

The Goodman Report

Spring 2011

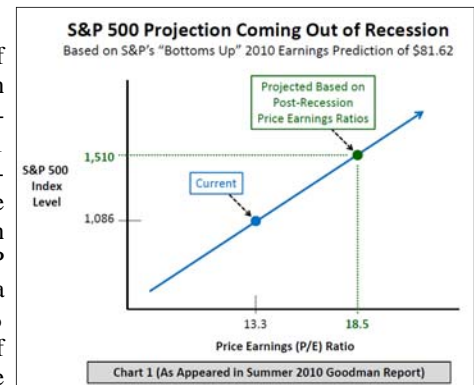


The Stock Market Rebound: Are We There Yet?

By Steven R. Goodman, CPA, CFP®
President & Chief Investment Officer

How do you answer that question when investing is both a journey and a destination, with the destination being a goal or target at a certain point in time? Of course the journey continues after reaching that target; unless, of course, one's goal is to spend every penny by the time that he/she dies. While our institutional clients measure targets against the benchmarks, many of our individual clients have a goal of growing their principal to a level where they can live off of the portfolio's return upon retirement, leaving the principal fully intact. Thus, the journey continues.

Last summer we published the chart to the right (Chart 1) referencing the current level of the S&P 500, as well as a projection based on S&P 500 earnings and historical post-recession price to earnings ratios (P/E). This post recession analysis follows the methodology of Wharton Business School professor Dr. Jeremy Siegel. With the S&P 500 currently at the 1,295.11 level, we are now 19.2% percent above the 1,086 level referenced in the summer 2010 newsletter, and 91.4% percent above the March 2009 low. On page 3 we have printed an update (Chart 2) indicating progress to date in that recovery as well as an updated target based on current 2011 earnings projections of \$95.46 per share for the aggregate earnings of the S&P 500 companies. Using the same post-recession P/E ratio of 18.5, the revised target would be a S&P 500 level at 1,766 points. This would suggest a further increase in stock prices of 36.4% from the current level, although the time period over which that gain will be achieved is, of course, unknown. Working in favor of reaching that target are the beginning of the



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Who is *Your* Chief Financial Officer?

By Ed Roth, CFA, CPA, CFP®, CEBS
Vice-President, Investment Advisory Services

In the last issue of *The Goodman Report*, we cited several reasons why it is beneficial to rollover your old 401(k) or 403(b) assets to an IRA. Consolidation of accounts, or centralized management of accounts, was among them. Let's describe why this reason is so important.

Financial well-being requires each of us to consider many variables when making decisions. Sometimes the issues are broad and strategic while other times very narrow and focused. Technical knowledge of finance, economics, taxation, accounting, and investments must be applied and tailored to specific goals and objectives. Emotions can influence decisions which may produce unintended consequences. Because these variables are quite common and demanding, it is reasonable to need the assistance of one or more experienced financial advisors. Ultimately, to oversee your overall financial well-being, the best solution is to have your own Chief Financial Officer (CFO). *Your* CFO will be a trusted advisor who

- 1) Retains a comprehensive appreciation of your goals and objectives,
- 2) Comprehends the complete picture of your financial situation,
- 3) Possesses vast technical knowledge,
- 4) Informs your other advisors of key decisions and coordinates necessary actions among them, and
- 5) Implements and monitors the investment strategy designed for you.

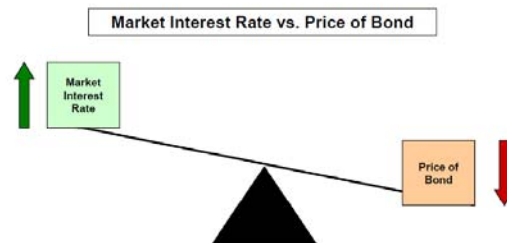
Your financial assets are directly linked to prudent financial decisions. Therefore, working with your CFO to consolidate your accounts and manage them in a centralized environment is a wise decision. Goodman Financial has a team of highly qualified professionals ready to serve as *your* CFO. Please call us at 713-599-1777 to schedule an appointment.



Bond Funds, Bond Premiums, Price Volatility and Market Interest Rate Changes

By Drew R. Roever, Financial Planner/Analyst

Fixed income mutual funds have gained a lot of attention in recent publications and media. While an investor is able to easily gain fixed income exposure in his/her portfolio through the use of the many bond funds available (short-term, long-term, taxable, non-taxable, etc.), a very important negative associated with most of these funds is that they never mature. As shown in the 'Market Interest Rate vs. Price of Bond' chart, bond prices trend in the opposite direction of the general trend of market interest rates. This is especially relevant for bond funds in today's interest rate environment because of rates being at historically low levels. As market interest rates rise in the future, bond prices will fall.



