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Newsletter

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A Steady Hand Pays Off in Unsteady Markets

Each December, four of my friends gather at a coffee shop to exchange pleasantries and talk investments. The four then decide what changes, if any, they will make to their portfolios, and then go out and execute them.

My friends discussed modern portfolio theory in an intelligent fashion during a December 2007 meeting. This approach revolves around establishing a portfolio with a set ratio of stocks and bonds and then rebalancing once a year to maintain the original weightings. The idea is that this steady Eddie Investment process will maintain the integrity of the portfolio and potentially increase returns long-term.

All four friends decided to give modern portfolio theory a try. At the beginning of 2008, they independently invested \$100,000 each in two exchange-traded funds that track stock and bond indices. This involved each putting \$60,000 into Vanguard U. S. Total Stock Market ETF and the other \$40,000 into the Vanguard Total Bond Market Index ETF. The plan was then to rebalance annually to restore this 60/40 mix.

As we know, 2008 was destined to be a brutal year for stocks. All four of my friends lost money, and by year end their \$100,000 portfolios had shrunk to \$80,567 each.

The mood at the December 2008 gathering was somber. Talk centered on government bailouts, the ballooning federal deficit, and the generally depressed tone that had overtaken America. When the discussion turned to investments, there was grave concern about the future. Finally, the four friends questioned whether modern portfolio theory was the right strategy for the new investment environment.

In a sign of the lack of agreement, each of the four ultimately pursued different paths.

- Panicky Pete decided he couldn't take it anymore. He sold out of the Vanguard stock ETF entirely in early 2009 and put the money in his bond index fund.
- Nervous Nelly was also very concerned about the stock market and sold half her stock position around the same time. She also added the proceeds to her bond ETF.
- Wait-and-See Willie didn't know what to do, so he didn't do anything at all except worry.
- Disciplined Diane stuck with the original plan and rebalanced at the beginning of 2009, as if oblivious to the stock market storm raging around her. She took about \$10,000 out of her bond ETF and put it into the stock ETF, bringing her portfolio back to her original target allocation of 60 percent bonds.

Diane had no better idea than anyone else what would happen to the stock market in the year ahead. She had, however, seen enough recessions to know that the stock market and economy eventually right themselves. That wasn't her main reason for hanging tough, though. Diane told me she was tired of following get-in get-out advice and wanted a plan that was more stable and long term. Modern Portfolio theory was that plan. Earlier this year, I asked my friend how their 100,000 accounts had done during 2009. Here is a summary of their results:

2009 Year-End Value Total Return 2008-2009

Panicky Pete \$83,526 -16.5

Nervous Nelly \$90,320 -9.7

Wait-and-Willy \$90,053 -6.9

Disciplined Diane \$95,706 -4.3

Disciplined Diane was far ahead of Panicky Pete and Nervous Nelly, who'd sold into the downturn. She also was ahead of Wait-and-See Willie by about 2.6 percentage points. This excess return was earned because Diane rebalanced last year while Wait-and-See Willy didn't.

Diane's result provides a nice example of why a buy, hold, and do nothing strategy—and far more beneficial than a market timing strategy.

The Power of Passive Investing by Richard A. Ferri

A CRASH COURSE IN INVESTING

Six Lessons from the Market Meltdown

The market decline from October 2007 to early March 2009 was the worst since the late 1930's. Stocks dropped 60%, investor uncertainty skyrocketed, and trust and confidence were shattered. The age-old rules for personal investing are now being questioned: Is Buy-and-Hold dead? Has Asset Allocation outlived its usefulness? Does Diversification still work? The answers contained in the following lessons serve as a guide for long-term investment success.

LESSON #1

NO ONE HAS TOMORROW'S PAPER

“Prediction is very difficult, especially if it's about the future.”

—Niels Bohr, 1922 Nobel Laureate

The truth contained in this whimsical quote reminds us that, in at least one respect, 2008 was not unique: it was just as hard as ever to beat the market by following the advice of Wall Street forecasters. Here's a review of the “where to invest now” advice offered by the country's leading financial magazines at the start of 2008: To help its readers navigate an uncertain market, Business Week sought out guru Elaine Garzarelli, best known for advising her clients to sell just before the 1987 stock market crash. The “extremely bullish” Garzarelli, whose early 2008 models showed the S&P 500 to be “undervalued by 25%,” urged investors to load up on Lehman Brothers, Bear Stearns and Merrill Lynch. Oops.

