



Everything has it's Price

Todd Brand, President

“Inflation is the one form of taxation that can be imposed without legislation.” – Milton Friedman

Inflation. Have you felt it yet, and if so, how does it compare to the way you *felt* the last recession? The Federal Reserve Open Market Committee (FOMC) has been laser focused on the elimination of *recession* from the American experience. Both the 4th quarter of 2007 and the 1st quarter of 2008 came in “anemic” but not negative. Whew! That was a close one. Both quarters saw Gross Domestic Product (GDP) grow at less than 1% (0.6% + 0.9%, respectively). As a reminder, a recession has historically been considered two or more consecutive quarters of economic contraction as measured by GDP. Today the arbiter of such things, the National Bureau of Economic Research (NBER), is a bit looser in that definition and suggests that “a recession is a significant decline in economic activity spread across the economy, lasting more than a few months.” Under this terminology, we can now get scared much more quickly and with far less relevant data. So naturally,....we did.

The simple analysis would be that through a series of rate reductions beginning last September, the Fed Funds Rate has been cut from 5.25% down to 2.00% today. Presumably, this was done to stave off a recession then looming large from a meltdown in subprime lending.

One must never state emphatically, “mission accomplished” in fighting recessions because they are wave-like in their appearance on our shores. There have been 21 official recessions dating back to 1902. So we must ask ourselves, at what price did we battle this one to a draw.

This quarter’s article highlights the most obvious price we pay for recession insurance, that being price itself. We can all appreciate that food and energy prices have increased markedly over the last year. Making this even more challenging, we cannot choose an alternate to food, nor an alternate to energy. Both get us through our day. Like death, the price of food and energy don’t favor one man over another. One person can use more efficient lighting, drive a hybrid automobile, heat their home with solar power....but these solutions have a price. We aren’t likely to eat less than our 2000+/- calories just because each calorie costs more.

Rising prices, commonly called inflation, have multiple inputs, one of the clearest being when the *price rises in the currency of the*

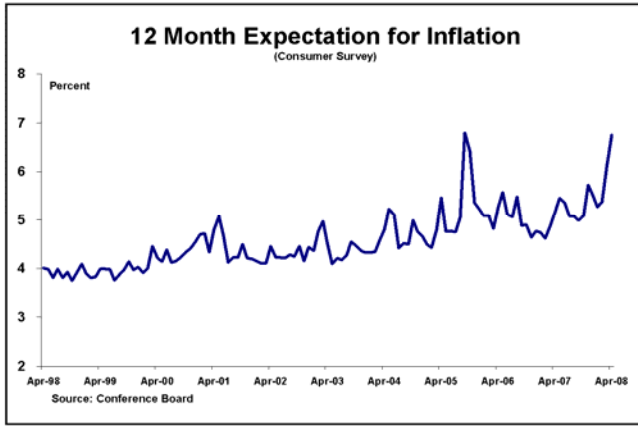
borrower. Specifically, a weakening dollar raises the number of dollars needed to purchase a particular product/service. This is the one way we pay the “price” of a Fed Funds cut. To elaborate, the Fed cuts rates to make borrowed money more attractive and available in the marketplace. Those extra dollars, easier to get, translate to less value per dollar, which itself translates to a higher number of dollars (price) per unit. To the extent that we are paying our dollars for products made in places whose currency is stronger, and which may have its own inflation driving prices higher, our dollar buys less than it might have formerly.

Curious statistic: Had the US Dollar merely maintained parity with the EURO over the last year or so, the price of a barrel of oil in dollars would be about \$50 per barrel lower in dollar terms.



A little US-specific data can help demonstrate the impact. There are approximately 117 Million households in the US. The median total savings/investment for those households is about \$8,100. Half the households have more, half have less. After choking down that little statistic, add to it that over roughly the last year, a family with 25,000 annual driving miles at 20mpg, would have seen their budget for automobile fuel alone jump about \$1,250 with the \$1/gallon increase since last Spring. This number doesn’t include the increased costs of airfare, heating oil and natural gas, food, etc. that this household is also exposed to. Inflation, in our opinion, is very real and is no respecter of persons. Recessions on the other hand, can be imaginary, often targeted, and on average, last only 10 months.

