



Dunn Warren Investment Advisors, LLC

The Portfolio Reporter

James Cornehlson, CFA
6143 S. Willow Dr. Ste.102
Greenwood Village, CO 80111
Phone: 877-491-7514
www.dunnwarren.com

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Recession – A Succession of Events

“ECRI (Economic Cycle Research Institute) notified clients that the U.S. economy is indeed tipping into a new recession. And there’s nothing that policy makers can do to head it off.” Reuters – September 30, 2011

A recession is not a state of being, but rather an economic course. The snowballing of items sets the direction. Individuals see incomes decline, and their confidence wanes. These two items have already begun happening. Real earnings reported by the U.S. Bureau of Labor Statistics declined 1.9% in August from the previous year (this is accounting for inflation). Second, the University of Michigan Consumer Sentiment index is down 15 points to 59.4 and is at the same level as the recession in 2008.

In past recessions, after these items begin to slow down, other components of the economy begin to falter. Companies slow hiring, post fewer job offerings and begin laying people off. Companies then reduce capital investment in infrastructure and durable items (equipment that will last three years or more). Sales begin to falter, earnings slow down or decline. Stock prices follow suit. Consequently, recessions are not a state of being but rather a snowballing of ever declining demand for jobs, staples, equipment and confidence. A recession is a succession of adverse events. They don’t all decline at the same rate or the same time.

Despite the slow-down in the economy, the Federal Reserve (FED) has done a stupendous job at enticing investors to take more risk. The FED is keeping interest rates low and buying back bonds. As a result, the FED is antagonizing investors to take more risk than they otherwise would. Investors that were previously comfortable with returns on certificates of deposit (CDs) of 4% or 5% cannot attain these returns now. With the nationwide average CD rate of 0.38% (Bankrate.com - October 5, 2011) investors are antagonized to reach for higher returns elsewhere. This is rational considering that with inflation at about 2%, investors in CDs are **losing** future purchasing power; their returns are not keeping up with inflation.

Taking more risk by investing in the stock market should reward investors with greater returns. However, high levels of debt and high valuations limit the upside and increase the risk investors are taking when investing in the stock market currently.

The Fed’s goal of trying to improve consumer confidence and spur spending is admirable. The game plan is simple. Keep interest rates low to encourage people to buy more. However, when people buy more, they are potentially taking on more debt. This brings us back to the problem we had in 2007, mainly that individuals, corporations, and government already have too much debt. Given the high valuations and high levels of debt, expecting the stock market to go higher is a risky proposition because economic growth is meager.

Dunn Warren’s willingness to take less risk has frustrated many investors this year. Early this spring we invested in the volatility index and then inverse funds (investments that increase when the underlying investment decreases, but decline when the underlying investment appreciates), and added to inverse funds in August, all which hurt performance when the market was moving higher during that time period. However, with risk as high as it is now, we feel comfortable with the investment in inverse funds we currently have. In portfolios with exchange traded funds, in addition to the inverse funds, we have also invested in utilities, healthcare, and consumer staples, because even when the economy is declining, these three sectors are still

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needed.

In the variable annuities that do not have the option of investing in inverse funds, we have invested nearly 80% of the portfolio in bond investments. With the government trying to lower interest rates, this should benefit these investors.

If we see the economy improve, marked by higher interest rates, lower unemployment claims, as well as other factors, this would cause us to sell the bond investments and inverse funds. However at this time, the risk to the market we have seen historically from these weakening factors means we will keep the current investment position.

Please feel free to pass "The Portfolio Reporter" to interested friends and family members. For more information about your investments, please contact your financial professional.

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MONTHLY CONFERENCE CALL

Our next monthly conference call will occur Thursday, October 20th at 11 a.m. Mountain Time (1 p.m. EST).

Phone Number: 866-740-1260

Access Code: 4682824

To view slides on the internet during the call, go to www.readytalk.com and enter 4682824 under "Join a Meeting".