



WHY DO WE FEEL SO BAD WHEN THE MARKET HAS BEEN UP AS MUCH AS 65% FROM ITS MARCH 09 LOWS?

BY THOMAS CURRAN

For one thing the market is still down 43% from its market high recorded in October, 2007. For most of us numbers are both overwhelming and confusing. I always try to remember: the climb back is always steeper after the fall.

The market fell approximately 58% from October 2007 to March 2009. Look at it this way: \$1 became 42 cents. While that fact is

bad enough for our psyches to handle, the climb back is even more challenging to our egos. In order for the market to get back to where it was two years ago, it needed to go up 238%. So the fall of 58% requires a recovery equal to 238%!

The dollar invested in equities became worth 42 cents. It has recovered to about 69 cents. Is it a wonder why we are depressed? Numbers like those leave a lasting impact on the way most of us view risk and the equity markets.

The easiest and most popular reaction is to buy “safe” investments. In today’s market safe usually means bonds and other fixed income securities like CDs. Investments in stocks and real estate are considered too risky.

In order for fixed income investments to be safe they must offer at least enough interest income to offset inflation plus 1 - 2 points to provide a real return above inflation.

The big question concerns future inflation. Now the markets are assuming prices will remain stable and therefore interest rates will remain low.

But what if inflation increases and as a result interest rates rise? We do not believe investors fully understand the negative impact inflation and higher interest rates would have on longer term fixed income securities.

For example, the current 30 year US Treasury bond paying about 4.5% would decline in value by approximately 25% if long-term rates rose to 6.5%. The 10 year note paying about 3.5% would decline about 15% if the rate rose to 5.5%.

Our advice to investors concerning fixed

income is to buy short-term securities and fight the temptation to “reach” for higher yield. We believe longer term rates have already begun to move higher as the market is anticipating higher inflation. After almost 30 years of declining inflation and interest rates, our conclusion is we are entering a long-term inflation cycle.

The bull market in bonds is ending after almost 30 years. Unlike other asset classes, changes in bond values change very slowly. The double digit yields earned on CDs in the early 80s have been replaced by rates approaching 0.

We remain very positive about equities and we are equally negative regarding fixed income. We believe real earnings will continue to improve. Our opinion is the recession ended in June and the economy will continue to gradually improve through 2010. We do not expect employment prospects to improve until early next year. When the uptick does occur in employment, our expectation is there will be widespread disappointment in the rate of growth in jobs. Productivity, on the other hand, is expected to improve offsetting the need for new workers.

Our advice remains to buy high quality equities for growth and short-term high quality fixed income securities to enable a safe and efficient strategy to increase yields when the Federal Reserve moves to increase interest rates. The longer it takes for the Federal Reserve to change their current policy of 0-1/4% causes our expectation for inflation to increase.

During the first half of 2009 the inflation rate was -0.6%. Inflation was even lower in the 3rd quarter.

July - 2.1%
August - 1.5%
September - 1.3%

As a result interest rates are very low and the real rate, after adjusting for inflation, is very high. Even 0 is positive when inflation is less than 0.



VARIABLE ANNUITIES

BY ANDREW BLACK,
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The severe stock market correction at the end of 2008 has given all of us a permanent adjustment to the way we view risk. Double digit investment losses are no longer hypothetical metrics. We have lived through the worst possible scenario for a stock investor. While we gather our emotions and develop a plan to move forward, we face an intimidating environment.

Investors are finding products with low risk or guaranteed returns much more appealing. However, traditional investments in low risk securities are paying paltry rates. Variable annuities with “guaranteed lifetime income” benefits are being aggressively pushed as the answer. With 5%, 6%, or 7% advertised rates, it is hard to ignore their lure. These types of annuities are complex products, and further analysis proves that their benefits are much smaller than promised.

To take a look at how these products work let's take an example of a 55 year old that wants to invest \$100,000 into a variable annuity with the guaranteed lifetime income. The policy will guarantee a 7% growth rate for the next 10 years (\$196,715). After the 10 year period, the annuity will guarantee a 5% withdrawal rate for life (\$9,835 per year)

On the surface, those rates look very enticing. The 10 year treasury is currently paying less than 4%. But the problem with this product lies in the payout guarantee. Once an investor is ready to begin the payment stream, they only receive an annual

guarantee of 5% of the beginning account balance. That is not a guarantee of 5% growth. In fact, the insurance company only needs to grow your money at around 1.5% to pay you the guarantee. Guess who keeps the difference between the real return they receive and the guaranteed payment?

In addition to the misleading payout guarantee, the initial 7% growth rate is only hypothetical. You cannot receive this benefit without locking into the very low payout rate. If you choose to withdraw the money in any other way, the guarantees go away. Your actual account value will have grown far slower than the 7% advertised.

If we return to the original goal of the investor purchasing this product - lifetime guaranteed income - a different solution may provide a much greater result. A single premium immediate annuity would provide a lifetime income stream at a higher real rate. Without locking into the more complex and convoluted product, a pure immediate annuity costs less and is easier to calculate the true benefit.

Variable annuities with guaranteed income benefits dazzle the investor with very good initial growth rates. Unfortunately, these growth rates are coupled with lackluster withdrawal factors. The two rates are purposefully tied together to dress up a fairly mediocre product. If you are considering purchasing this type of annuity, please let us show you the real guaranteed return and possibly offer an alternative solution that will be easier to understand and cost less.

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