On the next page, we show a chart that demonstrates that the consumer has seen inflation coming. We, society, have been “expecting” inflation for some time and the Fed has, in our opinion, not been terribly interested in controlling that “expectation.” We went through more than one FOMC meeting where the term “inflation” wasn’t uttered. It was the proverbial elephant in the room. *Expectation* of future inflation is another aspect of inflation that can be detrimental. It can curtail what we spend on “non-essentials” to save up for the inflating basics.



While the Fed feels and states that inflation can be brought under control by simple policy move (i.e. make money harder to get through tighter credit and higher rates), our belief is that the fed can't as easily control food and energy prices, two major components of inflation.

Therefore, we may be in for a bit longer ride on the inflation train. How this impacts the investor is interesting to me. My opinion, as this article has surely been, is that inflation scares the markets into additional short-term volatility. That short-term volatility scares investors into the shorter term safety of the lower returning fixed income markets. This reduces future purchasing power and therefore slows down future consumption. This lower consumption results in less production, sometimes lasting more than two quarters. And then maybe, we get later the recession we should have already had.

Now that markets have rebounded nicely from their March lows, the financial news alone is proof enough that recession is fading from the limelight of negative press. The inflation issue is beginning to fill that space. We look forward to sharing with you in the coming quarters how you are positioned for this potential challenge.

In the meantime.....don't aim at getting a refund for your 2008 taxes. Those dollars may not be worth as much and I'd rather owe them than receive them!

The Intentional Spending Plan

Phil Daniels, Advisor

So, what's your spending plan? You know - your budget.



The discipline of defining how you'll spend your income before you spend it is so unpleasant for most Americans, that multiple articles encourage us as your financial advisors to not even use the b-word.

Whatever you call it, it can be tremendously valuable to identify how

you'll allocate your income whether it's earned income, pension income, social security payments, or portfolio distributions. Doing so allows you to confirm that your spending is consistent with your priorities and values. It also allows you to identify leaks, those areas where money is being spent at levels greater than you may intentionally choose. Knowing where those areas are helps you plug the leaks.

Additionally, a spending plan can help you answer the question we ask when reviewing your financial independence study: How much income do you need to meet your lifestyle objectives? While the software we use to analyze your financial independence is quite sophisticated, the results are only as good as the inputs. In other words, if we don't accurately identify the income you'll need, the value of the results is diluted.

We've seen many of you implement very effective spending plans, while others of you haven't gotten around to it yet. What we frequently see is that at higher levels of affluence, it may seem less critical because you have the income to meet your needs and desires. However, the previously mentioned benefits from identifying where you'll allocate your resources are irrespective of your level of wealth and income.

I'd suggest that we all have a spending plan. The question is whether it is by design, or by happenstance. We'd encourage you to spend a little time developing yours so that you too will have one by design.

A spending plan is a valuable resource that serves different purposes at different life stages. For a young person just starting out, it can provide the answer to questions like, "Can I afford rent and this new car payment?" As our incomes improve, a spending plan becomes a useful validation that our financial resources are being used productively. For example, it can help identify where expenses might be reduced in order to free up cash flow to save for future goals like buying a house, going on a vacation, saving for retirement, or even targeting an estate or philanthropic bequest.

As you approach retirement, and even in retirement, a spending plan can be critically important in helping evaluate if your portfolio balance and retirement income stream will allow you to maintain your standard of living over an ever-increasing expected life span. When we discuss your financial independence, we rely heavily on your input for your withdrawal rate which is a reflection of the income you need to meet your expenses for your desired lifestyle. As a reminder, this is an all-inclusive income need.

So how do you construct your spending plan?

