FINANCIAL CONNECTIONS
GROUP INCORPORATED

For Clients and Friends of Financial Connections

The first quarter's gains in the U.S. stock market were the strongest in over a decade. Developed international stock markets surged as well. As we've noted in the past, in the short term, the market is a voting machine. The votes were extremely positive.

- Greece's debt was restructured
- The global economy is growing
- New jobs were materializing
- Fed's "Stress Test" on banks showed 15 of 19 banks well capitalized (Bank of America stock increased 72% and J.P. Morgan Chase 38%)
- Low interest rates moved many investors to take on more risk to achieve higher yields
- The S&P 500 and NASDAQ both benefited from the 48% increase in Apple stock (Apple is 4% of the S&P and 11% of the NASDAQ)
- China's inflation rate slowed

Many are skeptical (as we are) that the market will end the year at this level—many obstacles remain.

- Europe put a Band-Aid on its debt problem or, as many say, kicked the can down the road
- Other countries besides Greece are in similar debt positions (Spain, Italy, Portugal, and Ireland)
- Europe is entering a recession
- Gas prices are higher
- Fewer new jobs are opening up
- Reducing the federal debt may be economically painful
    - We favor a gradual decline in the deficit. By one estimate, if the Bush tax cuts and payroll tax cuts expire at the end of 2012, the resulting tax increase will cause a decline of 3.5% in the GDP.

In contrast, Treasury bond prices declined and their yields increased (bond price and yield are inversely related).

Risk On/Risk Off

Over the past few years, we've seen wide gyrations in the market. The SEC is trying to see if computer-driven trading causes some of the volatility. But even if it is a factor, the volatility reflects investors' swing from buying "safe" Treasuries (whose interest rate is very low) to buying stock-type securities—or Risk Off/Risk On.

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Quarterly Newsletter, 1st Quarter 2012
4/19/2012

SAVE THE DATE!
On May 22, from 4:30 PM to 7:00 PM, we hope you'll come to see our newly expanded Corte Madera office. Look for an e-invitation soon.

Please join Financial Connections in welcoming our new Executive Assistant, Sheri Remail. Her work experience includes the Pacific Stock Exchange, a solar company, a high-end construction firm, and the Ecological Design Institute in Sausalito. You will be able to meet Sheri on May 22 during our "office warming."

Clients of Financial Connections

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One of the roles we assume for you, as clients of Financial Connections Group., Inc. is not to let emotions of the moment govern our investing your money.

Risk On/Risk Off behavior in investing does not work. When fear is dominant, investors buy Treasuries. When investors feel more positive, they sell the Treasuries and buy stocks. This behavior requires an investor to:

- know when to buy Treasuries
- know when to sell Treasuries
- know when to buy stocks
- know when to sell stocks

Unless you have enough money that you can live on a 10-year Treasure yield of 2.2% (quarter-end yield), we don't see this as a viable investment strategy. Another consideration is your purchasing power is lost because inflation is higher than 2.2% (see Buffett Investing discussion).

We believe our role is to base investments of your money on your objectives, balancing risk with return to reflect those objectives and taking into account your emotional comfort zone. You can see what a complex dynamic these competing goals can create. We welcome the opportunity to talk with you about your investments.

<u>Content of this package</u>

Your reports for the quarter are included. Those of you who signed up for the web portal will also receive your reports electronically this quarter. Starting with the next quarter, these clients will receive both quarterly reports and newsletter electronically (but not on paper).

Also, as we do every year, we include our updated ADV Part 2A and 2B (disclosure statement) and our Privacy Statement. Please let us know if you have any questions.

If you'd like to make an appointment to talk with us, please don't hesitate to call or email us.

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WARREN BUFFETT: SOME INVESTING THOUGHTS FROM HIS ANNUAL REPORT

Investments in cash, cash equivalents, and bonds

Investments in dollar-denominated money markets, bank deposits, bonds denominated in one currency (for our purposes, the dollar) are frequently thought to be "safe." Hence, when investors are frightened, they pile into Treasuries regardless of the yield (interest rate).

