

INVESTMENT UPDATE

THE MUNCY BANK
& TRUST COMPANY

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Points of interest:

- Stock market bears point to 10 years of negative U.S. stock market returns since 1999.
- This particular 10-year period may not be relevant to an investor trying to meet long term goals.
- Longer periods that are well within most investors' time horizons have been positive.

IS IT A 'LOST DECADE' OR A ROSY FUTURE FOR STOCK INVESTORS?

The market bears are bemoaning the "lost decade" that equity market investors have suffered since 1999. A 10-year period of no returns negates the argument that stocks are the best investment for the long term, they say.

The argument may not hold water, however: expand your investment horizon out just a few years more and "lost decades" turn into positive returns on stocks.

First, the pessimists' argument: For the 10 years through February of this year, the Standard & Poor's 500 Stocks Index, with dividends reinvested, has lost an average of 3.4 percent per year, according to data from Standard & Poor's Index Services Group.

This is well below the average's long term annual gain of 9.3 percent since January 1926 and a great disappointment to long-term investors, the critics argue.

Why this period?

Is this even relevant to a long-term investor? This exact 10-year period is an arbitrarily-selected period that starts right at the peak of a 17-year bull market, when "irrational exuberance" brought the market to an absurdly high valuation.

Extend the investment horizon out a few years and things change. In the 15 years through this past February the S&P 500 returned 5 percent

per year, less than its long-term return but better than cash interest rates.

Investors should also note that it is deceptive to look at raw index numbers without accounting for dividends. Even if the index stands at 900 at one point and 10 years later is still at 900, an investor would have enjoyed a positive return due to dividends paid by stocks in the index.

The 1970s lesson

Accounting for dividend reinvestment belies the common misconception that we experienced a lost decade in the 1970s and early 1980s

due to bear markets at the beginning and end of the period.

The Dow Jones Industrial Average fell below 1,000 in the early 1970s and didn't regain that mark until the early 1980s. However, the S&P 500 returned almost 7 percent per year with dividends reinvested from the beginning of the first bear market in 1973 through the end of the last one in 1982.

Investors should not focus on headlined, arbitrary periods and instead look at their own goals. A 30-year-old has an investment horizon of



Investors over the last 10 years have not made any money in stocks, but this may not be relevant to their long-term success.

THERE HAS NOT BEEN A 17-YEAR LOSING PERIOD IN 200 YEARS

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as much as 60 years extending through retirement.

Someone about to retire still has to plan for as much as 30 years of retirement income. The best way to cope with inflation's effect on that income is to invest in stocks.

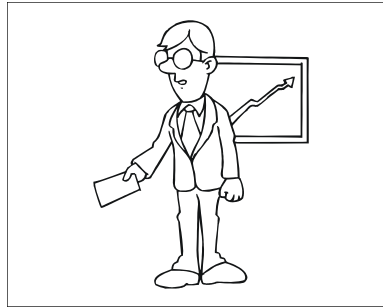
The probability of a positive experience is quite good: there has not been a 20-year period of negative returns on the S&P 500 during its 83-year history.

Wharton School Profes-

sor Jeremy J. Siegel has used stock indexes from before the days of the S&P to calculate long-term returns on stocks since the early 1800s.

His research showed there has never been a negative 17-year period in stocks after adjusting for inflation. Bonds and cash have fallen behind inflation in many of those periods.

Savvy investors will always keep a cash or short-term bond hoard that will get them through a bear market, should they need spending



Long-term investors are still rewarded.

money during that period. The rest of their money should be in stocks, growing at a positive long-term inflation adjusted rate.

INFLATION, NOT VOLATILITY, IS THE BIG RISK

Many investors have worried about principal loss recently as the stock market turned sharply lower.

They may be emphasizing the wrong danger: While the risk of loss in stocks declines the longer you own them, the risk of loss of purchasing power due to inflation is a given that only keeps growing steadily throughout an investor's lifetime.

Except in very old age, investors typically have a time horizon of at least 25 to 30 years. Since there has never been a 17-year period in U.S. stock market history with negative returns, they should have confidence that the risk of loss due to day-to-day fluctuations in the market should diminish to near zero.

Energizer bunny

However, inflation just keeps on going. The United States has experienced just a handful of years of declining inflation. There have been none so far this century. There were isolated incidents of lower prices in 1954 and

1949, and a string of years during the deflation of the late 1920s and early 1930s.

Otherwise, consumer prices since 1926 have grown at an average annual rate of about 3 percent.

Someone entering retirement today with a fixed income of \$50,000 would see the purchasing value of that income erode to just \$23,349 in 25 years.

That's why investing in

something that seems "safe" today, such as a bank certificate of deposit or a fixed-rate bond, can be a devastating choice in the long run.

After adjusting for inflation, short-term U.S. Treasury Bills have increased by only

0.7 percent per year since 1926, according to research firm Ibbotson Associates. Long-term government bonds grew by only 2.4 percent per year after inflation.

Income tax wipeout

Once income tax is paid on that interest, a saver would have had a negative return and would have fallen behind inflation.

U.S. stocks, however, have delivered a "real return" after adjusting for inflation of 7.1 percent per year from 1926 through 2007.

This real return was earned despite massive declines in stock prices in the 1930s and bear markets in every decade since then.

