

INVESTMENT UPDATE

THE MUNCY BANK & TRUST COMPANY

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Points of interest:

- Madoff was able to capitalize on personal connections, class status, and the lure of exclusivity.
- Investors took their friends' word for Madoff's acumen without doing their own research.
- The lure of non-spectacular, steady returns blinded some investors to the potential for fraud.

WHY INTELLIGENT PEOPLE FELL FOR BERNIE MADOFF'S PONZI SCHEME

The Ponzi scheme run by Bernard Madoff may have cost his investors some \$50 billion. For many, the big question is how could seemingly sophisticated investors be so stupid? Even more important, what lessons can we learn from their mistakes so that we can avoid the next con artist who comes along?

Interviews with victims show that class status, exclusivity, reputation, blind trust, an unrealistic expectation for "safety," and the old X Files "I want to believe" phenomenon contributed to their downfall.

Those influences were apparently powerful enough to make investors go against common sense and ignore easy warning signs that all was not well with their money.

The in crowd
Madoff and other investment firms that hawked his fund took advantage of referrals within country clubs in Florida and networks in various Jewish communities.

Investors were impressed that a friend or business acquaintance was doing well with Madoff and that made it easier for them to trust him with their money. The reports of good returns with low risk created a "feedback loop" of credibility for new investors.

There was also an air of exclusivity: hedge funds that invested with Madoff told their investors they were getting in on a wonderful oppor-



Bernard Madoff leaves a federal courthouse after being charged in a \$50 billion scam that could be the largest financial fraud ever.

tunity available to selected investors. That "snob appeal" attracted investors who felt they deserved more than the average investor, who had to be content with retail mutual funds and ordinary stocks and bonds.

Some made their decisions based on the reputations of their professional referral sources, whether they were lawyers, investment advisors, or hedge fund managers.

Safe and reliable
Investors also may have had unrealistic expectations about returns and risk, and were willing to shut their eyes

as long as reported returns were good. Madoff and his asset-gatherers didn't tout large returns, but instead played on investors' yearning for slow, steady returns that didn't go down when the market dropped.

"I wanted someone who was a little bit more conservative, someone who could let me sleep at night," one investor told *MSN Money*.

Some investors reported steady earnings over the years of 11 percent, year in and year out.

That was just high enough to attract investors

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IF AN INVESTMENT SEEMS TOO GOOD TO BE TRUE, BE VERY WARY

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but apparently not high enough to strain credibility.

Warning signs

If a potential investment seems too good to be true, beware. If an investment offers a steady return of 11 percent at the same time that bank certificates of deposit offer 3 percent, something is wrong. Either risks of loss are not being revealed, or the investment is bogus.

Think twice before putting money into a product

that you can't understand or lacks detailed written information on how and where money is invested.

If there is documentation, make sure an independent third party can verify it for you. Stick with publicly-traded investments whose results can be obtained from sources other than your advisor.

Finally, don't give money directly to an advisor. Your money should be held by an independent third party such as a brand-name brokerage or mutual fund. Those



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third parties should report your holdings, losses, and gains and their results should correspond with your advisor's reports.

STAGGERING LOSS IN RETIREMENT ACCOUNTS

The one-year decline in stocks from their high in October 2007 to October 2008 cost individual investors in the United States some \$5.6 trillion, says the Center for Retirement Research at Boston College.

Individual savers suffered a hit of \$2 trillion to their individual retirement accounts and 401(k) accounts, on top of a loss of \$3.6 trillion in their non-pension accounts, the Center said after reviewing Federal Reserve household wealth statistics.

Pension protection

Retirement savers who participate in traditional pension plans were partially shielded from the declines. Public and private defined benefit plans lost an estimated \$1.9 trillion. However, it is the employers who sponsor those plans who are on the hook for making up the losses, not individual workers, the Center said.

Traditional pension plans pay a benefit based on an

employee's years of service and pay level. It is up to the employer to make sure there is enough money to make the payments.

In 401(k) and other contributory pension plans, the retirement saver is liable for losses. Employers don't have to make them whole.

This is a dangerous trend, the Center said. More and more employers are ending their traditional pension plans and shifting the savings burden

onto employees by utilizing contributory plans like 401(k) accounts.

Bad timing

The Center worried about the reactions retirement savers had to the market meltdown in 2008.

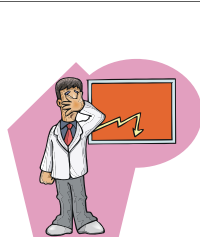
"In all likelihood, many panicked amid the turmoil and sold assets at depressed prices," it said. "And these people may be late in getting back into the market to enjoy gains as the market recovers."

The Center said government action may be needed to protect retirement savers in the future.

"The question this crisis raises is whether pension participants need to be protected from this type of gut-wrenching volatility," it said.

