QUARTERNOTES

April/May/June2009

Most swans are white, as most people know. Students of finance, oddly enough, are acutely aware that some swans are black. They know this because the phenomenon of the black swan was seized by economist Nassim Nicholas Taleb as a metaphor for the fundamental unpredictability of the financial markets. The discovery of a black swan in 1697 upended years of scientific “certainty” about this species. In the same way, there are events that upend what we think we know about and expect from the financial markets.

Taleb’s book, *The Black Swan*, was published in 2007, and it proved eerily prescient. The current recession began in December 2007 and has deepened dramatically since then. As a result, Taleb’s ideas have become prominent in the financial press. He defined a “black swan” as:

• rare, outside the realm of our normal expectations;

Continued on next page

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Jim Ostyn

To My Valued Clients:

During these uncertain economic times, I know that you will find the information in these quarterly newsletters to be very beneficial. We strive to keep you informed of current market conditions as they pertain to your portfolios. Together, we will weather this current financial storm. Do not hesitate to call me with any questions that you may have.

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• extreme, with an extraordinary impact; and

• retrospectively predictable, that is, although no one saw it coming, now we see how we might have.

The current banking crisis is a black swan. It's possible that the crisis in the auto industry is one as well. The trouble with black swans is that, because they are inherently unpredictable, one can't plan for them either.

The risk of missing out on the upside

Black swans are not always negative developments, however. Positive news can translate into a burst of bullishness in the stock market. Careful study reveals that a remarkable amount of the market's long-term gain comes on relatively few trading days.

Business professor Javier Estrada, of the IESE Business School in Barcelona, Spain, quantified the effect that black swans can have on investment returns. He studied the Dow Jones Industrial Average for the period from 1900 through 2006. Looking at the best 100 trading days, the lowest return was 3.9 standard deviations above the mean. Statisticians will tell you that suggests such a return should be seen once in 83 years—yet that return or better occurred 100 times in the period covered by the study.

To translate Estrada's findings into dollars, $100 invested in the DJIA at the beginning of 1900 would have grown to $25,746 by the end of 2006.* However, if the investor had missed just ten days of that 107 years, the investment would have grown to only $9,008, a reduction of 65%. Miss the 20 best days, and the portfolio grows to only $4,313. Finally, missing the 100 best days of the 29,190 in the period under study, one-third of one percent of the trading days, results in a loss of capital, as the terminal wealth would be just $83.

As for the black swans on the downside, Estrada documents that if you could keep all the best days and avoid just the ten worst days, terminal wealth would jump to $78,781. If you had predicted the 100 worst days and avoided them, your $100 would have grown to an astonishing $11,198,734!

Coming off the bottom

The tricky thing about bear markets is finding the bottom. In long downturns there can be a number of "bear market rallies" before the true bottom is reached, and the current market is an example of that. But history shows that once a bottom is reached, the subsequent bull market returns happen disproportionately in the next 12 months.

For illustration only. Past performance does not predict future results.

Date of bull market	Total bull market return	12-month return from bottom	% of total in first 12 months
June 1932 - March 1937	324%	121%	37%
April 1942 - May 1946	158%	54%	34%
May 1970 - January 1973	74%	44%	59%
October 1974 - November 1980	126%	38%	30%
October 2002 - October 2007	101%	34%	34%

Source: M.A. Co.

And it's not just the U.S. stock market that exhibits such behavior. Estrada went on to document similar results in foreign markets as well. He concludes: "A negligible proportion of days determines a massive creation or destruction of wealth. The odds against successful market timing are just staggering."

Lessons for investors

What can investors take away from studies such as these?

The costs and risks of trying to time the market probably are larger than the potential benefits. Academic studies of returns are inherently artificial and tend to overstate returns because they do not factor in transaction costs or taxes. Thus, the case against market timing is likely even stronger than suggested by Professor Estrada.

Over the long term, the stock market has balanced the negative and positive abnormal days. Past performance does *not* guarantee future results, but, overall, stocks have outperformed all other investment classes.

Diversification may help moderate the impact of black swans. On a day when the stock market overall is down, some stocks are, nevertheless, up. Stock selection matters. The bond market doesn't always move in lockstep with the stock market, so an allocation to this asset class also may reduce the impact of daily swings. Keeping some cash on hand may help the investor weather a rough patch, or even take advantage of opportunities that arise.

