4th Quarter 2012

Investment Thoughts

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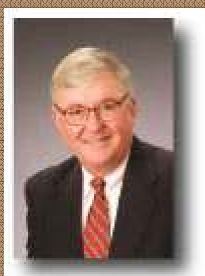
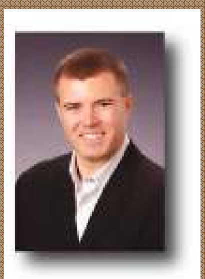
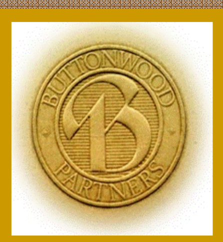






Dear Client,

Congratulations! If you are reading this, it means that the sun did in fact rise on Wednesday, November 7th. Which, given some of the posturing coming out of both parties prior to the election, hasn't always seemed like it was a given…

This barrage of hyperbole has contributed to an "all or nothing" mentality surrounding the election. A common question posed to us over the past few weeks has been, "What will it *mean* for my portfolio if *(insert "candidate you didn't vote for" here)* wins?" Our answer has been the same regardless of which candidate was referenced: probably less than you think it will. Recoveries from financial crises have historically been a slow process, and while it has been at a frustrating pace, progress is being made. And the recovery will continue to progress over the next four years under either candidate. Basically, our economy's future is more complex than simply who controls the White House (or Congress). While our response hasn't always been met with satisfied nods, we believe it is the truth.

Our featured article for this issue (page 2) touches on this subject by examining the historical stock market returns under both parties and concluding that presidents are most likely given too much credit when times are good - and are assessed too much of the blame when they aren't. (The author identifies interest rate movement as a more worthy candidate for driving stock market movements.) The bottom line is that old statistical adage: "Do not mistake correlation for causation."

No matter the outcome, what November 7th means is that the campaigning can end and the work of governing must begin. Because there is a lot of work to be done - starting by dealing with the "fiscal cliff." As a brief primer, the combination of expiring tax cuts and scheduled spending cuts that take effect January 1st are estimated to trim as much as 4-5% from GDP growth next year; in an economy growing at roughly 2%, the likely result would be a recession in 2013. Can the political parties, both of which have expressed their desire to avoid this outcome, find enough common ground (or negotiate enough give-and-take) to do so? The answer to that question is more likely to impact the day-to-day market movement in the coming weeks; but it is also likely to be a temporary impact.

We are quickly approaching the time of year that we like to encourage you to come in for a year-end review and begin making plans for the upcoming year. While the uncertainty surrounding the rules for 2013 makes this more challenging than most years, it also means there may be some unique opportunities that make getting together more important than ever. Please call or e-mail to set up an appointment and share some holiday cheer in person.

Sincerely,

Greg Rademacher, Chris Bugg and Jodie McLellan

"The Winner for Investors is…"

By: Jason Zweig

Date: October 20, 2012

Over the next few weeks, investors will be bombarded with commentary about how the outcome of the presidential election will influence the financial markets.

Before you even consider changing your portfolio based on the expected—or actual—results of the election, it's vital to analyze the conventional wisdom first.

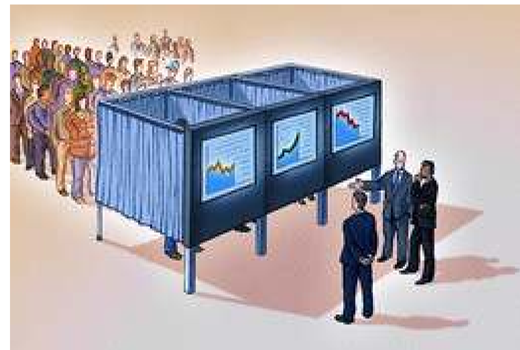
Is gridlock good—that is, should investors root against having the same political party control both Congress and the White House? Who is better for stock and bond returns: Republicans or Democrats?

Most of the answers you are likely to find are propaganda or wishful thinking; many are flat-out wrong. What matters are changes in interest rates, not which party passes through the White House gates.

Since 1926, when reliable stock-market data began, the United States has had 15 presidents and nine elections in which control of the White House passed from one party to the other. That's a small sample. So you should take any statistical conclusion about the relationship between presidential election results and financial returns with a grain of salt the size of the Capitol dome.

Such caveats won't stop pundits from speculating. One of their most prevalent beliefs: Gridlock is good for the stock market. (A Google search returns 135,000 hits on the phrases "gridlock is good" + "Wall Street.") And a divided Congress is what many political forecasters expect, with Pres. Obama winning re-election, the Democrats keeping the Senate and the Republicans retaining the House.

A hard look at the evidence, however, shows that "gridlock isn't good for stocks," says Robert Johnson, a finance professor at Creighton University in Omaha. In a working paper that covers 1965 through 2008, he and his colleagues found that gridlock had no effect on the returns of the big companies represented by the Standard & Poor's 500-stock index. Small stocks (as measured by Dimensional Fund Advisors' small-company portfolios) returned an average of 21 percentage points less in years when Washington was in gridlock than they did when Congress and the White House were under common control.



Bickering does have benefits: Corporate bonds have returned an annual average of nearly nine percentage points more in gridlock years than in years of governmental harmony. "Gridlock reduces the chances of the initiation of major government programs, which can be inflationary" and harmful to bond prices, says Prof. Johnson's colleague Gerald Jensen, a finance professor at Northern Illinois University.

