

December 31, 2009

*"We're on the path for fireworks in 2010."*

Richard Russell

I am writing to you on the last day of a remarkable year—a year in which we saw the U.S. stock market conclude its second most severe decline in U.S. history, followed by a powerful rally of approximately 68%. Like me, you must certainly be wondering, *how much longer will this rally continue?*

As you know, we became very cautious and implemented a new, lower volatility investment strategy in early 2009, which is based upon a philosophy we call *outcome-driven investing*. Our decision to change from a traditional buy and hold investment strategy to an outcome-driven strategy was, and still is, based upon our observation of mammoth global economic shifts which were revealed in the 2007 – 2009 financial collapse, and which continue today. In hindsight, our strategy change looks very poorly timed: while our portfolios performed well on an *absolute basis* in 2009, they haven't come anywhere near the parabolic performance of the broad stock market. However, *they are not designed to do so!*

Rather, our outcome-driven strategy is designed to deliver positive results over 3-5 year periods by avoiding the severe volatility (i.e., risk) that accompanies major market, economic, and political shifts. While the performance of our outcome-driven investment strategy will never be perfect, and rarely exciting, we strongly believe the combination of lower volatility and consistent returns, versus traditional buy and hold investment strategies, makes this strategy particularly well suited for the economic environment we find ourselves in today, and will likely remain in for several years to come.

It is very important to understand that our economy is attempting to recover from a recession that was unlike any other we have experienced since the Great Depression. Simply stated, typical recessions are caused by inventory-adjustments, the result of businesses becoming overly optimistic about sales and then having to adjust their inventories, and then staffing, downward. This recession was caused not by too much inventory, but by too much credit and leverage in the system. We are now in the process of an unprecedented deleveraging, a process that is nowhere near complete: total consumer debt is shrinking for the first time in 60 years, and the decline shows no sign of slowing in the foreseeable future. The unpleasant reality, despite the so-called "improving" economic fundamentals, is that we have not seen economic conditions like this (deflation, 10% unemployment, etc.) since the 1930's.

So, how much longer will this rally continue? Of course, we have no idea how much further the market will rise, or how much longer the conditions which are supporting the current upward trend will last. Certainly, the factors affecting the market's 2009 rise are dubious and flimsy at best: unprecedented government intervention in the economy, resulting in federal budget deficits measured in the trillions of dollars, which cannot last, and which will be paid for by future higher income tax rates.

*"...there is no long term any more for investors. It is totally inappropriate in this environment to think in terms of...how high the stock market might go and how long it will keep rising. Estimates of numbers and time are useless and, in this highly uncertain world, no one should believe such forecasts. The issue is risk and uncertainty..."* J. Anothony Boeckh, Ph.D

We agree with Dr. Boeckh: the key issues facing investors in the months and years ahead are "risk and uncertainty", and we continue to invest accordingly.

A foundational understanding, upon which our outcome-driven investment strategy is based, is that *financial markets do not create wealth*; rather, they are merely a means of getting money into and out of assets (stocks, bonds, commodities, real estate, metals, currencies, etc.), which are benefitting from *fundamental trends*. What's important to note about this conclusion is that there are *always* opportunities to financially benefit from fundamental trends, even in economically uncertain times. For instance, a weakening U.S. Dollar trend often has the opposite effect upon the price of gold, i.e., the price of gold goes up when the value of the dollar goes down. Not surprisingly, there is often a direct relationship between the underlying cause of a fundamental trend (e.g., declining demand) and its effect on the value of certain assets (e.g., stocks). Therefore, by investigating and verifying trends in global financial markets, government policies, etc. fundamental investment trends become visible and, potentially, investable. After a careful analysis of these trends, we then make rational investment decisions within your portfolios, which we believe will benefit from the trends. Each security is selected based upon its perceived ability to offer diversification, risk reduction, and a certain degree of predictability, all of which are needed to increase the probability of producing a positive outcome over time.

While we endeavor to invest in wealth-creating trends, we also want to protect your portfolio from the irrational and unpredictable nature of the global financial markets. Thus, on the wealth-preservation side of our outcome-driven investment philosophy, we invest in instruments that "hedge" risk, i.e., investments which go up when others go down. While the particular mechanics and risks of hedging instruments are too complicated to discuss in this letter, our research indicates that portfolios employing such instruments outperform those which do not, and do so with considerably less risk.

Clearly, this letter is more technical than many you have received from me in the past. It is not meant to be a defense of our investment strategy as much as it is meant to help you understand our underlying assumptions, and both the risks and opportunities which remain in the market. I hope and expect that this letter will generate additional questions from you, questions which I am quite eager to answer. So, should you have any questions or concerns, please do not hesitate to call or e-mail me at your earliest convenience. While we believe 2010 will continue to be marked by financial uncertainty, we also believe that there will continue to be many good investment opportunities and fundamental trends which can be taken advantage of—your portfolios are well-positioned for both the good and bad which lie ahead.

We are humbled and amazed by the continued success of Telos Wealth Management; our survival through these very difficult times is entirely attributable to the trust and confidence you continue to place in us. So, most importantly, I am writing to say thank you—it is our sincere and humble privilege to be entrusted with your financial care, a stewardship we take most seriously.

Finally, I encourage you to not "*trust in uncertain riches but in the living God, who gives us richly all things to enjoy*."

Warmest regards and best wishes for a healthy and meaningful New Year,



Sean Gross, CFP®  
President & CEO, Telos Wealth Management, LLC