MITCHELL MCLEOD PUGH & WILLIAMS
INVESTMENT ADVISER

October 2011 | Volume 22 | Quarterly Newsletter

Benefits of Diversification

"Don't put all your eggs in one basket" is a common expression that most people have heard in their lifetime. It means don't risk losing everything by putting all your hard work or money into any one place.

To practice this in the context of investing means diversification—the strategy of holding more than one type of investment, such as stocks, bonds, or cash, in a portfolio to reduce the risk. In addition, an investor can diversify among their stock holdings by buying a combination of large, small, or international stocks, and among their bond holdings by buying short-term and long-term bonds, government bonds, or high- and low-quality bonds.

A diversification strategy reduces risk because stocks, bonds, and cash generally do not react identically in changing economic or market conditions. Diversification does not eliminate the risk of experiencing investment losses; however, by investing in a mix of these investments, investors may be able to insulate their portfolios from major downswings in any one investment.

Over the long run, it is common for a more risky investment (such as stocks) to outperform a less risky diversified portfolio of stocks, bonds, and cash. However, one of the main advantages of diversification is reducing risk, not necessarily increasing return. The benefits of diversification become more apparent over a shorter time period, such as the 2007–2009 banking and credit crisis. Investors who had portfolios composed only of stocks suffered large losses, while those who had bonds or cash in their portfolios experienced less severe fluctuations in value.

Mitchell McLeod Pugh & Williams, Inc. - Adviser Corner

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Extreme volatility returned to the capital markets during the third quarter of this year. Each day seemed to produce headline stories driven by the sovereign debt crisis in Europe, an apparent weakening of the U.S. economy, or the lack of government leadership in response to the growing federal deficit. These issues are complicated and the timing of their resolution is uncertain. It is no surprise that investors are concerned.

Given these concerns, we are including a brief memo with each client's quarterly reports. This memo outlines our firm's view and strategy along with providing some perspective with regard to recent market activity.

We would also like to reference an article on page three of this newsletter that addresses the "fiduciary standard." This topic has been heavily reported and debated over the last several years. We feel the distinction between the fiduciary and non-fiduciary standard is of great importance to investors and the management of their assets.

Monthly Market Commentary

September was filled with uncertainty, which continued to weigh both on businesses and investors. The European debt crisis, with its unknown effects and unclear resolution, has troubled the markets, causing increased stock-market volatility and a significant decline in financial-sector stocks. Not even Federal Reserve chairman Ben Bernanke could calm market sentiments with his "twist" plan, announced after an extended two days of discussion at the Federal Open Market Committee meeting. Despite 2011 being the third year of a presidential term, which historically has been good for stocks, the S&P 500 was temporarily in bear market territory as of Oct. 4, with a 20% decline from its most-recent 2011 high.

GDP: Second-quarter GDP growth was revised up to a final reading of 1.3% from 1.0%, driven mainly by export data. A weak dollar, a revival of the manufacturing sector, strong capital goods sales in emerging markets, and powerful agricultural sales have allowed the U.S. economy to trudge along at an anemic rate with strong exports in the first half of 2011.

Employment: Employers added 103,000 jobs in September, led by gains in the professional and business services and health care, sectors, as well as the 45,000 Verizon Communications employees that returned to work. Similar to August, private-sector growth continued to be offset by contractions in the government sector. In order to effectively put a dent in unemployment rates, job growth of about 150,000 is required per month. Unemployment remained flat at 9.1%.

Manufacturing: The ISM Manufacturing Index inched up slightly—indicating that manufacturing was expanding but still very sluggishly. An ongoing concern was the lackluster performance of new orders and backlogs, which hinted at a potential contraction in demand going forward. Durable goods orders, on the other hand, pointed toward a continued moderate uptrend in manufacturing.

