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February 2010 Newsletter

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Southerner's Response to Winter Weather Parallels Investor Psychology

I'm a creature of habit. I like structure. I take joy from a repetitive routine. My Saturday routine includes a workout at the gym, lunch at Quizno's, washing my car and filling it with gas, and stopping at the ATM to get cash for the week ahead (I like to have \$200 in cash at all times – an old habit I inherited from my father). After lunch, I work on projects on my "to do" list before organizing my closet.



I have a Sunday routine as well. It's a lot like my Saturday routine. As I write this, I am on the down slope of my Sunday routine. On today's "to do" list is "write monthly e-mail newsletter." This past weekend I was able to execute both routines flawlessly. In fact, I was more productive and efficient than usual. I even squeezed in dinner and a movie with my wife on Saturday night. The kicker is that I did all of this in spite of the near state of panic that has gripped my Mid-South community for several days.

Beginning Sunday a week ago (January 24, 2010), warnings of "winter weather" entered the forecast for Thursday night/Friday morning. The effect was – no pun intended – chilling.

Tension and anticipation mounted steadily throughout the week. The community hung on every word from our trusted – if routinely inaccurate – local television weathermen. The storm is coming!

The storm did come (on Friday morning) – this time, unlike many previous occasions when we spent a week preparing for and dreading a storm that never came. In Memphis, it deposited about a quarter inch of ice on the streets and topped that with a dusting of snow – maybe another half inch. The local schools closed; flights were cancelled or delayed at the

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-B. Lane Carrick

airport; most folks opted for the safe route – staying home (and off the streets). Sovereign Wealth Management closed our Memphis office for the day. Our COO, Michael Deutsch, blasted an e-mail to all employees with instructions on how to communicate with each other until we could safely navigate to our offices.

The local television stations went into crisis mode. For the past three days they've run a banner at the top of the screen (WINTER WEATHER CRISIS, or some similar title) and a ticker at the bottom with constant updates on everyone and everything related to the weather. It seems that no company or organization is capable of communicating directly with its constituents after a little ice and snow. Hundreds, perhaps more than a thousand, unique entities used the airwaves to update the citizenry on their situation.

By Friday mid-afternoon – within a few hours of the beginning of the storm – the snow and ice had turned to rain. I noticed that the ice on my street had turned to slush. I made a radical decision. I decided to drive to Sovereign's office – less than a mile from my home. To my surprise, I found the roads to be in good condition. There were a few bad spots here and there, but for the most part the streets were passable. Comforted by this knowledge, I decided to run a few errands more distant from home.

I continued to operate on a "business as usual" basis throughout the weekend – while the tickers continued to scroll. The aftermath of the storm was every bit as intriguing as the anticipation of the storm. As an undergraduate psychology major and student of human behavior, I was interested in how individuals gathered information, formed opinions, and acted upon those opinions. Most individuals waited for the storm to pass, assessed the situation, and resumed their regular pattern when the majority of others had concluded it was safe. Alternatively, a small percentage of Memphians took to the streets during and after the storm as if it never happened. An equal percentage are still holed up at home, fearing the last remaining ice patch in the county.

I was particularly interested in the behavior of drivers who defied the warnings and ventured onto the streets. By Saturday afternoon, the streets were mostly clean, but there were occasional ice patches in shady spots. So I thought the prudent course was to drive a bit slower than usual and keep an eye out for ice. Many drivers appeared to take the same approach, but quite a few others thought differently, on two extremes of the spectrum. The first group sped past me, switching lanes with reckless abandon, seemingly oblivious to any risks. The second group was hyper-cautious. With emergency blinkers flashing, they crept along at 10 or 15 miles per hour, appearing to anticipate a catastrophe around every corner.

Beginning in late 2007, and continuing through part of 2009, investors witnessed a financial storm of epic proportions. Unfortunately, there was no radar to capture the storm as it advanced – it struck largely without warning. The consequences were devastating: trillions of dollars of wealth erased amid plunging markets for securities, real estate, and other investment media, followed by a significant global recession. The U.S. equity markets bottomed in March of 2009, and staged a remarkable recovery for the remainder of the year. Similarly, the U.S. economy bottomed out in mid-2009, and has begun a slow recovery.

As our financial markets and economy recover from the storm, I am (again) particularly interested in the behavior of individuals – in this case, investors. While some plunged into the market amidst the storm, many, if not most, have opted for the safety of cash, C.D.'s, U.S.