In early January 2008, Fortune interviewed successful former hedge fund manager, globetrotting author and commodities bull Jim Rogers for tips on where to invest in 2008. Rogers favored commodities (“the commodities bull market still has years to go”) and China (“there are gigantic opportunities in China”). In fairness to Mr. Rogers, he was making long-term recommendations, not a 12-month forecast. Investors who over weighted their portfolios with either commodities (down 37% in 2008) or Chinese stocks (down 51%) are still hoping he is right. For its annual “Where to Invest” issue, Smart Money asked a prominent Wall Street strategist to help recommend stocks of companies “likely to increase profits in a world filled with trouble spots.” Unfortunately for followers of the magazine's advice, the average share price decline from recommendation date through year-end 2008 for the dozen stocks listed was 52.4%, more than fifteen percentage points below that of the S&P 500 Index. “Expert” stock picks?

2008 Longtime Forbes columnist, author and money manager Ken Fisher looked into his crystal ball and recommend “a whole new type of stock for 2008,” presumably one which could flourish in a year which was more likely to see a “robust market than a bust one.” From the January recommendation date through the end of the year, Fisher's five stock selections plummeted 55%, on average, far worse than the U. S. market's 37% slide. So, the next time you read an “expert” forecast, remember the words of legendary investor Warren Buffett: “A prediction about the stock market tells you nothing about where stocks are headed, but a whole lot about the person doing the predicting.”

LESSON #2

EVEN A CRYSTAL BALL MAY NOT BE ENOUGH

Last year was a disaster for many investors, but at least two managers can actually claim they predicted the crash. Both Robert Rodriguez, renowned manager of the FPA Capital fund, and Peter Schiff of Euro Pacific Capital accurately predicted the decline of the past 18 months. Did their prescient forecasts pay off for investors?

As far back as 2005, Robert Rodriguez bemoaned the “investment foolishness” in the market, noted the “financial strains” at Fannie Mae, Freddie Mac and identified problems in the real estate market. In June of 2007, Rodriguez delivered a speech to a group of financial analysts in which he outlined how the stock, bond, private-equity and hedge-fund markets were all caught up in “a speculative bubble”. In December 2007, Rodriguez was so worried the credit crunch would cause a severe recession, he temporarily halted all stock purchases in his fund. By March 2008, cash had swelled to more than 40% of the stock fund's total assets.

For these spot-on predictions, Money Magazine declared Rodriguez to be “the best fund manager of our time.” How were FPA Capital Fund shareholders rewarded for Rodriguez' prophetic calls? Unfortunately, not so well. The fund lost 35% in 2008. Perhaps not the result investors had hoped for from someone who predicted the future.

The financial media's praise of Rodriguez may take second fiddle, however, to the buzz surrounding Peter Schiff, president of brokerage firm Euro Pacific Capital. He gained attention on major television networks in 2006 and 2007 with his bold forecast of over-leveraged American consumers leading the U. S. economy into recession.

In 2007 Schiff authored a book, *Crash Proof: How to Profit from the Coming Economic Collapse*, in which he recommended investors pile into gold, commodities and high-dividend paying foreign stocks. As conditions in the U. S. economy and the markets deteriorated, his predictions brought him fame as an economic guru who could help shelter investors from the storm. Nervous investors poured money into accounts with Schiff's firm.

Sadly, for investors hoping to profit from Schiff's advice, 2008 made mincemeat of their portfolios. Many Euro Pacific customers attested to losing 50% or more, much worse than the 37% drop in the U. S. market. This was due, in part, to Schiff's expectation that the weakening U.S. economy would cause the U. S. dollar to depreciate rapidly, providing an extra boost to shares of international investments. Instead, the dollar advanced, magnifying the already steep losses in the international markets into which Schiff so aggressively steered his clients.

These examples highlight the difficulty of a market-timing strategy even for the smartest (or luckiest) of investors and provide a lesson for the rest of us: When it comes to trying to beat the market, even correctly predicting the future may not be enough.

LESSON #3

IF IT LOOKS TOO GOOD TO BE TRUE, KEEP IT OUT OF YOUR PORTFOLIO

On December 11, 2008, Bernard Madoff was arrested by federal agents for running what Madoff himself called a “giant Ponzi scheme.” Investor losses are estimated between \$10 Billion and \$50 Billion.

