

AFIM Insights & Observations

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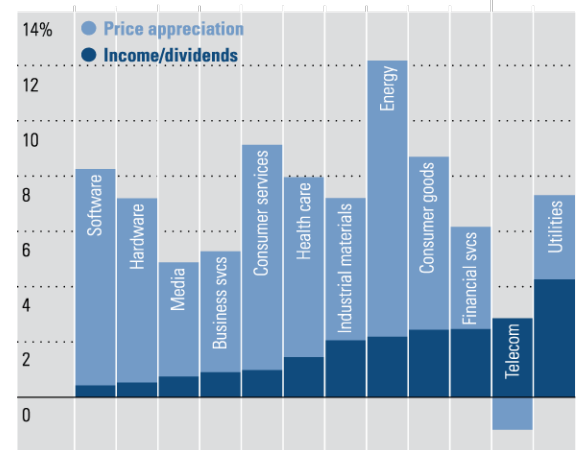
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Breaking Down Sector Returns

Owning individual stocks can be risky. Buying into sector funds allows investors to participate in ever-changing business and economic cycles while reducing company-specific risk.

Just as equity and fixed-income investments play different roles in investors' portfolios, so do sector investments. Some sectors generate greater income-return potential like bonds, while others focus on price appreciation. The chart shows the income and price appreciation of various sectors over the most recent 15-year period. The right side of the chart highlights sectors that historically provided a good level of income relative to the sectors on the left side of the chart, which have focused on growth. Certain sectors, like energy and utilities, combined the best of both worlds and became appealing to diverse investors.

Price Appreciation and Income Return of Various Sectors 1996–2010



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Instructor Corner

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Remember: It's not that we plan to fail, it's just we fail to plan

A Quick Guide to Leading Economic Indicators

Turn on CNBC on any given day and you are bound to hear about various economic indicators and how they might affect the markets. Although we believe in investing with a long-term horizon, investors should learn what the key economic indicators mean and how they could potentially affect one's portfolio.

Leading indicators are economic indicators that anticipate a change in the direction of the economy and are useful as short-term predictors. Some of these include the returns on the S&P 500 Index, consumer sentiment and expectations, changes in the employment rate, and production levels in the manufacturing sectors.

The unemployment rate represents the percentage of the working population that does not have a job, have actively looked for work in the prior four weeks, or are waiting to be rehired to a job from which they had been temporarily laid off. This figure is seasonally adjusted to reflect the impact of predictable seasonal patterns. In addition to the overall unemployment figure that is often quoted in the media, data on sector-specific unemployment figures can be obtained from the U.S. Bureau of Labor Statistics. For example, in December 2010, there were gains of 12,000 retail jobs while the construction sector lost 16,000 jobs. These figures can be important for investors who wish to invest in sector-specific ETFs, or are looking to increase their portfolio exposure to a specific sector.

Average workweek hours looks at the productivity of the workforce. In the past few quarters, statistics have shown that companies have been cutting costs by getting their existing employees to work longer hours, instead of rehiring laid off workers. In addition, the U.S. Bureau of Labor Statistics provides quarterly statistics on output per hour and productivity. Typically, in an economic recovery, real wages increase first, followed by hours worked, and finally employment. Given that there are only so many techniques that companies can use to

increase productivity out of workers, further increases in production will eventually result in an increase in employment. This indicator is a good gauge for overall business confidence sentiment.

The University of Michigan Consumer Sentiment Index is created using results from approximately 500 telephone interviews conducted each month. The index is used to forecast spending behavior and economic expectations of consumers, and consumer attitudes on savings, spending, and the business climate. It is frequently cited that consumer spending accounts for about 70% of the GDP in the United States and thus, is an important indicator especially if you are heavily invested in the consumer cyclical sector, in areas like the restaurant, retail, and travel industry.

Both the Chicago Purchasing Managers Index (PMI) and the Institute for Supply Management Index (ISM) look at economic activity in the manufacturing sector based on factors such as production, inventories, new orders, and exports and imports. These statistics are particularly important to investors who wish to seek exposure to the industrials or basic material sectors. However, investors should also take note that manufacturing activity increases because of increased consumer demand, and has been a shrinking portion of our GDP, as compared to the services sector.

