



## **For Clients and Friends of Financial Connections**

This was yet another quarter when there was no place to hide, and the daily highs and lows were reminiscent of 2008/2009. Third quarter percentage losses on global stock indexes ranged from the mid-teens to low twenties. Many people see what is going on today as an extension of the 2008/2009 problems.

### Volatility

Financial markets become volatile when there is uncertainty and fear. Such is our current situation, here and abroad. Since 2000, the Dow has moved an average of 0.87% per day, with gains or losses. Below are more recent statistics.

- ◆ Trading day movement of more than 1% was registered on the last 33 of 49 days
- ◆ Since August, the average daily movement was 1.69% and exceeded 3% on 7 trading days
- ◆ Since September 21, the Dow Jones Industrial Average (DJIA), moved more than 1% on 11 of 13 trading days; on 5 days it moved more than 2%

### Uncertainty

We could write a white paper on the different uncertainties facing the global economy. Some are financial but much is political.

### GREEK DEFAULT

Stratfor is a geopolitical analysis firm, and here are some of the recent highlights of its analysis:

- ◆ The Eurozone enters its nineteenth month of a financial crisis
- ◆ Germany is the strongest country in the Eurozone
- ◆ Greece does not have the domestic capacity to generate enough capital at a reasonable cost even in the most optimistic scenario
- ◆ Stratfor believes the only option is that Greece default; that the Eurozone eject Greece and manage the resulting situation with a bailout fund

### EUROPEAN BANKS VERSUS U.S. BANKS

In the United States, the financial system is a single network. In Europe, countries have

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Also, please notify us so we can update our records.

### **Quarterly Newsletter, 3rd Quarter 2011 10/20/2011**

Chris completed the program and passed the exams to become a Certified Divorce Financial Analyst™ (CDFA™). Please join us in congratulating her on this accomplishment.

She looks forward to helping people deal with the financial issues that arise during divorce.



## **Clients of Financial Connections**

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individual systems based on nationality. Regularly, the European countries use their banks as tools for policy. For example, Madrid forced Spanish banks to treat one million naturalized citizens as superb credit risks for purposes of lending—even though they had no credit history. This policy correlates directly with the current real estate and construction crisis.

In the U.S., the government is largely hands-off.

The pros and cons for each system form a complex subject best left for another day, but because of their banking system, the Eurozone approach will have a greater impact on their current problems.

Eurozone countries forced their banks to buy large amounts of Greek debt. So a sovereign debt crisis also becomes a bank crisis. Banks in Europe supply 70% of funding requirements for consumers and corporations. Banks in the U.S. supply less than 40%.

### U.S. PROBLEMS

Our domestic issues are well documented. Here are a couple of quotes from Paul McCulley, formerly of PIMCO, the largest bond company in the world. Though he retired from the corporate world, he is still active, offering opinions and context for the situation.

- ◆ “The greatest moral hazard is austerity here and now.”
- ◆ “My friend Paul Krugman,” he added, referring to the Nobel laureate, economics professor, and *New York Times* columnist, “has been writing a great deal about it recently. If the private sector is de-levering [reducing debt] and de-risking and you’re caught in the paradox of thrift, the *public sector is supposed to go in the exact opposite direction.*”

### SOME GOOD NEWS

Companies are increasing their dividends at a rapid pace. In 2011, 887 companies increased their dividends while only 87 lowered theirs. This is a 25:1 ratio versus the ratio in 2008 of 1:1.

Some examples: Microsoft raised its dividend 25%; Wells Fargo 140%, and IBM 15%.

Included in your portfolios are mutual funds that buy companies with strong dividends. If you wish to, please give us a call to discuss your investments.

### **FINANCIAL CONNECTIONS GROUP, INC.**

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## THE ANATOMY OF PORTFOLIO DESIGN

We thought it would be helpful to share how Brian and Jill develop a new portfolio and review existing ones. Portfolio design is a combination of quantitative and qualitative decisions.

### Setting the stage

The first question we ask is Will the client be withdrawing money? If so, when and how much? With that answer, we begin.

### Cash and cash equivalent

Cash reserves are a useful way to hold money for upcoming disbursements. They earn little if any interest because the amount doesn't decline or increase as an investment does. However, it won't keep up with inflation. In fact, it loses purchasing power. If inflation goes up 2% and your cash reserves are earning 0.05%, your money will not keep up with increased prices.

We allocate approximately one year of each client's distribution to cash or cash equivalents (i.e., CDs).

### Bonds

Bonds are basically loans to someone or something—to a municipality, state, nation, corporation, etc. Loan holders can expect to be paid interest and receive the principal back at its due date.

While we sometimes use individual bonds (especially tax-free bonds), the majority of our holdings are typically bond mutual funds. Made up of hundreds or thousands of bonds, bond mutual funds have an average duration date, just as individual bonds do.

If a client is withdrawing funds, we might allocate another year or two into bond funds with a short duration. Funds like these fluctuate little. But, while they pay more than cash, in this low-interest rate environment their yield is still low by historical standards.

We may place the remainder in funds buying international bonds, government bonds, and high-yield bonds (which pay higher interest rates, with a higher risk of bond default). Sometimes we use high-yield bonds as a surrogate for stock investing.

Many people think bonds are “safe” compared to equity. The environment of declining interest rates over 30 years has made bonds good investments. BUT when interest rates rise—and eventually they will—the price of bonds decline. Thus they are not completely safe from the loss of principal. How much they decline depends on how high and how fast interest rates rise.

Our balancing act is to try to earn a meaningful yield on our bond holdings and to minimize the risk of rising interest rates.

### Flexible managed funds

In this environment, we believe fund managers should have flexibility in what they purchase or sell on behalf of our clients. If managers find a company they like, they have the choice: lend the company money in the form of a bond or buy shares in that company, thus making an equity investment.

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## THE ANATOMY OF PORTFOLIO DESIGN

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Flexible funds is one of our largest allocations. It also includes one of our hedges against inflation.

### Stocks/Equity—domestic and international

In the global environment, the country where a company is domiciled is not the only criterion for investment. The economic problems that Europe, China, and the U.S. face today do not necessarily affect an individual company's profitability.

As borders blur for corporate profits, we believe a larger allocation to global funds (which invest in companies regardless of their domicile) is warranted.

### Specialty/Alternative funds

These funds don't fit neatly anywhere else. They can be specialized investments such as in health, energy, or equity-linked CDs.

This category also contains funds that have a low correlation to the stock market. They lose less in extreme market declines but will not make as much when the market increases rapidly. These are our defensive funds.

### The Dilemma

Bonds do not offer growth. Bond investors make loans and receive interest, but their principal does not grow.

Equities offer growth but are more volatile and risky. What is the correct balance between the two? What allocation to our specialty/alternative is appropriate?

Based on your spending pattern, how much money do you need for the remainder of your life? This, at best, is an estimate since we don't know how long you will live. If your expenses are high, is it reasonable to think investments can make up the difference? If you have enough and don't need much growth, why take on additional risk?

If your money needs to grow (through equity investing), can you handle the risk/volatility inherent in owning stocks?

We encourage you to come in and discuss these issues with us. The more we work together, the better our portfolio design will suit you.

## AIRLINE INDUSTRY ECONOMICS

We all travel and resent the nickel and dime fees charged by the airlines. Reading the information below, you might have some sympathy for their plight. According to the Transportation Department,

- ◆ The roundtrip ticket that cost \$410.30 in 1995 (in 2010 dollars) now sells for \$337.97 (including bag and reservation charges).
- ◆ Without those fees, inflation-adjusted fares are down 21% from 1995; with fees down 16%

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