For decades, investors were drawn to the consistent, high returns provided by Madoff' funds. By some accounts, Madoff's investors experienced losses in only a handful of months over a fifteen year period. For the privileged folks granted “access” to Madoff, there was

another benefit: Madoff performed these market-beating results for virtually peanuts. While other prominent hedge fund managers were charging 2% of assets and 20% of profits, Madoff was content to work for the commissions generated by client trades. While many of the world's largest banks, hedge funds and regulatory watchdogs like the Securities and Exchange Commission missed the warning signs, the signs themselves were clear. Had Madoff's victims insisted on any of the following, their losses could have been avoided:

Understandable Investment Strategy

Asked in 2001 by a reporter from Barron's magazine how his "split-strike conversion" strategy managed to avoid ever having a down year in over a decade, Madoff said: "It's a proprietary strategy. I can't go into it in great detail." Investors weren't able to elaborate much further. "Even knowledgeable people can't tell you what he's really doing," one formerly satisfied investor said. "People who have all the trade [confirmations] and statements still can't define it very well."

If your advisor cannot, or will not, clearly and concisely explain the strategy guiding the management of your life savings, don't invest.

Independent Custodian

Madoff took custody of his clients' cash, accounts and securities. Sensible investors demand a separate custodian to ensure appropriate checks and balances are in place to protect their assets from mishandling or fraud.

Independent Auditor

Audits verify a money manager's financial statements, as well as confirm that reported investments are held and trades actually made. Madoff sidestepped this by hiring a largely unknown accounting firm, reportedly controlled by his brother-in-law, to conduct annual audits.

This familial relationship should have disqualified the firm from acting as an independent auditor, but for 15 years it told its own oversight body—the American Institute of Certified Public Accountants—that it did not conduct audits.

Madoff is a crook, plain and simple. He ruined the lives of countless people who entrusted him with their life's savings. These same investors, however, carry the burden of knowing greed blinded them to signs that what Madoff offered was too good to be true. Had their appetite for returns not overwhelmed their better judgment, a great many would not be part of what will surely go down as the largest investor fraud ever.

LESSON #4

DON'T TAKE RISK WITH THE SAFE PART OF YOUR PORTFOLIO

There is a sense of betrayal among investors who thought their well-diversified and asset-allocated portfolios would protect them from a year like 2008. The focus of their ire? Asset allocation, the long-term strategy used to distribute one's nest egg among different types of stocks and bonds.

Asset allocation has been a cornerstone of investment management and financial planning since the early 1950's. It is based on the idea that different asset classes offer returns that are not perfectly correlated—they do not move up or down at exactly the same time. By allocating among these non-perfectly correlated assets, an investor can reduce portfolio volatility, or risk.

This thoughtful portfolio construction technique now appears under siege, as a number of prominent media outlets and other "experts" have proclaimed asset allocation to be dead.

Reports of its demise have been fueled, in part, by the poor results of the asset-allocated portfolios held by large university endowments, often viewed as the most sophisticated among us. In recent years these endowments were lauded as pioneers in asset allocation, as they took the traditional concept—complementing risky assets with safe bonds—to a whole new level.

Beginning with the dot-com bust of the early 2000's, large endowments began successfully reducing their exposure to traditional stocks and bonds in favor of "alternative" asset classes such as hedge funds, private equity, venture capital, direct real estate and commodities. While stocks languished, these alternative asset classes soared, adding credence to the growing belief that holding safe bonds to reduce portfolio risk was a thing of the past. Alternative asset classes increasingly began to occupy the traditional spot in portfolios reserved for high quality bonds. Early success of this "endowment model" inspired countless others to adopt a similar approach. Investors around the world began loading up on

investments ordinarily considered risky and volatile, falling prey to the belief that as long as the historical data showed the asset classes didn't move in sync, they could generate higher returns without higher risk. Then came 2008. "All these different kinds of investments got clobbered," one prominent university's Chief Investment Officer recently recalled overhearing his peers say. "Maybe we don't need such a complex portfolio."

Many of these endowments—and their followers—are now going back to the drawing board, claiming asset allocation no longer works. The problem, they say, is asset allocation failed when it was needed most. As evidence, they point to October 2008 when nearly all asset classes plummeted in unison. Hedge funds fell 10%. Gold lost 18%. Crude oil plunged 33%. International stocks dropped 20% or more. High yield bonds lost 16%.

The problem, however, is not that asset allocation no longer works. The problem, rather, was in its application.

Too many investors seem to have forgotten that spikes in correlation—periods during which ordinarily low-correlated asset classes become highly correlated and move in lock-step—are nothing new. These spikes tend to crop up during times of extreme market stress, like October 2008. It is during these periods of panic when it seems there are only two asset classes—U. S. Treasury bonds and "everything else."

"Safe" asset classes?

October 2008

While everything else plunged in October, U. S. Treasury bonds did what they were supposed to do—maintain their value. Short-term Treasuries gained 1.3% while intermediate-term issues rose slightly less than 1%. For the full year, short- and intermediate-term Treasuries rose 9% and 11%, respectively. Treasury bonds certainly can't be expected to provide investors long-term returns that compete with most other asset classes. They do, however, have one very attractive feature not shared by fashionable alternatives: they hold up when you need them most.