The returns on the S&P 500 Index are also regarded as a leading economic indicator. This index includes 500 of the largest publicly listed companies in the U.S., comprising 75% of all U.S. equities. It is considered a leading indicator because changes in stock prices might reflect investor's expectations for the future of the economy.

Past performance is not indicative of future results. Returns and principal invested in stocks are not guaranteed. Sector investments are narrowly focused investments that typically exhibit higher volatility than the market in general.

Another Option for Early-Retirement Withdrawals

The recent recession has hit older workers disproportionately. Older workers generally spend a longer time looking for jobs once they've lost them. The sad result is that individuals are tapping retirement accounts to stay in their homes and fund other living expenses, as well as to pay for major life changes such as relocation or further education.

IRA-withdrawal rules are particularly complicated, so this article will focus on one aspect of them in-depth: withdrawals based on the so-called 72(t) exception. Although it's almost never ideal to raid your retirement accounts prematurely, this type of withdrawal may be useful for people who need additional cash to carry them through a specific period in their lives--before they're eligible for a pension or Social Security, for example.

In a nutshell, the 72(t) exception allows individuals who are younger than age 59 1/2 to avoid the 10% early-withdrawal penalty for premature IRA distributions. (It does not help you circumvent any taxes owed on the IRA, however; just the 10% penalty.) To take advantage of 72(t), individuals must receive their IRA assets in what the IRS calls "substantially equal period payments" for a period of at least five years. The payments must continue until the age of 59 1/2 or until five years have elapsed, whichever is longer.

The net effect of that rule is that everyone using this exception will need to take withdrawals for at least five years, and younger folks will have to take distributions over many years. A 50-year-old woman, for example, would have to spread her distributions over 9 1/2 years, until she's 59 1/2. Meanwhile, a 57-year-old man who initiates 72(t) distributions would need to take the distributions for five years until he turns 62, well after he'd already hit the 59 1/2-year mark. If you've begun taking 72(t) distributions but later determine you want to stop, you'll owe the IRS the 10% penalties for early IRA distributions, plus interest. For that

reason, it's crucial to be sure that substantially equal periodic payments will work for you.

You don't have to liquidate all of your IRA assets to take advantage of 72(t); if you have separate IRA accounts, you can withdraw from some and leave others alone. It's also possible to reposition your assets in advance of a 72(t) distribution--that is, leave some money in an IRA to compound and grow while repositioning other assets in short-term securities for 72(t) distributions.

Furthermore, though the majority of people using this distribution method are doing so with traditional IRA assets, it's also possible to apply this distribution method to Roth assets. (This won't often be desirable, however.)

In general, 72(t) withdrawals will tend to make the most sense for people who need income during a certain period of time. And at the risk of stating the obvious, they'll also be best for folks who have an alternate source of retirement funding besides the amount that they're paying themselves through 72(t).

On the flip side, using this withdrawal method can be complicated and paperwork intensive. It won't make sense for those who need a lump sum to start a business or buy a vacation home because the whole point of 72(t) is that you're receiving payments during a period of at least five years. Nor will 72(t) usually make sense for Roth IRA holders, who have a lot more flexibility in taking withdrawals than do traditional IRA holders. Finally, those who leave their former employers at age 55 or after and have assets in their old 401(k)s can take penalty-free withdrawals directly from their accounts; rolling the assets into an IRA in order to facilitate 72(t) distributions wouldn't be necessary.

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Investing With(out) Frontiers

The United States is generally considered a developed country with a strong economy (lately, not so strong), but investments in other countries and regions have the potential to provide better returns than U.S. investments.

In the commonly used classification system, countries generally fall into two categories, developed and developing (or emerging). Developed countries have stable economic and political systems, strong levels of industrialization, and healthy economic indicators (such as gross domestic product and income per capita). Examples of developed countries include the U.S. and Canada in North America, the U.K., France and Germany in Europe, Japan in Asia, and Australia. Developing countries have weaker economies and lower economic indicators, but they are making significant progress toward becoming like the stronger, developed markets. Examples include Poland and Hungary in Europe, Mexico and Chile in Latin America, and China and India in Asia. But there remain countries that don't fit into either category, making the need for a third category apparent. These economic leftovers are called "frontier markets."

