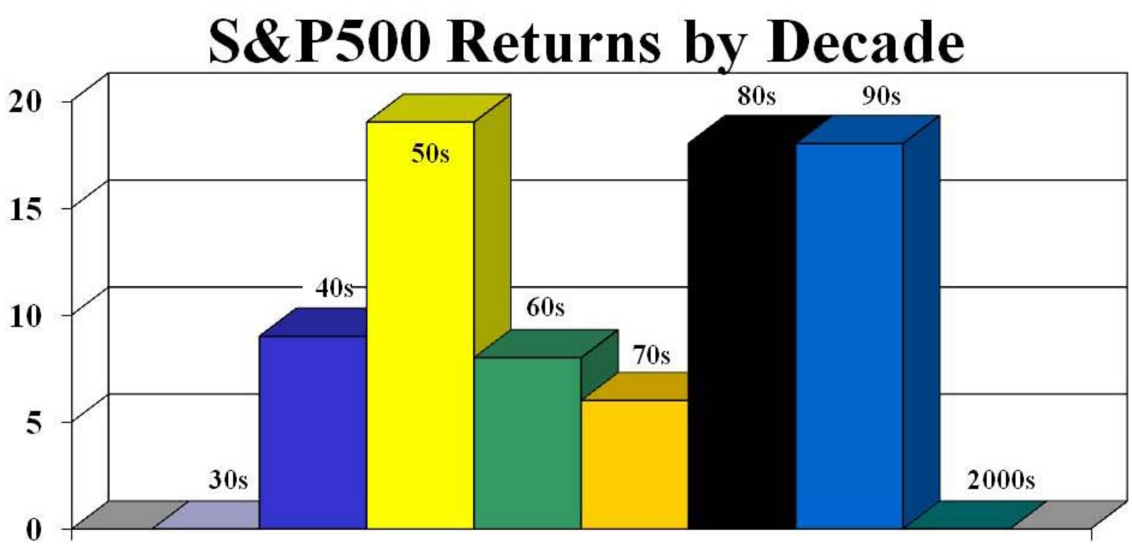
Pain Management in a Decrepit Decade

By Ron Surz   July 5, 2008

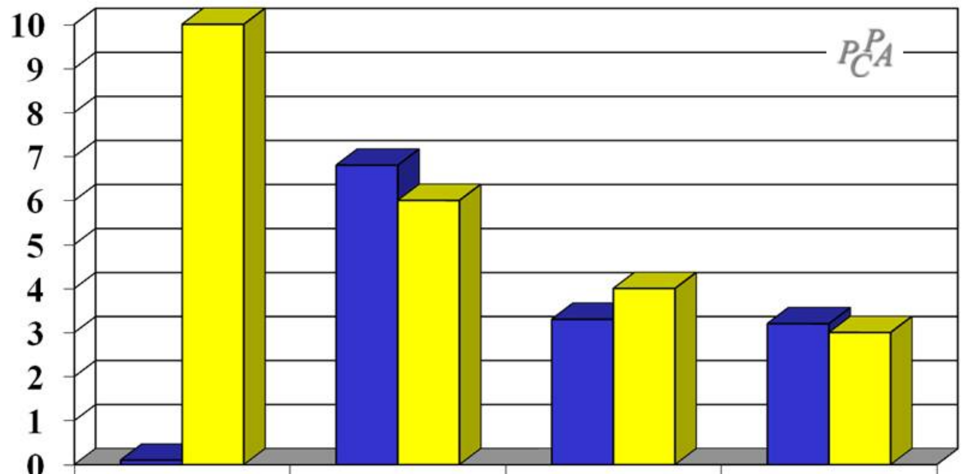
It's taken all the running we can do to stay in the same place

Unless there's a significant rally in the next 18 months, the 2000s will prove to be one of the worst performing US stock market decades, the likes of which have not been seen since the 1930s. The following chart shows the returns of the past 7 decades, and the 8.5 years to date through June 30, 2008:



Here we are, 85% of the way into the first decade of the 21st Century, and US stock market investors have barely broken even. The S&P500 has returned a measly 0.1% per year on average in the past 8.5 years, small enough to be just noise. The graph below puts this disappointment into further perspective. Investors would have been far better off in bonds or Treasury bills than in stocks. Do you think the next 18 months will bail the decade out, or bring more of the same? Where can we invest and be safe? One place that would have helped in the past 8.5 years is foreign markets, which have returned more than 8% per year. Similarly hedge funds have also protected reasonably well. In the following we focus on the more recent past, namely the year 2008 to date, to manage the recent pain.