LESSON #5

DON'T BE FOOLED BY THE "SMART" MONEY

Over the years, many studies have examined the investment results of individual investor's decisions. These studies consistently conclude that individuals trade too frequently and chase returns, resulting in much worse performance than would have been earned by simply investing in a market-tracking index fund.

Less attention, however, has been paid to how portfolio moves by large institutional plan sponsors—pension funds, endowments and foundations—have impacted those funds' performance. Plan sponsors collectively control billions of dollars, are managed by professional fiduciaries devoting considerable time and resources to selecting managers, and have access to consultants who are paid specifically to help their portfolios outperform. In other words, plan sponsors should know what they're doing. For this, they are labeled the "smart money." Just before the stock market began its swift decent in October 2007, a team of researchers headed by Boston University professor of finance Scott Stewart researched whether the smart money makes better decisions than the individual investor. Specifically, they wanted to determine if plan sponsors make or lose money when they hire and fire money managers.

The conclusions of Stewart's research may surprise you. The study found plan sponsors actually destroy value when shifting assets among managers. Fired managers outperformed those hired by 3% in the year following the hiring/firing decision. Over the subsequent five years, "fired" managers beat "hired" managers by 1% per year.

In dollar terms, these figures are staggering. The opportunity cost of plan sponsors' decisions, on average, amounts to \$20 billion in the twelve months immediately following a decision to change managers. Over one five-year period, as much as \$77 billion was lost due to firing managers who subsequently outperformed and hiring managers who proceeded to under perform. Professor Stewart concludes, "The effort that plan sponsors are putting towards hiring and firing managers is not just a waste of time. It is actually hurting them." It seems the "smart money" may not be so smart, after all.

LESSON #6

BUY AND HOLD IS STILL THE BEST STRATEGY

For almost sixty years, the nearly universally-accepted advice for managing one's nest egg was to select a diversified mix of stocks and bonds based on personal circumstances, diligently add to it over time, and rebalance when any single component of that mix gets too far out of whack. Buy, hold, and rebalance—a successful recipe for over half a century.

The worst year for stocks since 1931, however, has thrown the age-old advice into question.

"Buy and Hold?" the headlines taunt. "This is a stock-picker's market," the talking head on TV claims. "You can't be diversified in this market," your neighbor chirps. Followers of the traditional advice feel under attack. What's a sensible buy-and-hold investor to do?

The fashionable answer, of course, is that investors today need to be more "tactical" in their moves—moving in and out of investments more quickly.

Before turning buy-and-hold out on its ear, however, the thoughtful investor might ask for evidence to support the contention that an alternative approach to buy-and-hold is in order: Specifically, do professional fund managers—those who tactically choose asset classes, picking stocks and timing the market—really outperform a buy-and-hold approach?

This is an easy question to answer with the help of the mutual fund database Morningstar. Morningstar tracks the performance of thousands of mutual funds, of which hundreds aim to add value primarily through tactical asset allocation, more commonly known as market-timing. Morningstar classifies these funds as "asset allocation" funds, which are further broken down into three groups based on risk preference: Conservative, Moderate and Aggressive.

According to Morningstar, managers of asset allocation funds "use a flexible combination of stocks, bonds and cash; some shift assets frequently based on analysis of business-cycle trends." In short, they do exactly what your neighbor, today's papers and most TV prognosticators are now claiming is a superior approach to buy-and-hold: tactically move in and out of the market.

Once again, however, the conventional wisdom that a prescient stock-picker or market-timer can tactically sidestep the hazards of the market falls flat on its face. The vast majority of asset allocation funds actually fail to match the returns of the market.

The average conservative asset allocation fund, for example, lost 16% in 2008. An investor who chose instead an index mix consisting of 35% Total US Stock Market and 65% Barclays Capital Aggregate Bond, lost "only" 10%. Of the 37 conservative allocation funds, only 4 beat the passive index benchmark—the other 89% failed to do so.

Balanced asset allocation funds fared no better than their conservative peers in 2008. The average "moderate allocation" fund fell 27%. Of the 55 moderate allocation funds, 49 failed to keep pace with the index alternative.

Funds outperformed by index

2008

While aggressive allocation funds did perform better relative to their conservative and balanced peers, still fewer than one-quarter of funds managed to beat their benchmark. The average aggressive allocation fund lost 34% in 2008, poking a hole in the oft-heard argument that a fund manager's freedom to "go anywhere" offers refuge from the storm.