In 1992, the International Finance Corporation first established the term "frontier markets" to designate countries undergoing multiple economic changes with the goal of attaining a modern, capitalist market economy while still facing significant problems like unemployment and poverty. From an investor's perspective, these markets are obviously very risky and illiquid because of their general political and economic instability. On the positive side, these countries also have the potential to grow quickly and are usually in need of foreign funds in multiple areas, such as infrastructure, health care, and residential or commercial real estate. Opportunities for investment are abundant. Frontier markets may contribute to increasing returns, and their elevated risk levels can possibly be reduced if the investments are included as part of a diversified portfolio.

As of December 2010, MSCI Barra identified 26 countries as frontier markets. They include many countries in Eastern Europe and in what used to be the Soviet bloc, like Romania, Bulgaria, Kazakhstan, Lithuania, and the Ukraine. In Africa, frontier countries include Kenya, Mauritius, Nigeria, and Tunisia, while in Asia and the Middle East some examples are Jordan, Kuwait, Lebanon, Pakistan, Sri Lanka, the United Arab Emirates, and Vietnam.

The image illustrates the growth of \$100 invested in frontier markets, emerging markets, non-U.S. developed markets, and the U.S. market from June 2002 through December 2010. Emerging markets provided the highest return and the largest ending value during this time period, followed by frontier markets. International developed markets provided a decent return, but they lagged behind their less-developed counterparts. Out of all four investments, the U.S. market performed the worst during the time period analyzed.

Frontier-Market Performance



The short time frame is dictated by data availability.

Past performance is no guarantee of future results. All values are in USD. Returns and principal invested in stocks are not guaranteed. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, liquidity risks, and differences in accounting and financial standards. Frontier-market investments are riskier than developed- and emerging-market investments.

Source: U.S. stocks are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. International developed stocks are represented by Morgan Stanley Capital International Europe, Australasia, and Far East (EAFE®) Index. Emerging-market stocks are represented by the Morgan Stanley Capital International Emerging Markets Index, and frontier-market stocks by the Morgan Stanley Capital International Frontier Markets Index.

Be a Better International Investor

International funds have received a lot of attention in recent years, and this should come as no surprise. For starters, it has become increasingly common for investors to build multi-fund international portfolios rather than rely on individual foreign offerings for all their overseas exposure. Further, international funds have posted exceptional gains in recent years (except 2008). This may sound good if a significant part of your portfolio is devoted to international funds, but be sure the popularity and performance of overseas offerings hasn't made you complacent.

In fact, it's just as important to periodically reexamine the parts of your portfolio that have done well and reevaluate the portions that have lagged.

If you do take on international funds, remember to keep both your near-term expectations and your overseas exposure in check. You can also consider conservative foreign funds.

The first step is to set reasonable expectations for the short- to mid-term prospects of international funds. The superior relative gains posted by various types of overseas offerings in recent years, with the exception of 2008, may not be sustainable in the long run.

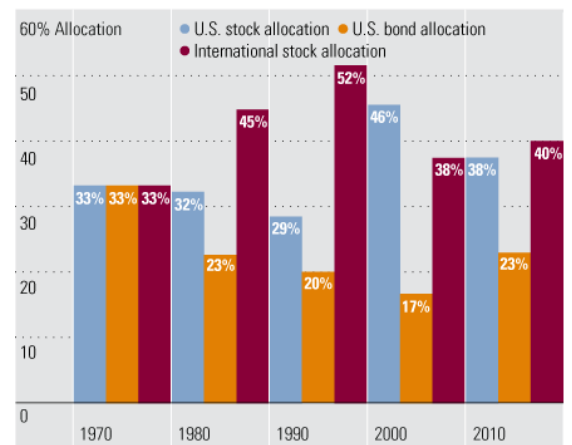
Given the superior performance of overseas offerings, check to see whether their overall foreign exposure exceeds the upper end of their international allocation range. A great portfolio performer can take on a larger percentage than you intended. Keeping an eye on your international allocation can help lower the overall risk of a portfolio.

The illustration paints a rather clear picture of this. In 1970 this portfolio began with an equal allocation to international stocks, U.S. stocks, and U.S. bonds. However, due to the strong performance of international stocks during the 1980s and 1990s, allocation to this asset class jumped to 52%. While many might overlook this shift in international exposure, keep in mind that international stocks have historically been riskier

than their U.S. counterparts. As a result, the portfolio may take on an additional level of risk.