Stocks, Bonds & Bills in the 21st Century
(8.5 Years Jan, 2000 – June, 2008)



	S&P500	Citi Bonds	T-Bills	Inflation
8.5 Years	0.1	6.8	3.3	3.2
82 Years	10	6	4	3

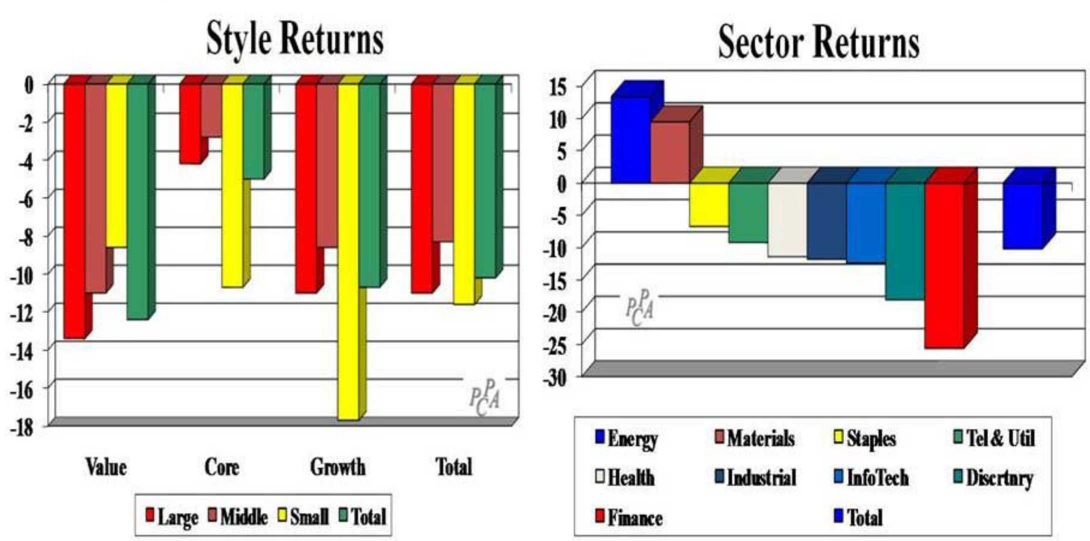
The ride to disappointment has been bumpy. First the bubble burst in the 3 years 2000-2002, and from there the stock market clawed its way back so that investors had earned a 3.5% per year return as of October of 2007. We were back even with inflation. But then the next 8 months took all of that back, with the S&P losing 16% from 11/1/07 to 6/30/08.

As painful as the last 8 months have been, we can still learn from this experience. This is the kind of period that serves to stress test our perceptions of what investments are good defensive plays. In the following we review various market segments and strategies, identifying what has worked in the year to date and what has not worked. What sectors, styles, and countries have performed best and worst? Did hedge funds protect? And how about those poor old folks who are retired, and living off their savings? This year is half over. Recent lessons can help us deal with the past and plan for what is still left.

What doesn't kill you makes you stronger

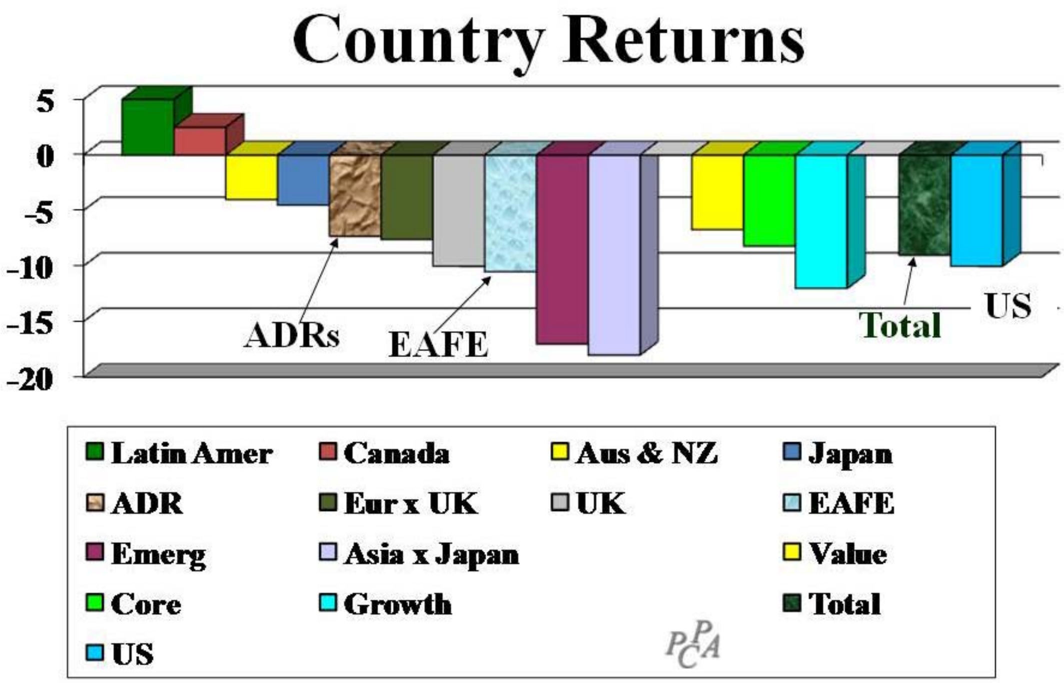
As the following 2 exhibits show, there have been a few places to hide in the long-only equity markets. On the sector front, US Energy and Materials companies have actually earned positive returns, delivering 13% and 9% returns, respectively. The spread between the best performing Energy sector and the worst performing Finance sector is a whopping 3800 basis points. Sector allocations have mattered big time in the 1st half of 2008. On the US style front, the stuff in the middle has surprisingly provided some protection. The surprise arises from the fact that this middling market has not performed in between the extremes. Large core has defended best, losing only 4%, compared to the hemorrhage that crippled small growth companies, losing 18% -- a spread of 1400 basis points. Our definition of "Core" is the stuff in the middle, between value and growth. The other stuff in the middle, namely mid-cap companies, also surprised by performing better than both large and small companies. Our style definitions are mutually exclusive and exhaustive, making them excellent for style analyses, both returns-based and holdings-based. We use Surz Styles and Countries throughout this commentary, as described in the Appendix

