors who do so can easily get whipsawed by sudden reversals.

For instance, what about investors who bought the day of the presidential election, when markets went up sharply, only to be caught in a huge downdraft the day after the election?

Those who sold during the declines of the first week after the election may have missed the trading of Thanksgiving week, which was the best in six months.

Ben Graham, the father of value investing, often cited the image of Mr. Market, a schizophrenic fellow who offers you new prices, both higher and lower, every day. The investor has no obligation to ever accept and trade at any day’s price, but instead has the luxury of waiting until the price is right.