Treasury obligations, and high quality fixed income securities. Last year witnessed the largest inflow of capital into bond mutual funds in history. It seems that most investors are waiting for the “all clear” signal before hitting the street (Wall Street, that is) again. In 2009, this turned out to be an expensive decision, as bond investors missed out on one of the great stock market rallies of all time.

At Sovereign Wealth Management, our primary mission is to protect client capital, and our secondary mission is to position that capital for real, long-term growth. To that end, we are neither the reckless driver throwing caution to the wind with ice patches still on the roadway, nor the overly cautious driver assuming a separate but very real risk. Instead, we will proceed with due caution while looking for opportunities to get to our destination as quickly as possible. In 2009, we positioned our client portfolios in accordance with this philosophy and we are very pleased with the results we achieved. As we begin 2010, we will be making additional modifications to portfolios to position for today’s environment – with an eye on tomorrow. If you’d like to learn more about our strategy for 2010, give me a call at (901) 685-5050.

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Looking Ahead to 2010

The New Year greets no shortage of opinion about the markets. While a number of pundits are saying that stocks must eventually pull back from their impressive gains in 2009, others think that equities are poised to rise as earnings recover. The corporate bond market’s phoenix-like ascension last year has been met with similar debate. The lack of conviction on either side of the argument suggests that 2010 will provide significant rewards for opportunistic investors.



The U.S. equity market’s overall direction may remain unclear, but it’s not impossible to separate the winners from the losers. Consider the retail sector, which has suffered as consumers have increased their savings rate due to economic uncertainty. The difficulty in obtaining financing for inventory has been another shock to the system. Virtually all sectors of the retail market have suffered, but firms with a larger footprint will inevitably find the staying power to survive, and eventually thrive, in an environment with less competition.

This same logic can be applied to the market as a whole. In this era of tighter credit and more prudent spending, large U.S. corporations have significant advantages over their smaller counterparts. Investors will flock to these shares, especially those with sound dividends, while small company stocks will remain relatively unloved.

Worldwide economic growth will continue to be uneven. While emerging market economies and commodity-led countries enjoy garish expansion, developed countries will lag. Exposure to these markets is a prudent hedge against inflation. The fixed income markets in these countries are particularly appealing, and have less downside than equities.

One dark horse to consider this year is Japan. Facing a host of economic and cultural problems, an aging workforce, and fading domestic consumption, 65% of Japan’s companies are trading below book value.

Nonetheless, the larger companies in Japan that are more export than domestic focused should do well. In my view, large-cap Japan represents a near-perfect combination of contrarian and value characteristics.

An economic view is not complete without a view on interest rates. In a nutshell, domestic rates are low and will stay that way until the economy becomes self-sustaining. That won't happen until later in 2010, at the earliest. Those anticipating a rate hike will eventually find their way hopping from bonds to stocks, a trend that will likely progress uniformly until the fourth quarter.

The Monthly Index Report for January 2010

Index	Jan-10	QTD	YTD	Description
S&P 500 Index*	-3.7%	-3.7%	-3.7%	Large-cap stocks
DJIA*	-3.5%	-3.5%	-3.5%	Large-cap stocks
Nasdaq Comp.*	-5.4%	-5.4%	-5.4%	Large-cap tech stocks
Russell 1000 Growth	-4.4%	-4.4%	-4.4%	Large-cap growth stocks
Russell 1000 Value	-2.8%	-2.8%	-2.8%	Large-cap value stocks
Russell 2000 Growth	-4.5%	-4.5%	-4.5%	Small-cap growth stocks
Russell 2000 Value	-2.9%	-2.9%	-2.9%	Small-cap value stocks
EAFE	-4.4%	-4.4%	-4.4%	Europe, Australasia & Far East Index
Lehman Aggregate	1.5%	1.5%	1.5%	U.S. Government Bonds
Lehman High Yield	1.3%	1.3%	1.3%	High Yield Corporate Bonds
Calyon Financial Barclay Index**	-1.4%	-1.4%	-1.4%	Managed Futures
3-mo. Treasury Bill**	0.0%	0.0%	0.0%	
<small>All returns are estimates as of January 29, 2010. *Return numbers do not include dividends. ** Returns are estimates as of January 28, 2010.</small>				

Ben Warwick is Chief Investment Officer of Sovereign Wealth Management and is based in Denver, CO. He is the author of Searching for Alpha: The Quest for Exceptional Investment Performance (Wiley, 2000) and The WorldlyInvestor Guide to Beating the Market (Wiley, 2001). You can purchase these books at the IA Bookstore at <http://www.investstore.com/investmentadvisor/>. He can be reached at (303) 471-0244 or ben@qesinvest.com.

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