If you hold individual bonds their value may temporarily decrease during rising interest rate environments, but the bonds will mature at their par value. Bond funds, however, hold numerous individual bonds with a targeted average bond maturity of, for example, 5 to 10 years. Since investors are able to trade in and out of bond funds at the end of each trading day, bond fund managers must be able to accommodate these trades. In order to do this, funds regularly sell individual bonds to meet withdrawal demands while staying in the funds' targeted average maturity range. Because these bond fund values are tied to the underlying values of the individual bonds they hold, a share owner is exposed to the full impact of changes in market interest rates. This means if an investor happens to buy a long-term fixed income fund today and market interest rates jump in the near future, the price of the fund will drop significantly, possibly precipitating withdrawals by others (and related sales of bonds in the fund); whereas, the individual bond holder experiences only a temporary, unrealized loss until the maturity date.

With the current state of the economy, and interest rates at historic lows, the bond market is seeing the majority of issues trading at premiums (prices above par, or 100) because they were issued in past years when interest rates were higher. However, rather than looking at these higher prices as instant 'losses' on principal when the bonds are purchased, the bond's ability to provide investors with higher income and reduced volatility should be recognized.

Imagine you have \$10,000 in your hand as you read this. As a *frequent* reader of *The Goodman Report*, you hopefully would never accept the opportunity cost of lending out your money for five years without receiving appropriate interest payments. Now, imagine a person sitting in front of you asks to borrow your \$10,000 but will repay you in full at the end of five years while also paying you annual interest payments. Pretty good deal, right? However, what if in the previous scenario you had to lend out \$10,900 to receive equal annual interest payments and \$10,000 back in five years?

At first glance, the majority of people assume they are instantly losing \$900 by not receiving the full \$10,900 they initially lent. This is a common notion among investors when purchasing bonds at a premium. To better understand fixed income premiums and their impact to investors, a general understanding of the price and interest rate relationship is needed.

Corporations issue bonds as a way to borrow large amounts of money. They are usually issued at a par value, which is how much the lender of the money to the corporation will receive at the time the bond matures. Bonds may later be sold to investors at a discount or at a premium. In the example above, \$10,000 would be the par (face) value, and \$10,900 would be the amount paid, which includes a premium for the bond (the extra \$900 on the original \$10,000 value). A \$600 interest payment, once a year, on \$10,000 principal is stated as a 6% annual coupon payment. Suppose in one year that market interest rates fall from the 5% rate they were at when you purchased the 6% coupon bond above to a new market interest rate of 4%. Corporations are now only willing to pay 4% annual coupon payments on newly borrowed money so the price for the outstanding 6% bond you hold will go higher (these bonds are more valuable to investors because they provide a 2% higher annual coupon payment than market rate, hence buyers are willing to pay more). This creates an inverse relationship between bond prices and market interest rates as was seen in the 'Market Interest Rate vs. Price of Bond' chart.

	Bond A	Bond B
Par Value	\$10,000.00	\$10,000.00
Coupon (Annual)	6.00%	3.00%
Years till Maturity	5	5
Market Interest Rate	4.00%	4.00%
Current Price	\$10,890.36	\$9,554.82

Paying a premium on a bond with a coupon rate higher than current interest rates will enable you to receive higher periodic interest payments on the money you lent to the corporation. This greater income can then be reinvested into additional fixed income securities, creating interest-on-interest.

For purposes of this illustration, assume we have the following two bonds, Bond A and

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Bond Funds, Bond Premiums, Price Volatility and Market Interest Rate Changes (continued from page 2)

Bond B, shown in Table 1.

We have Bond A offering a 6% coupon payment and Bond B offering a 3% coupon, with market interest rates at 4%. Bond A is offered at a price including premium of \$10,890.36 because we gain a full 2% more income than market rates offer, while Bond B can be bought at a discount, price of \$9,554.82 due to its lower coupon. In order to take advantage of the larger interest payments, we purchase Bond A at the premium price. Now assume market interest rates suddenly jump by 2% to 6% after you just purchased Bond A paying a 6% coupon. Before you kick yourself for paying a premium on a bond that is now at current market interest rates and par value, let's take a closer look at this situation in Table 2.

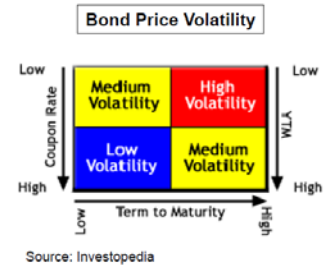
TABLE 2		
Market Interest Rates Rise by 2%		
	Bond A	Bond B
Par Value	\$10,000.00	\$10,000.00
Coupon (Annual)	6.00%	3.00%
Years till Maturity	5	5
Market Interest Rate	6.00%	6.00%
Revised Price	\$10,000.00	\$8,736.29
% Price Change	-8.18%	-8.57%

Bond A has dropped in value because of the rise in market interest rates, yet its percentage price change drop was less than Bond B which was purchased at a discount. And, you will continue to receive the higher annual interest payments with Bond A (\$600 vs. \$300). The rise and fall of fixed income prices as a result of outside factors is known as bond price volatility. Bond A has a more stable price than Bond B because of the premium providing a cushion if market interest rates were to rise. As we can see in Table 2, for a given term to maturity and market interest rate, the percentage price volatility of a bond is lower the higher the coupon rate.