Buffett believes these instruments "are among the most dangerous of assets. Their beta (measure of volatility) may be zero, but their risk is huge."

The impact of inflation—loss of purchasing power—is significant. These instruments are primarily savings, not investments.

According to Buffett, "the dollar has fallen a staggering 86% in value since 1965 [when Buffett took over Berkshire Hathaway]. It takes no less than $7 today to buy what $1 did at that time."

Buffett states that over the same 47-year period, the rolling U.S. Treasury bill yield was 5.7%. Or, when you deduct a 25% tax rate and inflation, the yield is "nothing."

A retirement rarely lasts 47 years. The terms of comparison may vary, but putting money into these types of instruments is not an investment.

Gold

Buffett, not surprisingly, is no fan of gold; it is not a productive growing asset. If the world's gold stock—now about 170,000 metric tons—were melded together, it would fit easily inside a baseball infield. Buffett calls it Pile A. At $1,750 per ounce, the value is $9.6 trillion.

Based on $9.6 trillion, what could we buy? In this Pile B, Buffett includes:

- *All* U.S. cropland (400 million acres), with output that equals about $200 billion annually,
- *Plus 16* Exxon Mobil's (world's most profitable company), which earns about $40 billion annually,
- *Leftover* of $1 trillion for liquidity.

Buffett views Pile B as far more desirable than Pile A—gold has limited use and is a finite commodity. And, he suggests, a century from now,

- Farmland will continue to produce crops that are sold,
- Exxon Mobil's delivered dividends and valuable assets will be worth *trillions* (recall you own 16 Exxons), but
- The gold is still the same size and doesn't produce anything.

While at times gold may be good, for a long-term investor, something that produces income to shareholders and an increased value of assets has more potential.

This is a brief synopsis of Buffett's Annual Report—always interesting reading. If you would like to read the report, go to: http://www.berkshirehathaway.com/reports.html

HOW ABOUT A FOOD & DRUG ADMINISTRATION (FDA) FOR FINANCIAL INNOVATION?

Financial instruments can be a double-edged sword. One side has the potential to reduce risk. Farmers use them for crops, others use them to hedge commodity or currency risk, as insurance to reduce risk (think homeowners, auto but on a global level). The other side, however, is speculation.

How do you allow for the growth of positive derivatives that actually reduce risk versus the speculative derivatives that were a major contributor to the 2008 financial crisis?

Law professor Eric A. Posner and economist E. Glen Weyl, both from the University of Chicago, propose a novel solution to assess the risk of new financial products. Their paper, titled "An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to Twenty-First-Century Financial Markets" propose the creation of the Financial Products Agency (FPA).

The parallel is this: We don't allow new drugs on the market until they have been tested for safety. We should have an agency that applies a similar logic to financial instruments.

"Our proposal is not as radical as it might seem at first. Our main goal is to regulate a form of speculation or gambling that takes place in financial markets."

To download the paper, go to:
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1995077

THE ARGUMENT FOR LOW INVESTMENT RETURNS

One of the problems seen in pension plan funding is the rate of return used for investments. It is too high and leads to underfunding (the lower the interest rate, the more money needs to be put in the pension fund for future retirees).

The same logic applies to individual investors, and we encourage people to have realistic expectations. Many analysts expect mid-level single digit returns for stocks. With cash basically paying zero and corporate bonds paying 3%, how would a balanced portfolio look?

Assumptions:
5% cash earning 0
35% bonds earning 3%
60% equities earning 8%

The portfolio return would be 5.85% before taxes and inflation. Of course this doesn't include other asset classes such as international, global bonds, high yield bonds, etc. But here are some of the questions it raises:

- Have you saved enough money to meet your goals?
- Is your spending in line with the funds available?
- If not, what steps do you need to take?

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