

# INVESTMENT UPDATE

## THE MUNCY BANK & TRUST COMPANY

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### Points of interest:

- The U.S. budget was in surplus in 2000, and the government began paying off its debt.
- Projections assumed the debt would be completely gone by 2012.
- Planners worried about the effects of a debt pay-off on the financial markets.
- Today the debt nears \$15 trillion.

## WOULD CHAOS RESULT IF THE U.S. PAID OFF THE NATIONAL DEBT?

United States politicians and voters have engaged in heated debate this year over the skyrocketing debt owed by the federal government.

Over the last decade the debt has ballooned to nearly \$15 trillion. Some taxpayers and politicians, angered by the legacy being left to their children, have argued that the U.S. should balance the budget and pay down the debt.

Many may have forgotten that just 11 years ago we were on track to pay off the entire debt by 2012. What we didn't know until now was that the prospect of an end to U.S. debt sent government officials scrambling to put together an emergency plan to deal with the event.

That's because the U.S. debt—in the form of Treasury bills, bonds, and notes—is considered the world's risk-free asset and safe haven, serves as the most important interest rate benchmark, and is used by the Federal Reserve to implement monetary policy.

**A potential crisis**  
In the last year of the Clinton Administration economists at the Treasury worked on a secret report speculating on the effects of the debt paydown and on alternatives that the government and markets could use in place of Treasury securities. That report, titled "Life After Debt," was never publicly issued. It was recently obtained by Na-



These days the United States is swimming in debt. But 11 years ago government planners worried about the effects of paying off the debt.

tional Public Radio through a Freedom of Information Act request.

It shows how worried some in the Treasury Department were about the projected debt elimination.

U.S. Treasury securities have become a ubiquitous holding for large and small investors, foreign countries, and even the Social Security System, and there is no clear idea how disruptive the absence of such debt would be.

For instance, where would the Social Security System stash the billions it collects daily from payroll taxes? It needs to earn inter-

est but it also needs a rock-solid security that will guarantee payout later in this century when the retired population increases.

**Fed left high and dry**  
What would the Federal Reserve use to manage monetary policy? Currently the Fed buys and sells Treasury securities in order to increase or decrease the money supply and interest rates. It needs a large, orderly, and very liquid market to achieve its objectives, and the Treasury security market is made to order.

The report proposed alternatives to using U.S.

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## ALTERNATIVES TO U.S. TREASURY SECURITIES PROVED TO BE RISKY

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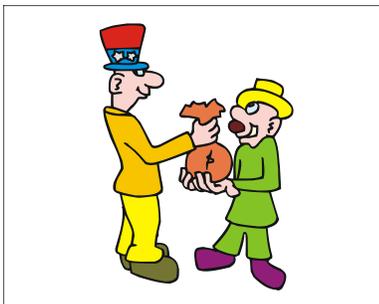
debt. However, in light of what happened during the financial crisis of 2008, such alternative instruments appear to be a lot riskier today than they did in the year 2000 when the report was written.

The report identified government backed agency securities issued by the giant mortgage companies Fannie Mae and Freddie Mac as alternatives. However, even at that time the market for their securities was not big enough.

In retrospect we know that the two agencies went bankrupt in 2008 and limp along today with government aid.

The swaps market, where banks and other institutions swap liabilities, was also identified as an alternative because it was “remarkably liquid” and a “vibrant market.” However that market froze solid in 2008 and has not fully recovered since then.

The report shows that even though our debt may be too big now, there may be



In 2000 the U.S. was paying off lenders.

virtue in always having some debt outstanding as a backstop for world markets.

## INVESTORS SHOULD KNOW REAL RETURNS

Many investors and most savers probably think about their returns only in “nominal” terms. That means they only take note of the yield or return on their investment before accounting for inflation.

In that view a 2 percent bond yields 2 percent. A 6 percent annual gain on a basket of stocks is a 6 percent gain.

However, the proceeds of savings and investments are not spent or exchanged in an unchanging world. Every minute of every day relative prices of goods and services are changing. In aggregate they almost always go up over time. That’s the basis of the concept of inflation.

### The silent killer

Inflation is the silent enemy of anyone who is trying to accumulate capital. It continually eats away at the value of one’s savings and investments. It can turn even an investment perceived as “safe” into a wealth destroyer.

Investors these days have been faced with two

hurdles: a volatile stock market that has had some sharp drops over the past five years, and a very low interest rate environment that has pushed yields at banks and money market funds close to zero.

### A slow decline

The market’s roller coaster ride has caused many in-

vestors to pull money out of their portfolios and put it into cash holdings, mutual fund industry statistics show.

Those who are hunkering down in cash may think they are protecting their nest eggs, but, with consumer inflation running at over 3 percent in the past 12 months, savers have actually been losing money that they thought was safe from the stock market’s volatility.

Dimensional Fund Advisors, a Santa Monica-based investment company, notes that the popular press has reported investors are “shifting their portfolios to money market funds... with the intent to return to stocks and bonds when the economy shows signs of improvement.”



**Inflation is running at a rate three times higher than average bank interest rates and is steadily eating into the value of your savings.**

At the same time, however, “investors ultimately may lose wealth even as they try to protect it,” DFA says.

The loss can come from two sources: the effects of inflation on the purchasing power of their cash, and by the loss of opportunity

to profit in the stock market when investors delay reinvesting their money, DFA says.