Quarter-end insights: The second-quarter of 2011 continued to defy predictions by economists, with the U.S. economy neither collapsing nor breaking out on the upside. In the wake of persisting uncertainty from the European debt crisis and its contagion effects, along with the U.S. budget debacle in August, investors and corporations became more cautious. Investors seeking yield continued to bid up more-defensive portions of Morningstar's stock investing universe, seeking stocks that provided income in addition to capital gains. Riskier sectors with less good news, including financials, basic materials, and energy, continued to sell at larger discounts than the overall average. Corporations with near all-time-high profit margins and large amounts of cash were still unwilling to spend or hire significantly given the economic and political uncertainty and the lack of investor confidence. In fact, merger-and-acquisition activities as well as stock buybacks (financed with money borrowed at exceptionally low rates) started to pick up. Consumer spending remained relatively strong, pushing ahead slowly, cautiously and consistently despite setbacks from the lingering effects of earthquakes, hurricanes and budget crises. However, consumers were selective with what they purchased and consistently punished businesses that raised prices too quickly. Gasoline demand in the U.S. declined for three quarters in a row, corresponding closely with the recent acceleration in gas prices. Auto sales and apparel sales were the same, as price hikes from Japan's supply-chain issues (for autos) and increased cotton prices (for apparel) caused sales to fall. Netflix saw its stock price drop following a pricing change. With regard to inflation, Morningstar economists believe that a slower world economy and a resolution of the Libyan situation should help drive oil prices (the key driver of high inflation) lower in the months ahead. Food prices should also begin to fall as crops are harvested and some of the dismal weather conditions around the world abate. A resumption of Japanese auto shipments should also help drive auto prices lower in the months ahead.

The Fiduciary Standard and Why it is Significant

Over the past several years the term "fiduciary standard" has been widely discussed in both the financial and mainstream media. Which type of financial advisors should be held to a fiduciary standard and who should not be has been the focus of this debate. Many investors, however, remain unclear as to the significance of the term and how having a fiduciary as an investment manager may impact their financial affairs.

In his article, The Critical Difference Between a Stockbroker and Registered Investment Advisor, W. Scott Simon defines a fiduciary as “someone that manages money for the benefit of another called a “beneficiary.” A fiduciary is bound by law to place the interest of its beneficiary first – before the fiduciary’s own interests.”

While this may seem self-evident, many investors are unaware that not all types of investment managers are held to the standard defined above. In fact as Mr. Simon states, “Stockbrokers (also called “Registered Representatives,” “Account Executives,” “Financial Advisors” or “Wealth Managers”) are not fiduciaries, even though they have engaged in high-visibility advertising to portray themselves as full-service investment advisors.”

One type of manager that is a fiduciary by law is a “Registered Investment Adviser,” subject to the Investment Advisers Act of 1940.

Mr. Simon states, “The legal investment advising standards that govern a non-fiduciary stockbroker and a fiduciary Registered Investment Advisor are very different.” He goes on the state, “A non-fiduciary stockbroker follows only the “suitability” standard, which doesn’t require a stockbroker to place the interests of its clients ahead of its own. Under the non-fiduciary suitability standard, a stockbroker need provide only “suitable advice” to its clients – even if the stockbroker knows that advice is not the best advice.

A Registered Investment Advisor must follow the “trust” standard – the highest known in law – which requires it to place the interests of its clients ahead of its own and fulfill critical fiduciary duties of trust and confidence. Under the fiduciary trust standard, a Registered Investment Advisor must provide its “best advice” to a client.

Even if a non-fiduciary stockbroker wanted to follow the trust standard of law and become a fiduciary to its clients, it cannot do so because of the contract it has with its broker-dealer. Such contracts require the stockbroker to place the interests of the broker-dealer before the interests of the stockbroker’s clients.”

The differences that Mr. Simon describes in the three paragraphs above are the central issues that continue to be debated by regulatory authorities, Congress and the media. The high standard that is required of a fiduciary governs all aspects of an investment management relationship. This includes the suitability of investment advice, objectiveness of investment decisions, and the overall cost of the relationship. Because of the differences in the standards and their potential implications for investors, this should continue to be a highly visible topic in the months and years to come.

Simple Steps for Late Savers

The sooner you start putting aside money for retirement, the more you might have once that highly anticipated day arrives. Saving for college tuition, purchasing a new home, unforeseen medical expenses, or life's other necessities, surprises, or even enjoyments can cause investors to postpone saving. Starting the retirement planning process late in one's life can be daunting, but it is by no means impossible.

Crunch the Numbers: The first step to getting back on track is to put together a budget—this will force you to focus on your financial situation and can serve as a roadmap to success. Once you have outlined all of your expenses, simply subtract the total from your net income. The result will give you a clear indication of how much you can potentially save, and also help you identify areas in which you may be spending too much.

Cut Any Unnecessary Expenses: There are essential expenses that cannot be eliminated: food, electricity, etc. However, most people can identify some areas, like entertainment, that are not vital to one's existence and can be cut back on. The more areas that you can trim will lead to more money that can be earmarked for retirement.

Take Advantage of Catch-up Contributions: Catch-up contribution limits allow investors age 50 and above to increase their contribution. For example, they can make an extra contribution of $5,500 to their 401(k) in 2011, equating to a maximum contribution of $22,000. IRA catch-ups are $1,000 in 2011, leading to a maximum contribution of $6,000.

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