TABLE 3			TABLE 4		
Market Interest Rates Rise by 2%			Market Interest Rates Rise by 2%		
	Bond C	Bond D		Bond C	Bond D
Par Value	\$10,000.00	\$10,000.00	Par Value	\$10,000.00	\$10,000.00
Coupon (Annual)	5.00%	5.00%	Coupon (Annual)	5.00%	5.00%
Years till Maturity	3	10	Years till Maturity	3	10
Market Interest Rate	4.00%	4.00%	Market Interest Rate	6.00%	6.00%
Current Price	\$10,277.51	\$10,811.09	Revised Price	\$9,732.70	\$9,263.99
			% Price Change	-5.30%	-14.31%

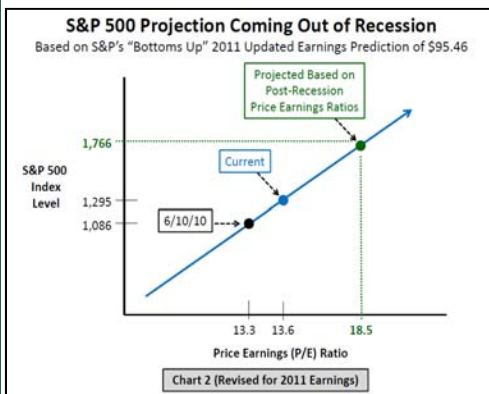
In addition to a bond's coupon, the other primary factor that influences a bond's price volatility is its term to maturity. The term to maturity is the specific date in the future that the corporation will pay you back the principal (face value) amount of the bond, which in this illustration is \$10,000. For a given coupon rate and market interest rate, the shorter the term to maturity, the lower the price volatility in terms of percentage price change. This is illustrated in Tables 3 & 4.

Goodman Financial Corporation's fixed income strategy has taken all these factors into consideration and we will continue to do so. Our purchases remain in individual bonds on the short to intermediate term of maturities, currently in the one to six year range, while also requiring minimum yield and coupon targets for each year. For example, in today's environment we will only purchase bonds with **at least** a 3% coupon rate with a maturity date three years out. This places our strategy in the bottom left corner of the 'Bond Price Volatility' chart, low volatility.

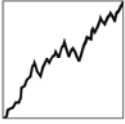


Also, keep in mind the majority of our clients hold their bonds to maturity, receiving the full par value of the bond. So if the value of a \$10,000 bond were to drop to even \$9,250 but it does not mature for another three years, then this is only a temporary, unrealized loss that will "disappear" as the bond approaches maturity. This is a key advantage that you cannot achieve with bonds held through mutual funds.

The Stock Market Rebound: Are We There Yet? (continued from page 1)



deployment of large sums of cash on corporate balance sheets, interest rates that remain at historically low levels, improved investor confidence, and rising corporate earnings. Working against that target are elevated oil prices, political turmoil overseas, and political and regulatory risk emanating from the U.S. Congress and Administration, primarily from a regulatory perspective. While some see the actions of the Federal Reserve as a risk, we would suggest that in the near term, it has been part of the solution, albeit, its actions shift the risk a good bit out into the future. On balance, the market should recover beyond the pre-recession levels as corporate earnings are now at all time highs and moving higher. It also may be a logical conclusion that once the targets indicated in Chart 2 are achieved, we will see more subdued returns. As with any journey there will be twists, turns, and bumps along the way, and there is no substitute for managing one's portfolio with an appropriate asset allocation.



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The Goodman Report

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FOCUS ON PHILANTHROPY

Goodman Financial Made Record Charitable Contributions in 2010

During 2010 our firm remained active in the philanthropic community. We served in both volunteer and professional capacities for a number of organizations and continued to grow our financial support. Probably the highlight of our 2010 giving was our pledge and initial funding of a **\$100,000 TierOne Scholarship Endowment** at **The University of Houston** thanks to the continued support of the **Fred & Mabel Parks Foundation** and matching by the **Conrad N. Hilton Foundation**.

Additional contributions (some big, some small) during the 2010 year include **Yellowstone Academy, UH Alumni Association, Clayton Library Friends, Houston TSCPA Foundation, Girl Scouts of San Jacinto Council, Santa's CPA's, Alzheimer's Association Houston & Southeast Texas Chapter, The Leukemia**

& Lymphoma Society, and Houston Area Women's Center.

The Goodman Financial UH TierOne Scholarship Endowment at the University of Houston



GIVEN IN SUPPORT OF THE UNIVERSITY OF HOUSTON

We also continued our support of the **Planned Giving Council of Houston**, hosting its monthly board meetings. Finally, Steve Goodman was privileged to begin service in January 2010 as an advisory director of the **Albert & Ethel Herzstein Charitable Foundation**. His service included being one of the two directors representing the foundation at the **Philanthropy Roundtable**.

Hopefully we can do even more in 2011. As always, let us know if we can guide you in enhancing your philanthropic participation.