



PERSPECTIVES

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A newsletter for the clients and friends of Mercer Advisors

MERCER
ADVISORS™

by Gene Dongjieux, Chief Investment Officer

RISK DU JOUR

As a Mercer Advisors client, you appreciate the relationship between risk and return. You understand that the level of calculated risk present in your investment portfolio has been thoughtfully and strategically engineered to achieve your financial goals within the parameters of your unique risk profile.

Right now, the elements of risk that you may be feeling, experiencing, witnessing or hearing about are decidedly stronger than the effects of any related short-term return — and this can be unsettling.

It is paramount for you to remember that the return payoff anticipated for the level of investment risk you have assumed is tied directly to a specific financial goal established within the broader context of your life goals. There is very good reason for this risk — it is linked directly to the level of return required to meet your goal.

Admittedly, this risk 'du jour' is feeling increasingly more overwhelming. Yet, while going to cash might feel better in the short-term, it will not and cannot provide the return necessary to achieve your long-term financial goals. Whatever your established investment profile — be it middle-of-the-road or leaning more toward either aggressive or conservative — stick with it. Succumbing to the influence of

uncertainty, deviating from your elected strategy can almost certainly guarantee that your actual return will fall far short of your expected and necessary return.

Each of the above factors has contributed significantly to the volatility present within today's market. On October 9, 2011, the Nobel Prize in Economic Science was awarded to two Americans who have spent, between them, more than 40 years conducting research on these factors and their impact on global economies.

Thomas J. Sargent of New York University and Christopher A. Sims of Princeton University each developed statistical methods for measuring the historical effects of government policy changes (such as an interest rate, tax rate or government spending change) on the broader economy. These methodologies are particularly relevant and in regular use today as governments and central banks around the world struggle to prevent their economies from experiencing an initial, subsequent or double-dip recession.

Let's examine in greater detail how each of these critical factors has influenced the market in the wake of recent and current financial crises:

Expectation Impacts Behavior and Outcome

Developed by Dr. Sargent early in his career, his rational expectation theory embodies the idea that people (and corporations) make choices and decisions based upon what they rationally expect to happen; consequently, these expectations can affect outcomes, sometimes with significant and far-reaching consequences.

The impact of **expectation** on **behavior and outcome**.

The contagion of **uncertainty and fear**.

The **cause and effect relationship** between the economy and government policy.

For several years now, corporate America has been anticipating a recession and has responded accordingly, has curbed hiring and expansion efforts, has reduced inventories and operating budgets and has stockpiled inordinate amounts of cash. In part, as a result of these preemptive measures, corporations have continued to report strong earnings amid rising uncertainty surrounding the serious global, economic, fiscal, monetary, social and legislative issues we are confronted with at present.

An unfortunate (and far-reaching) consequence of these proactive security steps taken by corporate America is that the current economic 'recovery' remains imperceptible to most Americans as the national unemployment rate continues to hover above 9%¹. Additionally, any appreciable and lasting measure of relief within the residential real estate market continues to be fleeting.

Uncertainty and Fear

While corporations continue to report strong earnings, some 14 million Americans remain unemployed² — a growing number of them now identified as long-term unemployed — which has a negative downstream effect on consumer spending, foreclosure and bankruptcy rates. Economic stagnation and devastated state and federal budgets are the result and the reality.

Uncertainty and fear breed frustration — an abundant sentiment on numerous fronts these days. While the ideologies expressed by the Tea Party and the Occupy Wall Street activists are derived from opposite ends of both social and political spectrums, the underlying motivation driving both entities is the same — a deep frustration with the political system and process in general.

Uncertainty frustrates the market at best. Yet uncertainty is what currently defines the market. We have a market highly susceptible to rapid sentiment shifts, and face the possibility of its present level

of volatility being remaining for months to come. Appetite for risk truly waned in September, a month in which the dollar seemingly beat every asset class.

*In September, fears of sovereign contagion grew on rumors that Greece would soon default on its debt. When investors were not worrying about Greek banks failing or Greece rejecting the euro to return to the drachma, they were concerned about China's economy. Its central bank is working to address a slowing economy where consumer prices continue to increase and the People's Bank of China has raised interest rates five times over the past 12 months.*³

Cause and Effect Relationship

Consider the inherent paradox of a bull market — it is born out of pessimism — another predominant sentiment among the American people today. Following this train of paradoxical thought — today's uncertainty should fortify the foundation of tomorrow's bull market. Risk and return are inextricably related. To reap the returns instrumental to the success of your financial goals, it is necessary to continue to assume your current level of risk, which is both measured and purposeful.

Stimulus efforts have been proven historically to fail on both economic and political fronts. How many times must we repeat the same actions in vain, each time expecting a different result?

The clarity of an issue does not make it any easier to address or accomplish. Take for example:

The current Administration ran on a platform centered largely on health care, with a secondary focus on jobs — a prudent, and successful political position in 2008 when the unemployment rate was at 5.8%. By the 2010 mid-term elections however, the U.S. economy had plummeted and our national unemployment rate had grown to 9.6%, translating into millions of jobless Americans.⁴

1 businessweek.com/ap/financialnews/D9PP5NB00.htm [9/15/11]

2 tradingeconomics.com/united-states/unemployment-rate [10/7/11]

3 businessweek.com/news/2011-10-03/china-s-expansion-in-services-may-ease-slowdown-concerns.html [10/3/11]

4 bls.gov/cps/prev_yrs.htm

Consequently, mid-term elections focused solely on the issue of fiscal responsibility (much of which was beyond the current Administration's sphere of influence). Fiscal conservatives who won congressional seats by promising to produce deep spending cuts have thus far fallen short of their commitment.

The fact of the matter is that working Americans do not want an income tax increase, retired Americans do not want an entitlement benefit decrease and no American wants the retirement eligibility age to be extended. However, the illusion of "guaranteed income for life", 50-plus years in the making, must be dispelled if America is to move forward as a whole toward resolution and prosperity.

Our Perspective

How exactly does this relate to your investment portfolio? Until there is a clear(er) path toward a definitive and collaborative resolution, our economic reality will continue to be riddled with uncertainty. Keep in mind that the uncertainty in the market today is not the artifact of rapid-fire day trading or hedge fund influence; rather, the market's current volatility is

a by-product of the decisions and, of greater concern, the indecision of policy makers both domestic and the world over.

Is there risk involved? Absolutely. Is there potential for greater return in the future? Indeed.

Yet, in order to reap the rewards we seek, we first must live through the risk, and its associated fear and uncertainty. It is because of the risk we assume now that we can expect to be paid a return — a risk premium — in the future. Is it necessary and worthwhile to take on this risk? Yes.

It remains vitally important to adhere to your long-term investment policy. In order to reap the rewards of your long-term objectives, you must continue to block out the seemingly endless political, financial and economic doomsday noise that might tempt you to do otherwise during any extended period of uncertainty. As history has borne out repeatedly, this too shall pass. By resisting the temptation to react, you position your investment holdings to reap maximum return over the course of the market's resurgence back into bull territory

**Bull markets are born on pessimism,
grow on skepticism, mature on optimism
and die on euphoria.**

– John Templeton