Which party controls the White House certainly appears to matter. Since 1926, the Standard & Poor's 500-stock index has gained almost exactly twice as much under Democratic presidents as under Republicans, according to quantitative stock analysts Pankaj Patel and Joseph Handelman of Credit Suisse CSGN.VX -0.92%. Stocks have racked up an average annual return of 15.4% when a Democrat is in the White House, versus 7.8% under Republican presidents.

That doesn't mean stocks are bound to boom if Pres. Obama is re-elected. But as Adam Parker, chief U.S. equity strategist at Morgan Stanley, MS +1.77%points out, a presidential election hasn't resulted in a Democrat in the White House with a Congress divided along those lines in at least 112 years. So the historical averages might not even matter.

The dominance of stock returns under Democrats might be a subtle kind of statistical illusion. The research by Prof. Johnson and his colleagues suggests the Federal Reserve's monetary policy is far more important.

Since 1965, according to the study, large stocks have returned an annual average of nearly 12 percentage points more when the Fed was cutting rates than when it was raising them. (The researchers started their analysis then because 1965 was the dawn of modern Fed policy.) Over the same period, the difference in stock returns under Democratic versus Republican presidents was less than seven percentage points; a statistical analysis shows that the effect of Fed policy dwarfs the impact of presidential party.

In short, Fed policies matter more than party politics. Democratic presidents happened to benefit disproportionately from periods when the Fed was cutting interest rates—which is rocket fuel for stock returns. That's especially true for small stocks, which have returned 26 percentage points more, on average, in years when the Fed was cutting rates rather than raising them. Says Prof. Johnson: "There's no systematic relationship between the party of the president and asset returns."

What does all this mean for investors? You should cast your vote based on what you believe will benefit the country, not what pundits think will benefit your portfolio. Don't let anyone scare you into making major investment changes because one party or the other takes the White House. No matter who wins, it's the direction of change in interest rates that will make the biggest difference to the returns of the financial markets.

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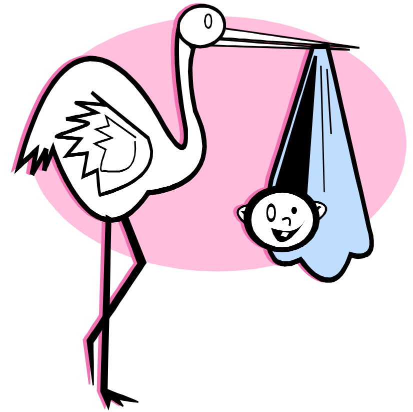
Still Waiting....

As of "press time" of this newsletter, Andrea and Eric are still waiting on the big arrival of their little girl. She was due on Nov. 13 and has decided that she's not quite ready to make her grand entrance. Despite this small setback, Andrea has officially started her maternity leave and will be returning to duty on Feb. 4, 2013. Our assistant, Linda Kwiatkowski, who has been with us since June 2011, will be taking over for Andrea while she is away. All of Andrea's email will be forwarded to Linda and she is more than capable of handling anything you throw her way. You can email her directly at linda@btnwd.com or call (608) 827-6411.



2013 RETIREMENT PLAN CONTRIBUTION LIMITS

PLAN TYPE				
	401(k), 403(b), 457	**Simple**	**Traditional or Roth IRA**	**SEP**
2012 Deferral Limit	**$17,500**	**$12,000**	**$5,500**	**N/A**
Catch-up if age 50+	**$5,500**	**$2,500**	**$1000**	**N/A**
Employer Contributions	**Match and/or profit-sharing**	**Up to 3% match**	**N/A**	**25% of pay or $51,000, whichever is less**
Annual pay eligible for contributions capped at $250,000				

It's the holiday season, time to gather with family and friends....

Due to the schedule of the New York Stock Exchange, Buttonwood Partners, Inc. will be closed on the following dates, giving us all time to enjoy our family and friends:

- November 22 (Thanksgiving Day)
- December 25 (Christmas Day)
- January 1 (New Year's Day)
- January 21 (Martin Luther King, Jr. Day)

On Friday, November 23rd and Monday, December 24th we will be open from 8:30 a.m. until 12:00 p.m.

"He had heard people speak contemptuously of money: he wondered if they had ever tried to do without it."

- **W. Somerset Maugham**
  Of Human Bondage

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Q4 Newsletter

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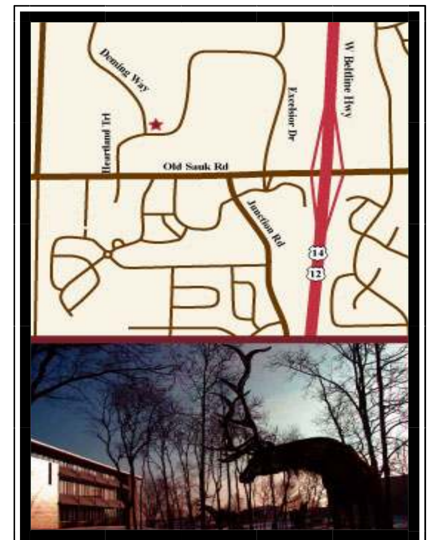

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