First, don't feel that you need to do so with complete precision. Broad expense categories (ten to fifteen) can serve most people very well. Each category should be classified as either a fixed expense that has to be paid (mortgage, car payment, insurance, etc.), or a variable expense that is more discretionary (clothing, dining out, entertainment, etc.).

The Intentional Spending Plan

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Once your categories are established you can either insert amounts that you expect to spend on each, or you can just begin tracking your actual spending (our advice). After a couple of months of recording your expenses, you'll have a pretty good feel for how much is being devoted to each item and which ones tend to vary by month. It isn't important that your amounts be accurate to the penny. Close approximations should work just fine.

There are a couple of additional items to be aware of as you develop a spending plan. Don't forget to include the irregular or perhaps annual items like vacations, property tax payments, assessments, and insurance premiums. Also remember to include a line item for gifts. At least for my family, it seems that there is some gift buying occasion almost every month. Finally, if you have charitable intentions, be sure to include them in your spending plan as well.

For those of you still trying to prepare for retirement, I'd be remiss if I didn't remind you that planning for savings is one of the surest ways to make sure that it actually happens. Sometimes you'll hear this referred to as "paying yourself first". The point is that most of us wouldn't save very much if we allocated whatever's left at the end of the month, because by the time we get there it's all gone. However, allocating a pre-determined amount can mean that you're more likely to actually fund your future objectives.

If you haven't had a spending plan before, don't be surprised if you learn a few things about your spending at this point. For example, you may learn that you spend more eating out than you thought. That's not necessarily bad if it's consistent with your desires. However, if that expense is preventing you from realizing other objectives that you consider a higher priority, then you know where you can modify your choices so that your spending is more consistent with your values.

As you compile data, part of the process will be to make adjustments over time to refine your spending plan. Expenses change and your priorities change. Both should be captured so that your spending plan remains an accurate reflection of how you choose to direct your resources. You may also need to amend your planned spending for a particular category if you learn that you consistently spend more or less than allocated in that area. You'll also likely see that some items unavoidably inflate over time (like gasoline or health insurance) despite the fact that your consumption hasn't increased.

A final word of advice: Don't get too caught up in what categories you use or how a particular expense is categorized. The key is that your spending plan is useful to you. So feel free to do whatever works to help you identify if your spending is going where you want it, and if not, to help guide changes.

Some financial advisory firms consider a spending plan to be such a critical input to the financial advice process that they actually require that their clients purchase and utilize a budgeting software package like Quicken, or Microsoft Money. While we aren't that emphatic, we do think these packages can have some value. However, they are more complicated than needed for basic budgeting and much of the benefit can also be derived from preparing an Excel spreadsheet or even tracking your spending on a sheet of paper.

There are also a variety of online resources. One example includes an Excel budget template that can be downloaded from www.simpleplanning.net for \$9.95 by clicking on "Budget Planner". Another option named by PC Magazine as the "best free finance software" is www.mint.com. It allows downloading and automatic categorization of account data (bank, credit cards, etc.) that can streamline the budgeting process. I just created an account at mint.com, and initially it looks like a pretty good site. By the time you get this newsletter hopefully I'll have learned a bit more about it if you have questions.

Alternatively, if you'd like us to provide you with a basic budget template that you can use to get started, we can either share a sample spending plan at your next review or e-mail an Excel file to you.

At your next review we'll look forward to taking a look at your spending plan and confirming this critical input to your financial independence study.

*2008 Ladies Lunch
& Learn
Save the Date!
October 3, 2008*



*Fourth Annual
Ladies Lunch & Learn
Held at Forest Hills Country Club
10:30 a.m. to 1:30 p.m.*

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Escaping the “Risk Drag” of Single Stock Positions

