Following the Herd (Right Off the Cliff)

Quaker Wealth Management, LLC
Daniel Roccato, MBA, CPM
President
101 West Main Street
Moorestown, NJ 08057
856-222-0110
dan@quakerwm.com
www.quakerwm.com

Proof that **smart Mom's make smart kids** - Stephanie is graduating from College of Charleston and has been accepted to the graduate school at University of South Carolina while Julia is graduating 8th grade and has been accepted to Merion Mercy Academy. Congratulations!

We love this time of the year - baseball, cold beer, grilles, convertibles and flip flops. We - and our families - thank you for your business and for allowing us to serve you. Enjoy the warm weather.

John and Dan.

Spring 2011

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Rising Interest Rates: The Downside of Economic Recovery

Are We in a Bond Bubble?

What health-care changes become effective in 2011?

Even after a combined 56 years of experience in the wealth management business, we continue to be **amazed that the vast majority of investors - and advisor's - still blindly follow the herd.**

You would think that the old saying "once bitten, twice shy" would provide at least some restraint on the inclination to chase "hot" sectors. But even after being mauled by the dot.com bubble of the 1990's and the real estate bubble of the early 2000's, **investors sheepishly continue to believe "expert's"** (tongue in cheek) prognastications and pile into narrow investment opportunities.

The latest example is commodities. Spooked by expert predictions that hyper-inflation is now upon us (think $10 Big Mac's), investors are buying into the vaccine called called commodities (e.g. oil, gold, silver, wheat, etc.).

But before you cash in your FDIC-insured CD for a Spanish Doubloon, think twice . Caution is in order. We are old enough to remember the last commodities boom in the 1980's which didn't end well for many investors. Following the peak in the mid 1980's, as many investors were piling in, the value of commodities plunged and remained comatose for two decades.

Without getting too technical, commodities prices are impacted by many factors including supply and demand, weather and economic strength. **But market speculation is an increasingly important driver of the price of commodities,** often causing abrupt price swings (as we go to print the price of silver is down 20% in 4 days).

The identity of the villain's may change from decade to decade. For example, today's **villain's include "leveraged ETF's" and Hedge Funds** versus the Hunt Brothers in the 1980's.

The media, never letting facts get in the way of a story, unwittingly help fuel the frenzy. Remember all the new age blather that the fundamental rules of real estate no longer applied because baby boomers were so unique? Try explaining these new rules to the 4 million Americans (and counting) who have lost their homes to foreclosure.

Are commodities bad investments? No. History has shown that commodities may be an effective way to hedge against inflation. But they are not a perfect tool nor are they the only tool (e.g. stocks and real estate are also good inflation fighters).

But encouraging investors to load up on gold - or any single asset - is wrong. We've never been big believers in the **"fear trade"** instead preferring to build diversified portfolios that include all asset classes and **in our practice we maintain a bias on investments that pay "rent"** (dividends and interest).

We expect inflation to return to the historic norm of 2.5% - 3%. But rather than pinning our hopes - and your wealth - on a particular commodity, we prefer **high quality short term bonds, U.S. Treasury Inflation-Protected Bonds, dividend-paying stocks and a small allocation to a diversified group of commodities** in our portfolios.

Even if we're wrong and the economy collapses and the world teeters on the brink of survival, it's unlikely that McDonald's will accept a Krugerrand for a Happy Meal.

Thank you for allowing us to serve you. John and Dan.

Rising Interest Rates: The Downside of Economic Recovery

Bonds don't respond uniformly to interest rate changes. The differences, or spreads, between the yields of various types of debt, such as corporate, government, emerging market, and municipal debt, can mean that some bonds are under- or overvalued compared to others. Don't forget that the total return on bonds is a combination of yield and price return. Financial professionals have many ways to adjust a bond portfolio to help you cope with rising rates.

Over the last several years, investors have grown accustomed to historically low interest rates. Ever since the Federal Reserve Board's target fed funds rate--the rate at which banks lend to one another--hit a high above 19% in mid-1981, the long-term direction of rates has been downward. In the last decade, the Fed's data* shows the target rate has never been much higher than 6%. And since December 2008, the Fed has kept it at a previously unheard-of level between 0.25% and zero to try to ensure that credit would be available to promote economic recovery.

Because bond prices typically rise when interest rates fall, that decline in yields has produced a bull market in bonds over the last decade. But what happens when the trend reverses? Even if they continue to remain relatively stable for a while, ultra-low interest rates have nowhere to go but up. When the economic recovery begins to show signs of strength, at some point the Federal Reserve Board will begin to raise the target rate again. When that happens, bond prices also will begin to reverse their long-term direction.