If you need to rebalance your overseas portfolio to reduce overall risk, or seek more foreign exposure, consider conservative foreign investment vehicles. Aggressive international investments have a higher probability of incurring damage during a prolonged downturn. Investing in conservative foreign funds can help balance this risk.

Importance of Rebalancing



Weights may not add up to 100% due to rounding.

Diversification does not eliminate the risk of experiencing investment losses. This is for illustrative purposes and not indicative of any investment. An investment cannot be made directly in an index. Past performance is no guarantee of future results. Government bonds are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest, while returns and principal invested in stocks are not guaranteed. International investments involve special risks like fluctuations in currency, foreign taxation, economic/political risks, and differences in accounting and financial standards.

Source: U.S. stocks are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. International stocks are represented by the Morgan Stanley Capital International Europe, Australasia, and Far East (EAFE®) Index. U.S. government bonds are represented by the 20-year U.S. government bond.

Closed-End versus Open-End Funds

The general term “mutual funds” usually refers to investment vehicles more specifically known as open-end mutual funds (the “mutual funds” denomination has become so mainstream that the open-end classification is commonly omitted). However, there exists a second mutual fund category identified as closed-end funds. This category is lesser known and much smaller: Closed-end funds total only \$216 billion in net assets, compared to \$8.4 trillion for open-end funds. Three important differences between these two categories of mutual funds are outlined below.

1. Share issuance: Open-end funds can issue an unlimited amount of shares and then redeem them on demand. Closed-end funds generally issue a fixed number of shares at inception in a process known as an initial public offering (IPO). These shares are then traded on an exchange, similar to stocks. A closed-end fund can issue new shares after the IPO, but this is rare. A closed-end fund can, if it chooses, convert itself to an open-end mutual fund and issue an unlimited number of shares.

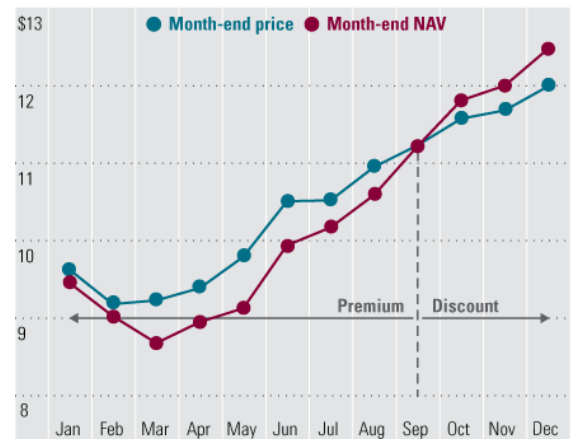
2. Share transactions: Shares of an open-end mutual fund can be purchased directly from the fund at any given time. An investor can go directly to the fund company and buy shares, or sell shares back to the fund if he or she already owns them. In contrast, closed-end fund shares trade on an exchange, like stocks, and are normally purchased through a broker, who charges a commission. Closed-end shares can be bought and sold during normal market hours and, as a consequence, their market prices also fluctuate throughout the day. Open-end shares are only priced once a day at market close.

3. Share price: The price of open-end fund shares is equal to the net asset value, NAV (the value of all the fund’s assets divided by the total number of shares). For closed-end funds, it’s not that simple. Since closed-end funds are traded on an exchange, prices are established by the market, and shares can trade at prices different than the fund’s net asset value. If the price is higher than

the NAV, shares are said to be trading at a premium—investors are willing to pay more than the fund is really worth. Conversely, if the market price is lower than the NAV, the fund is trading at a discount. This can be considered an advantage of closed-end funds over open-end ones: who wouldn’t want to buy something at a price lower than its true value?

The image shows how month-end price and net asset value can fluctuate for a hypothetical closed-end fund. From January through September, the fund’s market price is higher than its NAV; the fund is trading at a premium. From October through December, however, the situation is reversed and the fund is now trading at a discount.