It should be noted that the declines reported by the Center do not take into

account losses that occurred after Oct. 9, 2008; the stock market continued to decline through Nov. 20. That makes it likely that retirement savers suffered even greater losses from the market's high point to its low point.



Retirement savers lost trillions of dollars in the 2008 bear market and those who panicked and sold may have difficulty making up their losses.

"Individual savers suffered a hit of \$2 trillion to their individual retirement accounts and 401(k) accounts."

IF THE EXPERTS CANNOT PREDICT THE MARKETS, YOU CAN'T EITHER

Were you able to predict the global bear market that sucked trillions of dollars out of investors' pockets in late 2008?

In retrospect, it looks like it should have been easy to predict—after all, the sub-prime mortgage crisis had gone on for a year before stocks started crashing in October 2008. It seems obvious that the economy was collapsing and that stocks were going to head down sharply.

Hindsight bias

Unfortunately, that is our hindsight bias talking. The past always looks inevitable and predictable, because we now know what happened. But even the experts have a tough time predicting the markets. In fact, they usually make more wrong predictions than right, and these are the people who have more information at their fingertips and more experience than most investors.

Consider what the experts said at the beginning of 2008, when the storm clouds

were already gathering.

Global strategists for Citigroup in late December 2007 issued a report that said the bull market was not dead. While “undoubtedly mature and subject to increasing volatility, the current bull market is not yet over.”

Market analyst Jeffrey Kleintop of LPL Financial in Boston told his clients the market would have a ‘fourth quarter breakout to the upside as the uncertainty fades and the U.S. economy avoids a recession.’

Bullish on Europe

The Wall Street Journal told readers on Jan. 2, 2008 that “European shares are likely to rise this year for one reason: They are cheap.”

Even at the end of the third quarter, just before the crash came, the forecasts were muddy. *The Hulbert Financial Digest*, which rates the performance of invest-



Although everything seems easy in hindsight, forecasting markets is impossible.

ment newsletters, found that the 10 best performing newsletters were far more bullish than the 10 worst newsletters. Although the 10 best newsletters had demonstrated the most skill in allocating assets over the previous 15 years, that wasn't enough for them to foresee the bear market.

Apply this forecasting lesson to your own view of the markets going forward. It might be helpful to write your predictions down and look at them in a year.

“The current bull market is not yet over,” said one analyst.

RANDOM WITHDRAWALS, NO WORRIES, & MORE

Most older Americans have no set plan for tapping retirement savings. In fact, they mainly grab money at random, found a survey by Vanguard, the mutual fund company.

It surveyed Americans age 55 to 75 and found that most withdraw money on a random basis, usually in large amounts of more than \$10,000.

Only 20 percent of households had set up a regular withdrawal or income payment plan. About one-third



said they either had “no formal approach” or relied on their “gut feeling” to guide withdrawals.

Not worried enough

Some 40 percent of potential retirees aren't even aware that they are financially unprepared for retirement, says the Center for Retirement Research at Boston College.

It found that 24 percent of American households worried about retirement success even though they were not at risk of falling short, while 19

percent didn't worry enough and were at risk of falling short. It said many potential retirees underestimate the impact health care costs will have on their retirement.

Sell during recession?

You can sell your stocks in a recession and possibly avoid the risk of further declines, but you will do so “only by passing up higher expected returns,” say noted finance professors Eugene F. Fama and Kenneth R. French. “There is some evidence that expected stock returns are relatively high during recessions and low during expansions,” they say.

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TOUGH TIMES MAY BE HERE, BUT YOU CAN STILL IMPROVE FINANCES

The year 2009 is already proving to be financially tough, but the regulatory agency that oversees stockbrokers and the markets has some tips to help you weather the storm.

The Financial Industry Regulatory Authority suggests your top priority should be paying down credit card debt. "Banks are increasing interest rates and late fees and reducing credit limits on credit cards," it says. Paying down debt will save you interest and improve your credit score.

With credit harder to get, it recommends checking the accuracy of your credit report. Call 1-877-322-8228 or go to: www.annualcreditreport.com.

If you don't have one, create a rainy day fund. One in three Americans have no



Never mind the gloomy economic forecasts, now is the time to fix your financial situation.

liquid savings, FINRA says. Try to put away the equivalent of at least one month's salary, and preferably three to six months' worth if possible.

Avoid raiding your 401k or stopping contributions. Now is the time to keep your 401k funded so that it can recover with the markets, it says.

Diversify your investments by spreading your

money among different asset classes like stocks, bonds, and cash. This will reduce your overall risk and smooth your returns over time.

Avoid reacting to the market's current downs and ups and instead invest for the long term, it recommends.

"Instead of panicking or trying to time the market, focus on the long term," it says. "Investing incrementally, in good times and bad, is a tried and true way of bearing up in a bear market."

You should also take steps to protect yourself against identity theft.

"Virtually any news item, positive or negative, can become a 'hook' for a new scam," it says. "Phishing attacks surged in October 2008 by 103 percent following stock market drops."