Here are some factors to consider in anticipation of a future with rising interest rates.

Bond maturities: when short is sweet

When interest rates rise, longer-term bonds typically feel the impact the most. In an extended period of rising interest rates, bond buyers become reluctant to tie up their money for longer periods because they foresee higher yields in the future; the later the bond's maturity date, the greater the risk that its yield will eventually be superseded by that of newer bonds. As demand drops and yields increase to attract purchasers, prices fall.

There are various ways to manage that impact. If you own individual bonds, you always have the option of holding them to maturity; in that case, you would suffer no loss of principal unless the borrower defaults. Bond investments also can be laddered. This involves buying a portfolio of bonds with varying maturities; for example, a five-bond portfolio might be structured so that one of the five matures each year for the next five years. As each bond matures, it can be reinvested in an instrument that carries a higher yield. Laddering also can be used with certificates of deposit (CDs).

If you own a bond fund, you can check the average maturity of the fund's holdings, or the fund's average duration, which takes into account the value of interest payments and will generally be shorter than the average maturity. The longer a fund's duration, the more sensitive it may be to interest rate changes.

Rising rates and other assets

Higher interest rates often are an attempt to prevent rising prices. When prices go up, purchasing power goes down, including the purchasing power of a bond's fixed interest payments. That can make bonds less attractive to buyers. However, not all investments are hurt by higher prices. For example, commodities such as oil and wheat typically do well in inflationary periods; in fact, increases in commodity prices are often what trigger a bout of inflation. If you're primarily interested in the overall value of your portfolio rather than a regular income stream, your financial professional can help you explore whether you should consider diversifying into asset classes that tend to benefit from inflation and that might help counteract the potential impact of falling bond prices.

Though bonds are affected most directly, equities aren't necessarily immune to rate increases. Though many companies borrowed money in recent years to take advantage of low rates and postpone the need to issue bonds for some time, those that haven't may see their borrowing costs increase, which could affect their bottom lines. Even those that squirreled away cash could be hit when they return to the bond markets eventually. Also, if interest rates rise to a level that's competitive with the return on stocks, that could reduce investor demand for equities.

Higher rates aren't all bad news

For those who've been diligent about saving, or who have kept a substantial portion of their investments in cash, higher rates could be a boon. Savings accounts, CDs, and money market funds are all likely to do better at providing income than they have in recent years. The downside, of course, is that if higher rates are accompanied by inflation, such cash alternatives might not keep pace with rising prices. And bear in mind that a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at $1 per share, it is possible to lose money investing in a money market fund.

**Source: Federal Reserve Statistical Release Historical Data for Fed funds rate weekly since 1954.*

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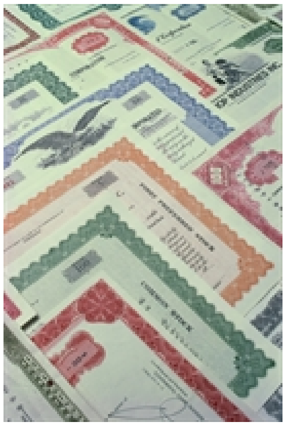
Are We in a Bond Bubble?



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Investors have been pouring money into bonds. Investment Company Institute statistics show that since January 2007, average net new money going into bond mutual funds each month has been roughly four times greater than net *outflows* from equity funds.* So does that mean we're in the bond market's equivalent of the late-1990s tech bubble?

What's been driving interest in bonds?

There are several reasons why bond funds have been attracting investor interest. First, in the wake of both the tech crash of 2000-2002 and the 2008 financial crisis, the Federal Reserve felt it needed to make credit more available by lowering interest rates. Over the last 10 years, the yield on the 10-year Treasury bond has fallen from 5% to well under 3% at the end of 2010.** And for the first time ever, 5-year Treasury Inflation-Protected Securities (TIPS) actually paid a negative yield when they were auctioned last October.*** Because bond prices rise as interest rates fall, that has increased bond prices generally.

As a result, bonds have outperformed stocks in recent years. For the last 20-year period, total returns from stocks and bonds have been equal: 8.2%.**** And during the decade between January 2000 and the end of 2009, bonds actually outperformed stocks; the S&P 500 saw a total return of -0.9%, while long-term government bonds returned 7.7%.**** That outperformance has lured investors who may have forgotten that past performance doesn't guarantee future results, and invest in an asset class based on its recent history rather than its prospects for the future.