The value of a trusted advisor

No one has magical answers for these unprecedented markets, but we can offer you our experienced perspective. We will be pleased to review your holdings and share our thoughts on how you may be positioned to weather the current storms.

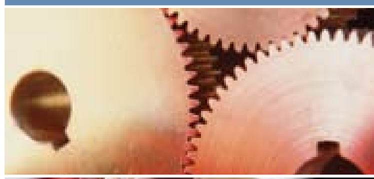
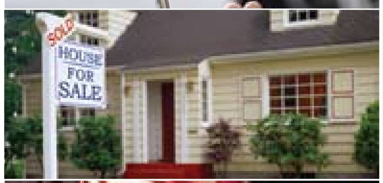
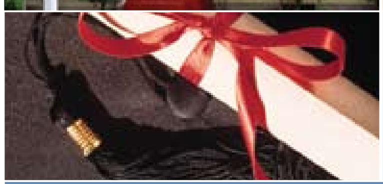
**The DJIA is an unmanaged index. You cannot invest directly in an index.*

What's in the "stimulus bill" for you?

Legislation to boost the economy, signed on February 17 by President Obama, included about $300 billion in tax breaks. Some of these benefits will flow automatically, such as the Making Work Pay credit of $400 for most taxpayers who are working. Their tax withholding will be adjusted to reflect the credit. Similarly, taxpayers need to do nothing to get the benefit of the inflation adjustment applied to the Alternative Minimum Tax exemption, which was the largest single element of the legislation in terms of lost tax revenue.

The following three tax breaks, in contrast, are conditioned upon taxpayer actions. Not everyone is eligible for each item, and there are some tricky dates, so it will be important to read the fine print or consult a tax advisor before taking action.

Could you benefit from these new tax breaks?

		Full benefit up to AGI of:	
	Change	Singles	Joint filers
	Making Work Pay credit	$75,000	$150,000
	New car purchase sales tax deduction	$125,000	$250,000
	First-time homebuyer's credit	$75,000	$150,000
	American Opportunity Tax Credit	$80,000	$160,000

Source: American Recovery and Reinvestment Tax Act of 2009

First time homebuyer credit.

To draw more buyers into the housing market, Congress last year created a $7,500 credit for those who bought their first home from April 9, 2008, through December 31, 2008. That credit, however, must be paid back to the IRS over time, so it's really more like a loan. A new $8,000 first-time homebuyer credit is now available, and this one doesn't need to be repaid. It's for homes purchased from January 1, 2009, through November 30, 2009. *Note*: The key date is when title passes, not when the contract is signed, so don't wait until the last minute if this credit will be important to you.

Sales tax deduction for new car purchase. To give the auto industry a boost, Congress created an "above-the-line" deduction for sales or excise taxes generated by the purchase of a new vehicle after February 17, 2009, and before January 1, 2010. The tax break applies to cars, light trucks, SUVs and motorcycles, and to both foreign and domestic makes. However, it does not apply to leases. The tax break is limited to the first $49,500 in vehicle value, and to only one vehicle purchase.

American Opportunity Tax Credit. The HOPE education credit has been replaced, for the 2009 and 2010 tax years. This new credit is for 100% of the first $2,000 in qualified education expenses and 25% of the next $2,000, for a total of $2,500. Up to 40% of the credit may be refundable. This credit is allowed for all four years of college.

Each of these tax breaks is subject to income limitations as well—see the box above for details.

JUST ASK US

I reach age 70½ this year. Do I need to start required minimum distributions (RMDs) from my IRAs?

No, you do not. Because of the steep market decline, Congress suspended the required minimum distribution rules for defined contribution plans for 2009. The concern is that RMDs force IRA owners to, in effect, lock in losses on their holdings. Those that don't have an immediate need for the funds can wait for the market to reach higher ground before withdrawing.

I reached age 70½ in 2008, so my first RMD was due April 1, 2009. Does the suspension of the rule apply to that distribution, too?

No, it does not. Distributions for the 2008 tax year remain required, even though the due date for receipt was April 1, 2009, for those age 70½ in 2008. You may skip your distribution for the 2009 tax year if you wish.

I've been receiving RMDs for several years already. What about me?

Contact your IRA custodian. You have the right not to take an RMD this year, but the custodian may send it to you anyway, unless you give contrary instructions. Of course, you can take the RMD if you need the money for retirement expenses. You can take more than the RMD without penalty.

Once canceled, RMD instructions will need to be re-established for 2010 and future years. New paperwork is required to re-establish RMD payments.