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February 5, 2010

### **Market Roundup**

The last week of January was a tough one for the markets, and while February got off to a decent start with two days of gains, on Thursday the markets fell back down to earth. Momentum is deflating while fundamentals are sobering. That's not necessarily bad news for long-term investors like us, but it will make traders uneasy.

On 2010's road, technology continues to be the driver. With top and bottom line beats by the big boys (from IBM to Apple), and forecasts of better business this year, thanks in part to innovations from Apple's iPad to Windows 7, there's still cause for reasonable optimism in this sector. And health care, our more defensive growth complement to our tech stake, continues to fare well; after beating the market with about 40% less risk last year, it's besting the broad market again this year.

More good news could be found in the fact that personal incomes rose for the sixth month in a row in December, according to the Bureau of Economic Analysis. And savings rates remain strong, which may not augur well for day-to-day spending, but does have longer-term benefits, as we aren't adding to our debtor consumer status. That said, mall and luxury retailers saw an unexpected bump in sales in January.

If those are bright spots, we saw analysts get a disappointment in existing and new home sales as well as mortgage applications. However, we've been looking for a stall here and were not so surprised by the news. The silver lining is that prices seem to be firming even as sales are stalling. That's a floor to build upon.

While unemployment remains front and center across the country (despite Friday's report that unemployment fell below 10% to 9.7% in January), there's one person who, just moments away from a pink slip, has gotten a reprieve: The Federal Reserve's Ben Bernanke,

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whose term expired at the end of January, has dodged the unemployment bullet for the next four years. As the top Republican of the Senate Appropriations Committee said, the markets don't need more uncertainty piled on them. Consumer and investor confidence continues to stabilize, as does confidence in Bernanke and the Fed. That's not misplaced, but could be displaced if negative momentum gains a bit.

The mortgage market has been artificially supported by the Fed's buying of mortgage debt. They're slated to stop such funding in March. That may be their first trial balloon, which comes at the risk of turning a stall in that market to a fall. That fall will likely find its parallel in a market fall of 10%-15%, which will be a buying opportunity. We don't think even a prolonged fall in the housing market will translate into a sustained fall in the stock markets, and we remain optimistic for overall gains in 2010.

No doubt you've been watching the markets play their game of taking the indexes down just when you thought the worst of the worst was behind us. Well, it is behind us. We don't believe that the Dow's decline from the recent January 19 high is anything more than a step backward after many, many steps forward. We shouldn't have to remind you that the markets don't move in one direction only, nor that all the worries we've been dealing with suddenly disappeared. But, let us put the market's rally into numbers so that you can put the current downturn in perspective.

From the March 9, 2009 low to the January 19, 2010 high, the Dow Jones Industrial Average gained 63.8% (which translates into a 77% annualized return). We all know that's unsustainable and needs to be corrected. Now, whether that correction is 5%, 10% or 15% (possibilities that could take us down to a Dow in the low 9000s or so, but which still wouldn't be disastrous or unprecedented), we think it means we're headed for some changes in market leadership going forward.

Until mid-January the market's advance from the bottom had been led by some of the smallest and some of the most financially suspect companies in the public markets. In fact, in 2009 the top performing segment of the market was the micro-caps, which are teeny-weeny companies that can be some of the riskiest around. Large-cap value stocks, like those that pay nice dividends and have rock-steady balance sheets were the laggards, though of course they still did okay. We think the "pause that refreshes" in the current market run is going to also yield a shift in leadership which will benefit us, as most of the companies in our portfolios are the solid kind, not the speculative kind.

The economic news continues to vacillate from good (Cisco's great sales and earnings report, and projections) to not so good (Thursday's employment numbers) and the markets are becoming more volatile as a result. The lousy jobless claims numbers revealed late this week took the markets down in a hurry, and weakness in Europe isn't helping matters either. A robust rebound still remains a cautious wish rather than a foregone conclusion.

### **Fidelity Storms the ETF Market**

Fidelity announced this week that it is entering the ETF business in a big way by offering 25 iShares ETFs on their brokerage platforms with no commission in a bid to gain market share of ETF investors. This is a major acknowledgement that the now \$1 trillion ETF industry has come of age, and that Fidelity wants to own it. We figured the first part of this equation out years back and have been incorporating ETFs into client portfolios for some time now.

The following iShares ETFs are now commission-free through Fidelity's website: S&P 500 (ticker: IVV), S&P 500 Growth (IVW), S&P 500 Value (IVE), Russell 1000 (IWB), Russell 1000 Growth (IWF), Russell 1000 Value (IWD), Russell 3000 (IWV), S&P Mid Cap 400 (IJH), S&P Mid Cap 400 Growth (IJK), S&P Mid Cap 400 Value (IJJ), S&P Small Cap 600 (IJR), S&P Small Cap 600 Growth (IJT), S&P Small Cap 600 Value (IJS), Russell 2000 (IWM), Russell 2000 Growth (IWO), Russell 2000 Value (IWN), MSCI ACWI (ACWI), MSCI EAFE (EFA), MSCI EAFE Small Cap (SCZ), MSCI Emerging Markets (EEM), Barclays Aggregate (AGG), Barclays TIPS (TIP), iBoxx \$ Investment Grade Corporate (LOD), JP Morgan USD Emerging Markets (EMB), and S&P National AMT-Free Municipal (MUB).

This announcement is a gut punch to Schwab, E-Trade, and TD Ameritrade in terms of \$0 commissionable trade costs on these core ETFs. It's a double-barrel shot, as Fidelity has also cut its retail trade commissions to \$7.95, below Schwab, E-Trade and TD Ameritrade, too. Finally, this move puts Fidelity into direct competition with Vanguard in the ETF arena, while also giving Vanguard's other big competitor, iShares, the potential to gain even more market share. Of course, the largest benefactors are ETF investors, who can cut down on their transaction costs, keeping more of their hard-earned money.

### **Vanguard Dividend Growth Switches Benchmarks**

Vanguard announced on February 1 that it was putting Dividend Growth into direct competition with Dividend Appreciation Index, changing the former's index bogey from the Russell 1000 to the same Mergent Select Dividend Achievers benchmark that is the basis for the index fund.

The Select Dividend Achievers Index consists of U.S. stocks that have increased their annual dividends for the last 10 or more years in a row. The index has considerable overlap with the largest companies in the S&P 500 Index. Since Wellington's Don Kilbride came onboard Dividend Growth four years ago, he's handily outperformed both this new benchmark, and Dividend Appreciation Index fund. This

benchmark change should have little to no impact on performance or how Kilbride manages this excellent fund.

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