Demographics also have played a role. Many aging baby boomers who became accustomed to investing much of their IRAs and 401(k)s in stocks are beginning to realize that their time horizon for retirement isn't as long as it used to be, and that they should consider allocating an increasing percentage of their retirement portfolios to income-producing assets. The financial crisis also sent many frightened investors scurrying to put their money anywhere besides stocks.

Finally, diminished dividends from stocks have encouraged many investors to look elsewhere for income. During the tech boom, companies preferred to reinvest in growth or buy back stock rather than increase dividends, and according to Standard and Poor's, 2009 was the worst year on record for dividend payments. Though there has been some reversal of that trend in recent months, stingy dividends helped make bonds and their income more attractive.

What to watch out for

No investing trend lasts forever without interruption. Here are some factors that could affect bond prices:

- Signs that inflation is picking up: Higher inflation means fixed income payments will have less purchasing power in the future, diminishing bonds' appeal as income vehicles.
- Fed reversal on interest rates: As the economy recovers, the Federal Reserve will need to withdraw the support it has given the bond markets. As it gradually rachets up interest rates, bonds will begin to reverse their pattern of the last decade. Depending on the pace of the Fed action, that reversal could be swift. Rising interest rates typically mean falling bond prices, and longer-term bonds often feel the most impact because bond buyers are reluctant to tie up their money long-term if a better rate lies ahead.
- Lack of overseas interest in U.S. debt: Foreign buyers have been large purchasers of U.S. government debt. If foreign buyers show signs of turning away from U.S. debt, it could send shivers through the bond markets.
- Muni bond troubles: Some experts worry that defaults by cash-strapped state and local governments could become a problem.

However, balance those factors against the possibility of further sovereign debt problems abroad. Several European nations are still struggling to deal with their debt problems; another bout of global jitters like the one in spring 2009 could remind investors that the United States has never defaulted on its debt. Also, if the potential for deflation that the Fed is so concerned about turns into an actual decline in wages and prices, that could be a positive for bonds, since the income they pay would be more valuable as prices fall. Either way, now is an especially good time to keep an eye on your bond investments.

*Average of monthly net new cash flows from January 2007 through September 2010 as reported in Investment Company Institute's "Long-Term Mutual Fund Flows Historical Data" as of Nov. 20, 2010.

**Source: U.S. Treasury historical data on daily Treasury yield curve rates.

***Source: "Record Setting Auction Data," www.treasurydirect.gov.

****10- and 20-year returns based on data on the Standard and Poor's 500 and long-term government bonds from *Ibbotson SBBI 2010* .

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Daniel Roccato, MBA, CPM
101 West Main Street
Moorestown, NJ 08057

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Ask the Experts

What health-care changes become effective in 2011?

The Patient Protection and Affordable Care Act (PPACA), signed into law in 2010, makes significant changes to our health-care delivery system. Here are some of the most important changes scheduled to take effect in 2011.

The cost of over-the-counter drugs not prescribed by a doctor can no longer be reimbursed through a health reimbursement account or a health flexible spending account, nor can these costs be reimbursed on a tax-free basis through a health savings account (HSA) or Archer medical savings account. Also, the tax on distributions from HSAs and Archer MSAs that are not used for qualified medical expenses increases to 20% (up from 10% and 15% for HSAs and Archer MSAs respectively).

Medicare Part D participants will receive a 50% discount on brand-name prescriptions filled in the coverage gap (i.e., the "donut hole") from pharmaceutical manufacturers, and federal subsidies for generic prescriptions filled in the coverage gap will start to be phased in.

Also, certain preventive services covered by Medicare are no longer subject to cost-sharing (co-payments), the deductible is waived for Medicare-covered colorectal cancer screening tests, and Medicare now covers personalized prevention plans including a comprehensive health risk assessment.

Medicare Advantage (MA) plans can no longer impose higher cost-sharing for some Medicare-covered benefits than would be imposed by traditional Medicare insurance. Also, MA plans cannot exceed a mandatory maximum out-of-pocket amount for most Medicare services. The maximum amount in 2011 is $6,700, but MA plans can voluntarily offer lower out-of-pocket amounts. Also, the annual enrollment period for MA plans is changed to October 15 through December 7.

The requirement that employers report the total value of employer-sponsored health benefits on employees' W-2s was to begin in 2011. However, the IRS has deferred this requirement until 2012.