A Closed-End Fund Can Trade at a Premium or at a Discount



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. The closed-end fund represented in the image is a purely hypothetical example and does not represent an actual fund. The investment return and principal value of mutual funds will fluctuate and shares, when sold, may be worth more or less than their original cost. Closed-end funds are subject to unique risks, most notably liquidity risk. **Holding a portfolio of securities for the long term does not ensure a profitable outcome and investing in securities always involves risk of loss. Mutual funds are sold by prospectus, which can be obtained from your financial professional or the company and which contains complete information, including investment objectives, risks, charges and expenses.** Investors should read the prospectus and consider this information carefully before investing or sending money. Total net asset values from Morningstar’s database as of April 27, 2011.

The Labyrinth of Financial Statements: The Balance Sheet

Public companies in the United States are required by law to disclose relevant business figures and other information. They do this in the form of financial statements: documents whose purpose is to offer detailed information on the company's financial situation: what the company owns (assets), what it borrowed and therefore has to pay back (liabilities), its stock, profit, cash going in and out, and other figures. All financial statements must follow official accounting rules and must be publicly available. There are three major financial statements: the balance sheet, the income statement, and the cash-flow statement. This article will focus on the balance sheet.

The balance sheet basically lists, in detail, what a company has and what it owes. It is organized into three sections: assets, liabilities, and shareholders' equity. Think of it as an individual sitting down at the end of the year and making a list: 1) Items owned (assets): house, furniture, car, books, and so on.; 2) Items owed (liabilities): mortgage, college loan, etc.; 3) Shareholders' equity can be thought of as total value—an individual's net worth.

1. Assets: Assets refer to resources the company owns. They include cash and cash equivalents, accounts receivable (payments the company is waiting for after the sale of products or services), inventories (supply of materials used in operations), and PP&E (property, plant, and equipment). Assets can be current or non-current. Current assets are defined as cash and other items that will be converted to cash within one year. Cash, accounts receivable, and inventories are considered current assets. Property, plant and equipment are considered non-current assets. An important term you may see in this section is depreciation or accumulated depreciation. This represents the decrease in the value of physical resources caused by wear and tear over time. For example, a piece of factory equipment is originally purchased for \$50,000, but after being used for a year, its value decreases to \$40,000. The \$10,000 difference is depreciation.

2. Liabilities: Just like an individual, when a corporation does not possess the resources necessary for its operations, it has to borrow (from investors or other corporations). When the company borrows, it owes money and is therefore in debt. Debts owed are called liabilities on financial statements. Liabilities include short-term (current) and long-term debt (obligations lasting longer than one year), accounts payable (what the firm has to pay its suppliers, for example), taxes payable (what the firm has to pay in taxes) and interest payable (interest the company owes to its lenders). Who does the company borrow from? A company usually borrows by issuing bonds, which are bought by investors (either individuals or institutions). When you include a bond in your portfolio, you are, in reality, lending money to the company and receiving interest on that money.

3. Shareholders' equity: The third item on the balance sheet is called shareholders' equity (or owners' equity). This represents the total sum of money stockholders have invested in the firm. The shareholders' equity portion of the balance sheet will list the dollar value and the number of shares for the company's common and preferred stock. Total shareholders' equity is composed of paid-in capital and retained earnings. Paid-in capital is the amount the company has raised in the past by issuing stock. Retained earnings represent the sum of past earnings (profit) that have been retained in the business.

A very important point about the balance sheet is what is generally known as the balance-sheet equation: $\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$. Also, it is important to remember that the balance sheet shows the company's financial situation at a specific point in time; for example, Dell's balance sheet as of Dec. 31, 2010.

The Labyrinth of Financial Statements: The Income Statement

Public companies in the United States are required by law to disclose relevant business figures and other information. They do this in the form of financial statements: documents whose purpose is to offer detailed information on the company's financial situation: what the company owns (assets), what it borrowed and therefore has to pay back (liabilities), its stock, profit, cash going in and out, and other figures. All financial statements must follow official accounting rules and must be publicly available. There are three major financial statements: the balance sheet, the income statement, and the cash-flow statement. This article will focus on the income statement.

The income statement shows how much money the company has made (or lost!), how much of that it has spent, and how much it has retained as profit (net income). An income statement begins with the revenue generated from sales and deducts the various expenses to determine the amount of profit or loss.

