

The Ten Year Investment Drought

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February 2009

■ Even the most in-the-know market professionals were unable to accurately predict the severity of the events of 2008.

■ The average equity fund investor, as studied by Dalbar, Inc.,* underperforms the market by more than 50% due to actions motivated by fear and greed.

■ Many current stock market valuation measures show markets are well below historical valuation levels.

■ Historically, periods following a 10-year market drought have delivered healthy and even above-average market returns. See the graph on page 3.

Well, it's official. When 2008 finished with one of the worst quarters in the stock market's (S&P 500) history, it wiped out all of the cumulative gains the market had over the prior ten years. In fact, the S&P 500, as of year end, reflects a -1.38% annual loss over the past ten years. This means that a \$100,000 investment in the market ten years ago would be worth only \$87,026 by the end of 2008. If one followed a more diversified approach and put 40% of the portfolio in bonds (as measured by the Barclays Capital Aggregate Bond Index) the portfolio would have seen a paltry annualized 1.43% return over the last decade. When compared to the annualized inflation rate (Consumer Price Index-CPI) of 2.65%, we have indeed been in a ten year investment drought.

Although the last ten years of stock market returns were lousy, there were some bright spots. In fact the market (S&P 500) was up 21% in 1999 and cumulatively up 82% from 2003 through 2007. But, when combined with the roughly 40% decline in 2000-2002 and the 37% decline in 2008, the net result has been negative.

Some people might ask why we were not able to see the massive sell off coming in order to do something to protect their principal. On that note I am reminded of some of the predictions made in 2008 by supposedly some of the most respected minds in finance. Following are a few of the more noteworthy predictions:

- "Freddie Mac and Fannie Mae are fundamentally sound... I think they are in good shape going forward."
-Barney Frank (D-Mass)
House Financial Services Committee Chairman
July 14, 2008

Two months later, the government forced the mortgage giants into conservatorships.¹

- “I think Bob Steel’s the one guy I trust to turn this bank around, which is why I’ve told you on weakness to buy Wachovia.”

-Jim Cramer
CNBC Commentator

Two weeks later, Wachovia nearly failed as depositors fled. CEO Steel eventually agreed to a takeover by Wells Fargo. Wachovia shares lost half their value from September 15 to December 29.¹

- “I think you’ll see \$150 a barrel (of oil) by the end of the year.”
-T. Boone Pickens
Financier/Chariman BP Capital Management
June 20, 2008

Oil was then around \$135 a barrel. By late December it was around \$40.¹

- “I expect there will be some failures... I don’t anticipate any serious problems of that sort among the large internationally active banks.”
-Ben Bernanke
Federal Reserve Chairman
February 28, 2008

In September, Washington Mutual became the largest financial institution in U.S. history to fail. Citigroup needed an even bigger rescue in November.¹ In January, Bank of America was provided with an additional \$20 billion.²

The aforementioned predictions by individuals seemingly “in the know” support why it has been our steadfast belief that no one can accurately predict the future, including the market’s direction. Therefore we recommend maintaining a broadly diversified portfolio at all times. In fact, our firm had some real time experience with large market timing firms during the 1980s and early 90s. While they occasionally made good moves by being out of the market when it was going down or in the market when it was going up, more often than not, they were whipsawed with returns significantly lower than what a buy and hold strategy could have produced.

Dalbar, an independent research firm, has noted the same results with the average equity fund investor realizing returns of less than half of that of the market from 1988-2007; poor results all stemming from investor emotions of fear and greed. The typical investor wants to get out of investments after returns go down and are attracted to investments that have been profitable *in the past*. Hence they buy high and sell low.

So where do we go from here? It is our opinion that the stock market and certain segments of the bond market are currently undervalued resulting in huge discounts to intrinsic value. This may well be the buying opportunity of a lifetime. While the markets can, and will remain volatile, we believe there are reasons to be optimistic.

Reasons to be Positive about the Market

- projected low price/earnings ratios to historical norms
- According to the American Association of Individual Investors (AAII) there is high bearish sentiment among investors, which means most of the sellers have sold

- historical levels of liquidity on the sidelines to fuel a major rally when it occurs,
- the dividend yield of the S&P 500 is higher than the yield on the 5 & 10 year Treasuries – this typically signifies stocks as having better value than Treasuries and
- a government that has its full attention on repairing the economy through stimulus spending, liquidity injections and tax relief. This three prong approach indicates the government’s desire to use all the tools they have to turn the economy around.

Finally, we can view the chart below which reflects a visual representation of the only other two periods where the stock market experienced a ten year drought.

Annual Percentage Change: 1927-2007 (10 Year)



Source: Ibbotson & Associates and Morningstar. Past performance is not a guarantee of future results. One cannot invest in an index. The S&P 500 is a benchmark indicator of the overall U.S. stock market based on the average performance of the 500 largest U.S. firms' common stock.

As noted above, the ten year periods ending 1939 and 1974 were the only other periods where investors experienced the same anemic returns we have witnessed recently. Also noteworthy, the returns during the following 10 years and beyond ranged from a low of 7% (a decade ravaged by a world war) to the mid teens. Although past performance is no guarantee of future results, the reasons listed are foundational as to why we feel optimism is in order.

In summary, we recognize that it has been a most difficult year and many investors feel their investment strategy is broken and in need of repair. Let me assure you that every recession eventually ends and the economy and market will rebound. Investing is unfortunately one of the few areas where trying to “fix” what looks broken can leave you with lower overall returns, as noted in the above Dalbar study.* Should you wish to discuss your portfolio further or have other concerns, please do not hesitate to call for a review appointment.

1. Source: BusinessWeek
2. Source: CNNMoney.com, “2nd UPDATE: US to extend \$20 billion in fresh cap to Bank of America,” January 19, 2009

*Any information is not a complete summary or statement of all available data necessary for making an investment decision and does not constitute a recommendation. An investor cannot invest directly in an index. Index returns do not reflect the deduction of fees, trading costs or other expenses. **The Standard & Poor's 500 (S&P 500) Index** measures changes in stock market conditions based on the average performance of 500 widely held common stocks. **The Barclays Capital Aggregate Index** measures changes in the fixed-rate debt issues rated investment grade or higher by Moody's Investors Service, Standard & Poor's or Fitch Investor's Service in that order. The Aggregate Index is comprised of the Government/Corporate, the Mortgage-Backed Securities and the Asset-Backed securities indices. The Consumer Price Index (CPI) is a measure of inflation. There is no assurance that any investment strategy will be successful or that any securities transaction, holdings, sectors or allocations discussed will be profitable. It should not be assumed that any investment recommendation or decisions made in the future will be profitable or will equal any investment performance discussed herein. The fact that buy-and-hold has been a successful strategy in the past does not guarantee that it will continue to be successful in the future.*

**Source: "Quantitative Analysis of Investor Behavior" Report, 2008 Update, Dalbar, Inc. & Callan Associates. Data as of 12/31/07. The method of calculation used for returns captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses and any other costs. The average equity investor refers to the universe of all equity mutual fund investors whose actions and financial results are restated to represent a single investor that does not have a buy-and- hold investment discipline, but rather, their investment behavior includes market timing, lack of retention, and short-term allocation changes, primarily based on an aversion to loss. The fact that buy-and-hold has been a successful strategy in the past does not guarantee that it will continue to be successful in the future.*