



# DAVID R. KERN

**ASSET MANAGEMENT**

*Dynamic Asset Allocation Strategies*

[www.advantageplanning.com](http://www.advantageplanning.com)

## 1<sup>st</sup> Quarter 2004 Newsletter

### ***We're Moving***

We have scheduled Friday, April 23, 2004 as the official date when the movers arrive to take us to our new location with more space for our growing business. We are moving to Hometown, Indiana, a city just north of Fort Wayne, and we will be able to keep the same phone number. Our phone service will be interrupted for a period on Friday; however, our asset management activities already have multiple off-site locations for continuous monitoring and repositioning of investment assets.

For those of you who will be visiting our new office in the future, take Highway 3 north of Fort Wayne and turn left at the flashing light onto Cedar Canyon Road; when you reach the stop sign at the T, turn right onto Lima Road, and it's the first building on the right. Our new address is 16616 Lima Road, Hometown, IN 46748.

### ***The Right Time for Market Timing***

The Putnam family of mutual funds' recent agreement to pay penalties for allowing portfolio managers and investors to market time its funds has brought market timing into the spotlight again. Market timing involves frequent trading, and takes advantage of "stale" fund-share prices that understate the value of the securities, often due to time zone differences. Market timing is legal, but Putnam did not disclose the activity to fund shareholders or the board of directors, and the policy in its prospectus was against market timing, both of which resulted in the fraud charges. The issue is whether the trading was done in a deceptive manner, even though investors may benefit from market timing.

Some firms, such as ProFunds Advisors LLC and Rydex Funds, fully disclose the fact that they allow shareholders to trade as frequently as they want. More advisers are drawn to firms like ProFunds and Rydex as most mutual funds tighten restrictions on fund trading. Advisers are attracted by the flexibility and the ability to move often, without restrictions on amount, and without having fees imposed. ProFunds and Rydex also offer advisers index-based funds that can be used as tools in active management.

Even proponents of conventional investing such as Peter Bernstein, author of a number of books, including *Against the Gods* and *The Remarkable Story of Risk*, have endorsed market timing. Mr. Bernstein, who has run his own investment- and economic-consulting firm since 1973, states that investors need to be more flexible and opportunistic if they are to meet their financial goals. After the recent years of stock market losses, pension-fund managers and other institutional investors, as well as small investors, are rethinking their buy-and-hold strategies. During the past 20 years of bull markets in bonds and stocks, the dominant asset-allocation strategy worked well. However, when the difference between stock and bond returns narrows, without any decline in volatility, the chances of losses are the same, but the rewards are smaller. Therefore, the risk of being out of the market is less if the upswing is of short duration. Mr. Bernstein still recognizes the value of an underlying asset-allocation strategy based on an investor's financial goals and risk tolerance, but investors must decide when to rebalance assets in a portfolio.

Investors have become more sophisticated and their expectations have gone up. There are imbalances in the market that investors can benefit from in the short term. Market timing is becoming less of a choice and more of a necessity.

---

#### **ADVANTAGE FINANCIAL PLANNING, INC.**

**16616 Lima Road, Hometown, IN 46748 - (Phone: 260-637-1019 or Fax: 260-637-1373)**

*Securities offered through Questar Capital Corporation*

*Member NASD, SIPC, and a Registered Investment Advisor.*

*Advantage Financial Planning, Inc., a Registered Investment Advisor, is independent of Questar Capital.*

**David R. Kern, Registered Principal**

## **Chain Reaction**

With the beginning of the second quarter of 2004, an important jobs number was released on Friday, April 2. The big surprise from the Labor Department was that March was more than double the economists' forecast of 120,000 new jobs created. The jobs number for January that had been previously reported at 97,000 was revised upward to 159,000, and the dismal February number was revised upward from 21,000 to 46,000.