The first item on an income statement is sales revenue. The table illustrates a hypothetical income statement. Let's say the company sold goods or services worth \$100 million. The first expense to deduct is called cost of goods sold (COGS), which represents how much the company has spent on items directly related to what it produced (for example, the cost of raw materials and the salaries of non-managerial employees). If we assume COGS was \$70 million, deducting that from revenue leaves us with \$30 million. This is called gross margin or gross profit.

From gross margin we deduct general, administrative, and selling expenses. These include the cost of managing the firm (managers' salaries), marketing and distribution costs, rent, heat, electricity, and others. The result after these expenses are deducted is called operating income: \$20 million. The firm pays interest on its debt, and interest expense has to be taken into account, which brings us to taxable income. This is the income that is subject to corporate tax. We deduct

taxes paid, and the final number we arrive at is net income, or profit: \$9.6 million.

Simply put, the income statement can be summarized like this:

$$\text{Total Sales} - \text{Total Expenses} = \text{Profit}$$

It is important to remember the income statement displays information on the company's profitability during a certain period of time (a quarter or a year); for example, Coca-Cola's income statement for the year ending Dec. 31, 2010. This is different from the balance sheet, which displays information at a specific point in time.

Hypothetical Income Statement

Sales revenue	\$100
Cost of goods sold	(\$70)
Gross margin	\$30
General, administrative and selling expenses	(\$10)
Operating income	\$20
Interest expense	(\$4)
Taxable income	\$16
Tax expense	(\$6.4)
Net income	\$9.6

All numbers listed above are in millions.

The Labyrinth of Financial Statements: The Cash-Flow Statement

The Labyrinth of Financial Statements: The Cash-Flow Statement Public companies in the United States are required by law to disclose relevant business figures and other information. They do this in the form of financial statements: documents whose purpose is to offer detailed information on the company's financial situation: what the company owns (assets), what it borrowed and therefore has to pay back (liabilities), its stock, profit, cash going in and out, and other figures. All financial statements must follow official accounting rules and must be publicly available. There are three major financial statements: the balance sheet, the income statement, and the cash-flow statement. This article will focus on the cash-flow statement.

The cash-flow statement shows cash going in and out of the firm during a period of time. Based on activity type, it is organized into three sections: cash flow from operating activities, investing activities, and financing activities.

1. **Cash flow from operating activities** This section lists the sources and uses of cash that result from normal, day-to-day operations of the firm. The operating activities portion always starts with net income (the profit the company has made). Usually, there are four items that need to be added to or subtracted from net income in order to arrive at operating cash flow: depreciation, the change in accounts receivable, the change in accounts payable, and the change in inventories. The result is net cash flow from operations.

Depreciation represents the decrease in the value of physical resources resulting from wear and tear over time. For example, a piece of equipment is originally purchased for \$50,000, but after being used for a year, its value decreases to \$40,000. The \$10,000 difference is depreciation. Accounts receivable designates the money the company is waiting to receive as payment for products sold or services rendered. Let's say the company sells a

product for \$5,000 on Oct. 3, but it does not expect payment until the end of the month. That \$5,000 will go under accounts receivable until the actual payment is made. Accounts payable is just the opposite—the company has already received a product or service, but will not pay for it until later. Inventories represent the raw materials, work in progress and finished products the company has in stock at a certain point in time. Changes in all these items affect operational cash flow.

2. **Cash flow from investing activities** A company, just like an individual, can invest its money in order to increase the value of its assets. For example, if a construction company purchases new construction equipment, this will probably be considered an investment in property, plant, and equipment (PP&E), and the cash outflow will show up under investing activities on the cash-flow statement. A company can also invest in the equity of other firms, subsidiaries, joint ventures, acquisitions, and others.

3. **Cash flow from financing activities** This section indicates how the company is raising capital to finance its operations. Cash inflow can be created by stock or bond issues, and cash outflow by debt payment or the repurchase of shares. Also, if the company pays a dividend to its stockholders, this will have to be recorded here (dividend payment is usually a significant financing cash outflow).

The sum (positive or negative) of cash flows from operating, investing, and financing activities represents the net increase (or decrease) in the firm's cash during a certain period of time (normally a year). Of the three numbers, the most important one is cash flow from operations; ideally, this would be the company's largest cash inflow. The cash flow statement is essential in determining a company's situation because it focuses on what's happening to the firm's cash. Even if net income looks great on the income statement, a company's position may be very weak if it doesn't have enough cash coming in.

