Tarheel Advisors LLC

Tarheel Advisors Newsletter

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2010-A Market Mystery

We are now three quarters into 2010 and the markets have presented quite a conflicting story. We've been up or down 10% at different points this year — currently we're edging closer to 52 week highs. More recently, we've seen the historically non-correlated assets of stocks, bonds, and gold all making significant gains in tandem. As an investment manager and student of the markets, I can't help but feel like I'm stuck playing a grandiose game of Clue. Typically, stocks, bonds, and gold have very little correlation and rarely move up simultaneously (see graph below). So, if these asset classes are all telling a story at least one of them must be hiding a lead pipe in the library.

GOLD—Gold is typically considered the ultimate safe haven asset and tends to rise with inflationary pressures as well as the opposite extreme scenario of a severe deflationary environment.

BONDS—The price of bonds is directly correlated to the relationship between current and future interest rates. If interest rates go up bond prices will go down and vice versa.

STOCKS—Stocks can move up and down for a variety of reasons, but historically speaking a rise in stocks is usually a leading indicator of better corporate earnings and economic conditions. Periods with low levels of inflation are also historically beneficial to stocks.

Based on these axioms, gold is predicting higher interest rates and inflation, bonds are predicting lower interest rates and deflation, and stocks are predicting increased corporate profits and thus a stronger economy. One would think that it would be highly unlikely for all of these predictions to come true!

So, which is the asset class imposter? I would suggest it was Ben Bernanke, in the Federal Reserve, with monetary policy. The deadly weapon in this case is the tool the Federal Reserve has used to artificially inflate asset prices for the past two years. With a full arsenal of monetary policy tactics, Ben Bernanke and the Fed have succeeded in lowering overnight interest rates to between 0 and 0.25%, where it still stands after almost two years. More recently the Fed has started purchasing 30 Year Treasury Bonds in order to decrease longer term rates. Yes, the US Government is massively buying its own debt, (but not to retire it) in what can be best described as a massive interest rate shell game. This is how bonds prices have continued to appreciate at the same time as stocks and gold.

Now, if the above accusation is true, then investors would be wise to discount (pun intended) the bond story and bet on the clues provided by the prices of gold and stocks. By that logic, impressive returns in gold are signaling some form of significant future inflation. The Federal Reserve can't successfully manipulate interest rates and keep them down forever. During a global recovery, which the stock market seems to predict, rising corporate profits and a growing economy (although at the moment quite modest) will force the Federal Reserve to close the monetary policy spigot.

The good news is that if this story holds true, we'll have avoided the dreaded double-dip recession. The bad news from an investor's standpoint is that it will remain difficult to obtain historically above average market returns without correct asset allocation and some successful market timing.

In conclusion, it is a little ironic that the asset class with potentially the most risk now is the one that traditionally should have the least. While bonds are not subject to substantial interest rate risk in shorter term maturities of 10 years or less, there could be substantial hazards for investors who have bet heavily on longer term debt with maturities of 20 years or more. If we return to an interest rate environment of just 4 or 5% (where we were just 3 years ago), the resulting valuation of a long maturity bond portfolio could drop by 20% or more.

-Ryan Glover, CFP®

2010 Market Update

S&P 500	**+3.89%**
DOW	**+5.57%**
NASDAQ	**+4.48%**
MSCI World	**+1.66%**

Mortgage Rates

15-Year	**3.875%**
30-Year	**4.375%**
5/1 ARM	**3.25%**

Did You Know?

If you filed an extension on your 2009 tax return back in April, it is due no later than October 15th!

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The Dow Jones Industrial Average last month recorded its best September since 1939.

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Only 4 U.S. publicly traded companies have a AAA Credit Rating. ADP, Exxon, Johnson & Johnson, and Microsoft are the only ones to hold the top honor.

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The Nikkei Japanese Market Index hit an all-time high of 38,915 on Dec. 29 1989. Currently it sits around 9,500 down 75%.

Out-of-State Wills

First things first: Yes, an out-of-state Will should be valid in North Carolina as long as it was prepared and executed in accordance with the laws of the other state. This is also true for other documents such as financial Power of Attorney and Health Care Power of Attorney. The problem is that these out-of-state documents may be much more difficult to use here in North Carolina and this may create headaches for your family. Our courts, financial institutions and health care providers, will likely not be familiar with most out-of-state forms and this disconnect leads to delay and added administrative requirements.

North Carolina has very specific requirements for language which must be included in a Will for the document to be probated in the normal course. Without this magic language, it can be a real pain to probate a Will; you may have to locate witnesses from years ago in another state, or you may have to pay for a substantial security bond for an out-of-state Executor. For this reason I regularly advise clients that, at a minimum, they should have their documents reviewed by a North Carolina attorney. We often recommend that a client execute a new North Carolina Will to replace their existing document simply to ensure that the necessary language is included to avoid problems with probate. We also regularly replace existing financial Powers of Attorney and Health Care Powers of Attorney with our North Carolina versions because they will be easier to use with our local institutions; since they are fairly standard forms they don't require much time and expense to prepare.

Some clients have a Living Trust as part of their estate plan which is designed to work in conjunction with the Will. In many cases that Living Trust is designed to continue to function under the old state's law regardless of where the client may live. One benefit of a Living Trust is that it will not be subject to probate or review by the court at the client's death. In this case, we are not concerned with any special North Carolina language for these documents and we often don't recommend any changes to a Living Trust simply because of the relocation to our state.

When people relocate to North Carolina, particularly for retirement, they regularly have other revisions to include in their documents which can be addressed at the same time their new North Carolina documents are prepared. For example, if a client is moving to be near one of their children it is common to have that child serve as the primary fiduciary for the client (e.g. Executor or Health Care Agent) and this will often require an update in the documents. There is also the ever-changing landscape of estate tax laws and this too will dictate changes in documents if they have not been revised recently.

If you or someone you know recently migrated to our fair state, be sure this chore is added to the list right along with changing your driver's license and voter registration and finding a great Chinese food place.

-J. Alan Campbell, Esq.

Kennon Craver, PLLC

Options Corner: Selling Puts

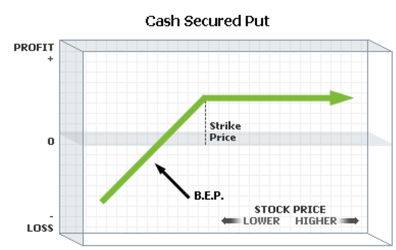
Selling or "writing" put options can be a great way for investors to generate income and/or acquire shares of a company at below market price.

For example, let's assume that you like company ABC, but the stock price has run up as of late to $20. You believe the stock's fair value is closer to $17.50. One thing you could do is place a limit order at that price and wait and see if the stock ever trades down to your level. Alternatively, you could sell the November $17.50 put for $.50 per share. OK, what exactly does that mean?

Well first of all, there are only two possible outcomes. First, stock ABC never trades down below $17.50 through November and you have made $.50 per share or about 3% on your cash-secured put option. The second possibility is stock ABC falls below $17.50 and you purchase the shares at that price while keeping the $.50 premium to off-set the transaction. Basically, you bought a company you like for a net of $17, which is 15% below where it is currently trading at $20. Not a bad scenario if you are comfortable with the stock at that entry point.

In summary, selling puts is a neutral to slightly bullish options strategy that reduces the overall risk of owning company ABC by lowering the break-even point by the premium received.

-**Walter Hinson, CFP®**



The X-axis (horizontal) represents the price level of an underlying stock. The Y-axis (vertical) represents profit and loss, above and below the X-axis intersection respectively.

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