Both the stock and bond markets had been reacting to the low new job creation in a way indicating that further growth in the economy may be stalled, and therefore the Fed may not be ready to raise interest rates any time soon. Interest rates are one of the single most important factors fundamentally affecting the markets and the economy. With these new jobs numbers, investors decided that the Fed may raise interest rates sooner rather than later, and a chain reaction began. Those asset classes that are sensitive to interest rate changes, such as U.S. Government bonds, real estate, financial institutions, and a few other sectors, began to sell off. The precious metals, or gold, sector sold off as well in reaction to a higher dollar, relative to other currencies. The perception is that with higher interest rates, dollars will be more attractive to investors from around the world, and a stronger dollar is often tied to a lower demand for gold as a hedge against the currency.

The real estate asset class, primarily real estate investment trusts (REITs), which are traded on the exchange like a stock, had a quick negative reaction to the jobs report. On Monday and Tuesday of the first trading days of April, the REIT Dow Jones Index fell about 8%, which is the largest 2-day drop since the index was created about 12 years ago. REIT has been an important alternative to the stock market as measured by the S&P 500 Index over the last few years. REITs, companies that own things like apartments, offices, and shopping centers, and distribute dividends, have jumped 63% overall since the end of 1999. During this same period, the Dow Jones Industrial Average has fallen 9%, according to an article in the Money & Investing section of *The Wall Street Journal* on Monday, April 12, 2004. Our diversified management program includes this important asset class, but we are currently not positioned in the REIT sector.

Yields on U.S. Government bonds, in particular, but also other bonds as well, jumped during the same period, meaning that bond prices fell. The bonds that you currently own become less valuable as interest rates rise, while they become more valuable during a period when interest rates are falling. One important impact of rising interest rates is that the mortgage refinancing boom may be coming to a close. Over the last few years, investors have refinanced, raising cash

for other expenditures and reducing monthly outlay for the interest portion of a mortgage payment. It's hard to say if this recent turn of events will be the beginning of a longer-term cycle; however, with corporate earnings showing positive gains each quarter, and the economy showing signs of strength, it looks like we are moving away from the continuously low inflation and interest rate environment we've witnessed over the last few years.

## **The Big Picture on Currency Trading**

Every night on the news, the movements of the Dow Jones Industrial Average and the NASDAQ Composite are dutifully reported, occasionally accompanied by Japan's Nikkei 225 or Germany's DAX index, on an exceptionally busy day. Public and media attention are fixated on the movements of these equity markets, creating the impression that they dominate the world's financial activity. It may be surprising, then, to hear that the amount of money traded every day on all the world's equity markets combined (roughly \$100 billion) is less than 1/10 the amount of money traded daily in foreign currency exchanges (\$1.5 trillion), where different currencies (U.S. dollars, yen, euros, pesos, yuan, etc.) are bought and sold.

What is all this activity in foreign currency exchanges (or FOREX, for short)? Some of the activity is the direct result of international trade when, for example, American steelworkers, whose checks are in dollars, send steel to Chinese construction companies, who pay in yuan. Some of the activity is more complicated, involving hedging and speculation. When foreign currencies are held, their value rises and falls with the exchange rates. In extreme cases, exchange rates can be affected by single parties, as has been the case when the Japanese government bought nearly \$200 billion in U.S. dollars in the last year to strengthen their export-dominated economy.

Most individual investors feel far removed from FOREX activity. After all, how many 401(k)s allow you to invest in rupees? Exchange rates affect U.S. stocks in different ways. Companies who import or export their products will be more or less profitable as the dollar rises against other currencies. Commodity prices, such as gold and silver, are also affected by the value of the dollar. As the dollar gets weaker, for instance, holding gold bars becomes a winning proposition. Dollar exchange rate fluctuations are a relatively small component of gold price fluctuations (supply and demand of gold dominates its price), but they do play a consistent role. Of course, it is no easier to put 401(k) investments in gold bars than in rupees, but by investing in mining companies (or, even better, mutual funds that invest in many mining companies), an individual investor can capture many of the benefits of holding gold as a commodity while exchange rates fluctuate.