How to Invest in a Deflationary Environment

While inflation was the hot topic not too long ago, it's downright tame right now. Instead, some market participants are now concerned that we could confront a period of declining prices, particularly if unemployment stays high and the housing market stays in the doldrums.

Declining prices may not sound that bad, particularly for consumers who might be able to take advantage of lower prices for everything from groceries to televisions. But a persistent need to slash prices can be bad for businesses and could ultimately lead to layoffs, reduced consumer spending, and declining prices for assets ranging from real estate to commodities. Those forces, in turn, could put pressure on corporate profits and stock prices. Inflation is a force to be reckoned with, too. But it's deflation that really makes economists shudder.

It may not be a good idea to go overboard in anticipation of one specific economic scenario or another. For such a bet to pan out, you'd need to get your arms around numerous difficult-to-predict factors, including growth rates not just in the United States but overseas, as well.

If you're truly concerned about deflation, you can take comfort in knowing that the investments that will tend to perform best in a declining-price environment are probably already in your portfolio. The classic deflation hedge is a simple fixed-rate investment—cash or government-issued bonds (corporate bonds will tend to be more vulnerable in a deflationary period because charging lower prices will tend to cut into the profitability—and viability—of many companies). Because their payouts are fixed, the cash you receive via income from such vehicles is effectively worth more and more each year as prices fall. For the same reason, fixed annuities can also be attractive in such an environment.

And while bonds will typically hold up better than stocks in a period of declining prices, it should be noted that dividend-paying stocks should hold up

better than non-dividend-payers in a deflationary period.

Although these investments are mainstays for investor portfolios regardless of the economic environment, it can be a mistake to go full-throttle into deflation-protection mode. That's because the to-avoid/downplay list for deflationary times is a pretty long one, encompassing equally important investments such as most stocks, corporate bonds, commodities, real estate, and inflation-protected bonds.

And over the long haul, it's also worth noting that inflation has been a bigger issue in the U.S. than has deflation. So hedging your portfolio against the former threat, particularly if you're retired and relying on fixed-rate investments for much of your day-to-day income, might be a better bet than getting too fancy about defending your portfolio against deflation.

Finally, bear in mind that the usual prescription for a deflationary period—government bonds and cash—aren't currently offering much in the way of yield today. Cash investors are lucky to earn 1% on their money, whereas investors in intermediate- or long-term government bonds would be grateful to pick up 3% or 4%. Those yields would shrivel to next to nothing if inflation were to pick up.

Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than other asset classes. With corporate bonds, an investor is a creditor of the corporation and the bond is subject to default risk. Transactions in commodities carry a high degree of risk, and a substantial potential for loss. In light of the risks, you should undertake commodities transactions only if you understand the nature of the contracts (and contractual relationships) into which you are entering and the extent of your exposure to risk. The annuity income guarantee is based on the claims-paying ability of the insurance company that issued the annuity product.

Investing in Emerging Markets

Emerging-market economies offer tempting rewards and are becoming more standard among investors willing to take on additional risk. Commonly called developing-market economies, they are in transition but are beginning to see a substantial increase in living standards and income, rapid economic growth and a relatively stable currency. They can be small or large economies and can be found all over the globe. Examples include China, India, Korea and Thailand in Asia; Poland, Egypt, and Turkey in Europe and the Middle East; and Brazil, Chile and Mexico in Latin America. As of May 2010, MSCI Barra identified 21 emerging countries worldwide.

Since these economies are still developing, the risk of an emerging-market investment is higher when compared with a developed market. Some of these risks include currency fluctuations, foreign taxation and political, social, and economic upheaval. However, such added risk comes with the potential for higher returns.

Perhaps the easiest way to include emerging markets in a portfolio is to buy an emerging-markets mutual fund. This is a mutual fund that holds various investments in emerging countries, bringing you the added benefit of diversification. Make sure to read the mutual fund's prospectus very carefully before investing or sending any money.