Brad Davis, Advisor

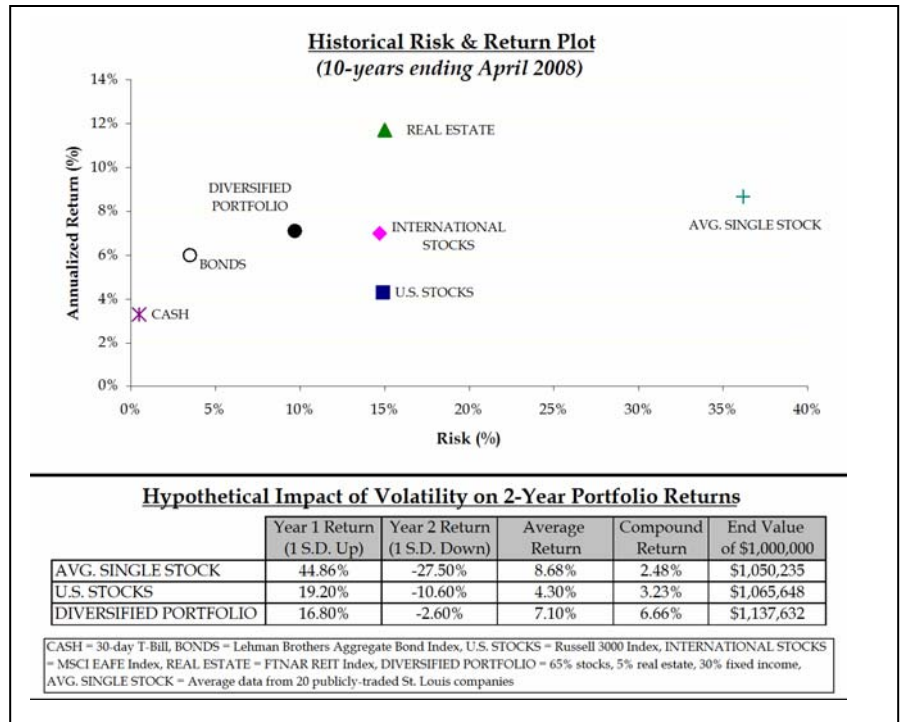
History has certainly taught us that risk – the ups and downs in returns – is inherent in the capital markets. The particularly extreme experience since mid-October of last year only serves to highlight this point. What’s important for investors to understand is that not all risks are created equally. As outlined by William Sharpe (Nobel Prize winner in Economics in 1990), the total risk associated with an investment in equities is a



combination of systematic and unsystematic risk. Systematic risk includes macroeconomic conditions affecting all companies in the market (war, recession, inflation, etc.). While this type of risk cannot be diversified away, investors are generally compensated over time for accepting the incremental volatility (i.e. stock indexes outperform bonds and cash historically). Unsystematic risk includes company or industry specific developments (product failure, management fraud, etc.) that can be virtually eliminated through sufficient diversification. In the aggregate, investors should not expect markets to reward them for taking risks that can be diversified away.

Holding a large position in one stock, any one stock, is the purest definition of uncompensated investment risk. As can be seen from the 10-year risk and return plot included, the average single stock (as represented by 20 publicly-traded St. Louis companies) carries more than double the risk of stock indexes in general (as measured by standard deviation). “Risk drag” is a term used by investment professionals to describe the depressing effect of too much portfolio volatility on long-term growth. It is typically calculated by taking the difference between average annual returns and the compound return throughout a market cycle. In the lower portion of our table, we’ve utilized the historical risk and return data to project two hypothetical years (one good and one bad). Under this scenario, the average single stock would have risk drag of 6.2%. Notice how risk drag is reduced, and ending portfolio values are enhanced, when the portfolio’s scope is broadened. Ultimately, by limiting volatility and the erosion of value during periods of loss, periods of gain become more fruitful as growth goes more directly to principle.

While it’s counterproductive to establish investment plans that seek to eliminate volatility, the goal of minimizing risk drag is a worthy one. When concentrated stock positions are present (commonly resulting from stock option awards or inheritance), we generally advise the implementation of a tax-efficient exit strategy designed to improve the chances of long-term wealth creation. Important to remember is that returns alone are only half of the equation. The effective management of risk and portfolio volatility is the remainder, and it is here that we aim to apply our knowledge to your specific situation.



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