So the short-term risks of big price fluctuations did not prevent a long-term investor from earning enough income to ease inflation's bite.



Inflation affects worldwide consumer prices year after year, reducing the purchasing power of a portfolio invested in fixed income instruments.

"The risk of loss of purchasing power due to inflation is a given that only keeps growing steadily throughout an investor's lifetime."

EMPLOYER PENSION FUNDS BEAT MUTUAL FUNDS BY A WIDE MARGIN

Employees who are still covered by traditional pension plans have something to cheer about: their pension fund investments are probably doing better than their individual mutual funds.

A new study by a Dutch finance professor shows that pension funds outperform actively-managed mutual funds by as much as 2 percentage points per year.

Surprisingly, this doesn't seem to be due to greater skill on the part of managers of pension funds vs. those of actively-managed mutual funds, says Rik G.P. Frehen.

"Pension funds hire (and fire) institutional asset managers who provide mutual funds for individual investors as well," he wrote.

All about costs

His study performed a number of tests to see whether pension fund managers were investing differently than mutual fund managers.

"We show striking similarities in net performance patterns over time, which

makes skill differences highly unlikely," he concluded.

Instead, he believes a different factor is at work: hidden costs of mutual funds that relate to the way they are distributed through brokers and other salesmen.

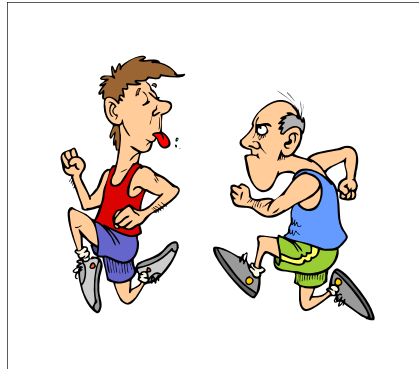
Agent fees

These costs are known in the business as "agency" costs, because they relate to the price of having an agent distribute funds to the public.

He notes that other studies have shown an "inherent conflict that results from for-profit organizations providing management services directly to countless faceless mutual fund investors."

Mutual fund companies have been known to pay distributors "pay to play" fees in order to get funds sold, for instance.

Another striking finding for Frehen was that passively-



Pension funds don't invest better, they just invest cheaper than mutual funds.

managed index funds, which do not typically face hidden costs, perform almost as well as the pension funds.

Some have theorized that individual investor behavior also hurts mutual funds. Individuals tend to crowd into a hot fund and then flee when it loses ground, forcing the fund to make bad investment sales when markets are down.

Pension funds, managed by professionals for the long run, do not face this type of short-term selling pressure.

"He believes a different factor is at work: Hidden costs of mutual funds that relate to the way they are distributed through brokers and other salesmen."

GLOBAL STOCKS, RISK TOLERANCE, & MORE

Global stock market rankings from late 2008 show that the U.S. stock market is still roughly five times bigger than its nearest competitor, Japan, says Bloomberg news service.

The United Kingdom and China followed right behind Japan, all with between \$3 trillion to \$4 trillion in assets.

Rounding out the top ten were France, Hong Kong, Germany, Canada, Brazil, and Australia.

The smallest of the 30 largest stock markets at the



time was Kuwait, with about \$200 billion.

Risk tolerance up?

Despite the fear and panic in the investment markets over the last year, the risk tolerance of the average 401k investor may have increased slightly, says research firm The Spectrem Group.

Its survey of 401k participants in March 2008 found that 31 percent of workers were willing to take on a significant risk to earn a high return. By May, the num-

ber had increased to 37 percent. Spectrem said more workers might be willing to take risks to make up for lost value in their accounts.

Boomer statistics

The first wave of retiring baby boomers won't feel old until they are 78, and if they are healthy, not until 83, found a survey by MetLife.

While a third plan to take Social Security at 62, another third want to wait until 66 or later to get higher benefits.

Only 2 percent claim to have attended the music festival at Woodstock in 1969.

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MARKETING MAY LEAD INVESTORS TO MAKE BAD MUTUAL FUND CHOICES

If an investor was able to predict which mutual fund within a similar class of funds would perform the best, wouldn't it be more likely he would invest in that fund?

Not so, found a study of Standard & Poor's 500 Index funds done by professors at New York University and Emory University.

It should be easy to distinguish the potential winners in the S&P 500 index funds category since they all invest in the same stocks held in the index.

The main determinant of success should be the cost of owning the funds, with the cheapest funds delivering the highest returns.

"They have substantial differences in fees and differences in return that should be economically significant to



Mutual fund salesmen may put clients into badly performing index funds.

investors," wrote Edwin J. Elton and Martin J. Gruber of NYU and Jeffrey A. Busse of Emory.

However, the worst-performing (and highest cost funds) delivered returns that were as much as 2.09 percentage points below the best funds, they found.

They examined the track records and cash flows of 52 S&P 500 funds from 1997

through 2001. They found, to their surprise, that the weakest S&P funds drew more money than they should have from investors, given their performance and fees.

"We would expect the investors who buy index funds to be among the most knowledgeable of all investors and to make the allocation among index funds to maximize their economic payoff. As we show, this is not the case," the study said.

They theorize that payments made by fund companies to brokers who distribute their funds may be at the root of the problem.

"Thus, financial advisors or brokers who advise clients to purchase funds to improve their own profits could cause much of the flow into index funds," they conclude.