All told, nearly 85% of the 141 unique asset allocation funds failed to match an equivalent index mix. While a sensible buy-and-hold approach in 2008 certainly tested the resolve of even the steeliest of investors, it sure beat the alternative.

WHAT CAN WE LEARN FROM 2008?

- Be skeptical of expert forecasts—even the "smart money" gets it wrong.
- Don't be tempted to time the market, and don't believe anyone who claims they can.
- If you turn your life's savings over to an advisor, ask hard questions, demand sensible answers and insist on an independent custodian
- Put a portion of your nest egg in truly safe assets—tough times can and will happen
- A basic buy-and-hold strategy gives you the best chance for long-term success

WHAT SHOULD I DO NOW?

- Keep it simple. There is no better advice on how to live longer than to quit smoking and buckle up when driving. The lesson: advice doesn't have to be complicated to be good. The same is true with investing:
- Spread your nest egg across a mix of different asset classes—stocks, bonds, real estate and cash
- Diversify broadly within each asset class
- Use index funds to keep a lid on costs and taxes
- Rebalance whenever a part of your portfolio gets too far out of whack, even when doing so seems most uncomfortable

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Après le downgrade, don't expect a deluge

How did our nation get in such terrible shape? For decades, the federal government has been spending more money than it collects in taxes, accumulating a debt of about \$15 trillion. Interest on the debt costs taxpayers \$413 billion a year more we spend on interest payments, the more we have to pay in taxes and the less we have to spend on other important needs of our nation.

For this reason, people have become increasingly concerned about the federal budget deficit (the difference between the amount we spend and the amount we collect in taxes, resulting in an annual increase in the debt) and the size of the debt itself. In the 2010 election, many candidates campaigned on a promise to reduce the deficit and the debt, and a great many of them were elected.

As a result, there are two broad factions in power: those who are primarily concerned with spending money on programs designed to meet the perceived needs of the nation, and those who are primarily concerned that we can't afford to pay for those programs.

Just like a dieter who puts a lock on the refrigerator door in hopes the self-restraint will help him lose weight, Congress set itself a limit on the amount of debt it would amass. But akin to the dieter who breaks open the lock, Congress has continued to spend to the point that this year, the Treasury Department said that Congress would have to increase the debt limit so that spending could continue.

If Congress didn't raise the ceiling, the department warned, the federal government would run out of cash and be unable to pay any more bills.

S&P'S ANALYSIS

Meanwhile, Standard & Poor's Ratings Services Inc. said in April that it had analyzed the financial solvency of the federal government and concluded that the government's debt obligations were excessive relative to its income.

To fix the problem, S&P said, the government needed to reduce the federal debt by \$4 trillion over 10 years. If the government wouldn't agree to do so, S&P said, the nation would lose its AAA bond rating.

This set the stage for a political debate of historic proportion, as one party demanded that taxes be raised to sustain the level of spending, while the other demanded that spending and taxes both be reduced. Many from both parties offered variations of these demands, and the issue wasn't resolved until a few hours before the deadline.

In the end, Congress decided to reduce the federal deficit by \$2.1 trillion over 10 years by cutting spending (there were no tax reductions or tax increases). This was just over half of S&P's requirement, so four days later, the agency cut the rating, just as it said it would.

What does it all mean? What will happen next?

Let's look at how the bond and equity markets, and the economy itself, will react.

Credit ratings are designed to help investors assess risk. The lower the rating, the greater the risk that you won't receive the interest and principal payments that you're owed.

To compensate for this risk, investors demand higher returns. That is why the highest-rated debt pays the lowest interest rates and vice versa.

Therefore, the ratings cut suggests that interest rates will rise. If interest rates rise, bond prices will fall.

But will this happen? Don't be so sure, for these reasons:

- There is disagreement among the ratings agencies as to whether the rating should be cut.

Fitch Ratings Ltd. last week maintained its AAA rating and Moody's Investors Service, though it has a negative outlook, hasn't signaled a downgrade from triple-A. Because the agencies themselves are in disagreement, there is no reason to think that investors will pay much attention to S&P's action.

- Investors have been expecting the ratings cut for months. S&P's news wasn't a surprise as it has warned of this action since April. Many argue that current bond yields and prices already reflect the ratings cut.

- The ratings cut is of trivial economic significance. Although the raters use a school-like system, it is more complicated than the A-F grading. Instead, AAA is the highest rating, and the lowest is D (in default, usually because the issuer is or is about to be bankrupt). There are many iterations between D and AAA, Therefore, S&P's cut from AAA to AA+ is like going from a score of 100 to 98. The score might not be perfect, but the student is still near the top of the class.