“The problem with this strategy is that no one can consistently time markets, and the signs are never clear,” DFA concludes.

*“Investors ultimately may lose wealth even as they try to protect it.”*

## 401K LOANS ARE A TAX TRAP THAT CAN DAMAGE RETIREMENT CHANCES

Almost a quarter of employees who have 401k retirement savings accounts are using them as piggy banks, according to a new study by four finance professors from Stanford, Yale, and Harvard.

Although employees who use such loans apparently see the advantages, the potential retirement and tax booby-traps are not so evident, the study found.

### Hidden traps

Borrowers are hit by double taxation of the loan proceeds and they may hurt their overall investment gains. They also can get hit by unexpected taxes and penalties if they lose a job while the loan is outstanding.

The typical borrower is a middle-income employee making between \$40,000 to \$60,000 who has been with the employer between 10 and 20 years.

Borrowers can only take out up to one-half of the value of their accounts, to a maximum of \$50,000. That means only those who have accumu-

lated a sizeable account can borrow a significant amount of money.

The median loan is about \$4,000, and most loans range between \$1,050 and \$26,000, the study found.

### Taxes and more

The tax-deferred nature of 401k plans works against borrowers. When money is contributed, the worker escapes income taxes on that amount. The worker pays taxes later, when the money—and its earnings—are withdrawn in retirement.

But someone who borrows from their plan must repay the money in after-tax dollars, says James J. Choi of Yale, one of the study's authors. "Your 401k loan interest payments face double taxation, since they are made with after-tax dollars and then get taxed again when you withdraw them in retirement," he told the financial news site Marketwatch.



Loans from your retirement plan can backfire and cause unexpected taxation.

Borrowers are required to pay interest on their loans, usually at the prime rate. But since that rate currently is very low, at 3.25 percent, employees may not get higher market returns on their accounts while repaying.

Finally, if an employee leaves or loses a job while repaying a loan, the loan usually will come due. If the employee can't repay the entire amount, he will owe taxes on the balance, as well as a 10 percent early withdrawal penalty if younger than 59.5.

*"Borrowers are hit by double taxation of the loan proceeds and they may hurt their overall investment gains."*

## CASH IS KING, GOLD'S FAULTS, & MORE

Investors—younger ones especially—are making a dash for cash, a survey by the investment firm MFS found.

An unstable stock market caused a quarter of those surveyed by MFS to liquidate a portion of their portfolios during 2010 or this year because of market concerns, despite cash interest rates that are close to zero.

Generation Y investors say they have close to 30 percent of their money in cash, and won't reenter the



market until there is a "meaningful change" in the economy.

### Why gold?

The managers at Tweedy, Browne Fund Inc. are not impressed with this year's increase in gold prices, they write in their semi-annual report.

"We believe there are better ways to address economic uncertainties than to speculate in a commodity that produces nothing in the way of income, costs money to store,

and whose value is completely dependent on investors' continued faith in it... We think that gold's effectiveness as an inflation hedge has been nothing to write home about."

### Times haven't changed

Here is a timely quote on professional Wall Street investors from the wonderful 1940 classic investment expose, "Where Are The Customer's Yachts?" by Fred Schwed, Jr.: "At the close of the day's business they take all the money and throw it up in the air. Everything that sticks to the ceiling belongs to the clients."

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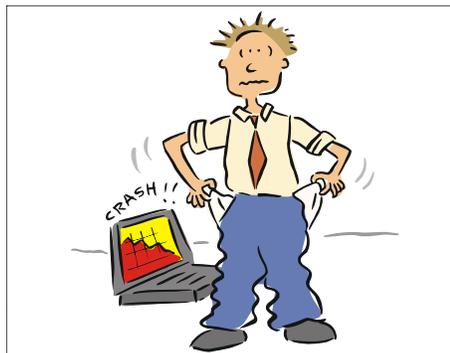
## ARE WE REPEATING THE 1930S? FOR THE MARKETS THAT COULD BE GOOD

The deep recession and big declines in the stock market in late 2007 through early 2009, accompanied by a lackluster economic recovery, have some observers comparing the present day situation to the dreary 1930s Great Depression.

Surprisingly, investors may only hope that this is the case, since a good argument could be made that the markets hit their lows on March 9, 2009 and that the recent downturn is just a blip in a long upturn, writes investment newsletter analyst Mark Hulbert.

“Contrary to the popular imagination... the 1930s actually contained one of U.S. history’s most powerful bull markets,” Hulbert wrote in September for the financial website Marketwatch.

The U.S. stock market



Is the stock market today comparable to the market after the Crash of 1929?

suffered a severe downturn from the October 1929 crash through June 1932, with the Standard & Poor’s Index losing nearly 83 percent. But during the summer of 1932, when things looked blackest and millions remained out of work, the market began a powerful rally that helped it increase in value four-fold over the next four years.

The 386 percent in-

crease in the S&P 500 helped investors recover most of the losses they suffered at the beginning of the decade.

However, as always with the market, the 1932-36 rally did not proceed in a straight line—there were dips along the way, including monthly declines of 18 percent, 11 percent and at least one stretch where the market fell four months in a row (note that American stocks fell in similar fashion from June through September this year).

Analogies are dangerous, Hulbert notes: there is no way of knowing whether his analogy to the 1930s rally or other analysts’ making comparisons to the worst of the 1930s are legitimate. But it may be a good sign that many analysts compare today to the 1930s, because bull markets often climb a wall of worry, he says.