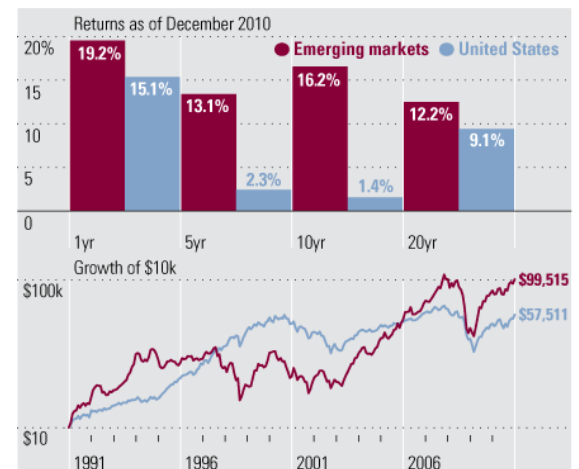
Another way to invest in emerging markets would be to buy stocks of foreign companies directly—much more difficult and risky to do on your own. You may also hear the term ADR connected with international investing. It stands for American Depositary Receipt, and it is an instrument allowing the stock of a foreign company to trade on a U.S. exchange. However, no matter how you decide to invest, always keep in mind the risks associated with international and emerging-market investments.

The graph illustrates the historical short- and long-term performance of emerging markets compared with U.S. markets. Emerging markets

posted very respectable returns, beating those of the U.S. market in every time period. However, these returns came with additional risk, as shown by the volatility of the line graph. A hypothetical \$10,000 invested in emerging markets would have grown to \$99,515 over this 20-year time frame, compared with \$57,511 for domestic investments.

While the emerging markets' ending wealth value easily surpassed that of the U.S. investment, it accumulated over a rather long time horizon. Note that emerging markets can experience a much greater upside and often a deeper downside in any particular year (2008, for example). Consequently, this type of investment is more appropriate for long-term investors who can handle potentially large fluctuations in returns.

Undeveloped Opportunities: 1991–2010



International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, and differences in accounting and financial standards. Emerging-market investments are riskier than developed-market investments. Liquidity is typically lower in emerging markets than in developed markets. An investment cannot be made directly in an index. Returns and principal invested in stocks are not guaranteed.

Source: U.S. stocks are represented by the Standard & Poor's 500® index, which is an unmanaged group of securities and considered to be representative of the stock market in general. Emerging markets are represented by the Morgan Stanley Capital International Emerging Markets Index.

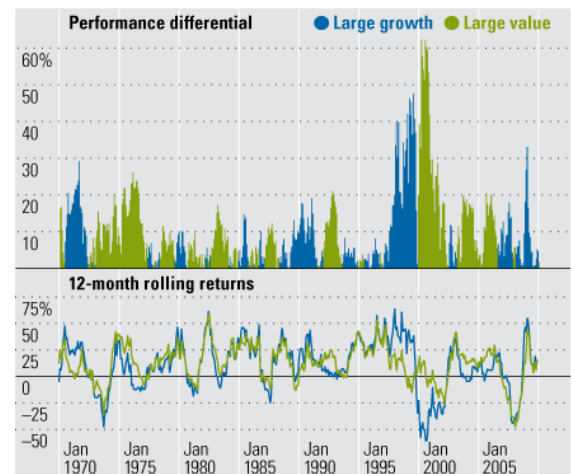
Head to Head Competition: Large Growth versus Large Value

The battle between large-cap growth and value investing has been going on for years, with each style trying to seize the spotlight. Although there is an annual frontrunner, history shows that leadership shifts with market conditions. In the bull market of the late 90s, growth stocks offered superior returns. But, since that bubble burst in 2000, value went on quite an impressive run. Growth seems to have captured the spotlight recently and many wonder if the tables have turned yet again.

Determining your allocation between growth and value can be difficult. Which style is more stable, or which will provide higher returns?

Unfortunately, there is no definite answer. Focus on finding the option that offers the most upside for your situation: perhaps it's growth, maybe value, or possibly a blend of both.

One-Year Growth and Value Cycles: 1970–2010



Performance differential measures the outperformance of one asset class over the other using 12-month rolling returns. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Past performance is no guarantee of future results. Returns and principal invested in stocks are not guaranteed.

Source: Large growth and value stocks in this example are represented by the Ibbotson Associates Growth and Value Indexes for 1970–1997 and the Morningstar Style Indexes thereafter. Ibbotson Associates Growth and Value Indexes are calculated based on data from CRSP US Stock Database and CRSP US Indices Database, Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business. Used with permission.

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