U.S. Performance for the 6 months 1/08 to 6/08



Fleeing the country has helped in the past 6 months, and we didn't need to go far to get relief. As the next exhibit shows, Latin America and Canada have delivered 5% and 2.5% positive returns, respectively. The overall foreign market was down 9%, losing somewhat less than the 10% decline in the U.S. EAFE, on the other hand, lost about the same as the U.S. The worst performing region was

Asia ex Japan, which includes China. This had been the best performing region for several years prior to this correction.

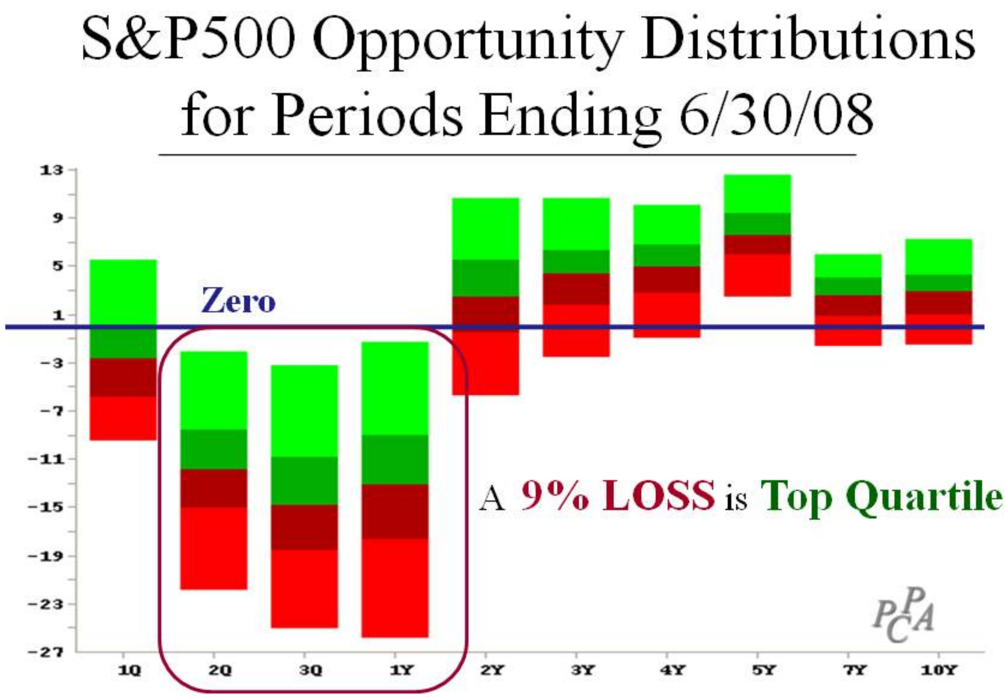


Make lemonade when the market gives you lemons: Winning the Losers Game

This is one of those unfortunate times when consultants and investment managers will try to console their clients by explaining how their pain is less, hopefully, than most others. This will be awkward and delicate, and is likely to bring forth the difficult questions about bailing or doubling down. As for good relative performance, we'll need to look back 2 years or more to find a timeframe where positive returns are winners. As the following exhibit shows, a 9% **loss** will win the performance race for those who are benchmarked against the S&P500, because a -9% return ranks in the top quartile for the 6, 9 and 12-month periods ending 6/30/08. "Congratulations Mrs. Client your manager performed very well, losing "only" 9% of your account in the year to date." Talk about pain management.

The universes in this exhibit are created using an unbiased scientific approach called Portfolio Opportunity Distributions (PODs). They represent all of the possible portfolios that managers could have held when selecting stocks from the

S&P500. Traditional peer groups are very poor barometers of success or failure because of their myriad biases. Everyone knows that it's easy to find a peer group provider that makes you look good, but for some reason the industry tolerates, even condones, this deceptive practice. PODs are bias free and are therefore a much more reliable performance evaluation backdrop, plus they're available now, many weeks before the "real" biased peer groups. As John Stossel says on ABC TV News:"Give me a break."



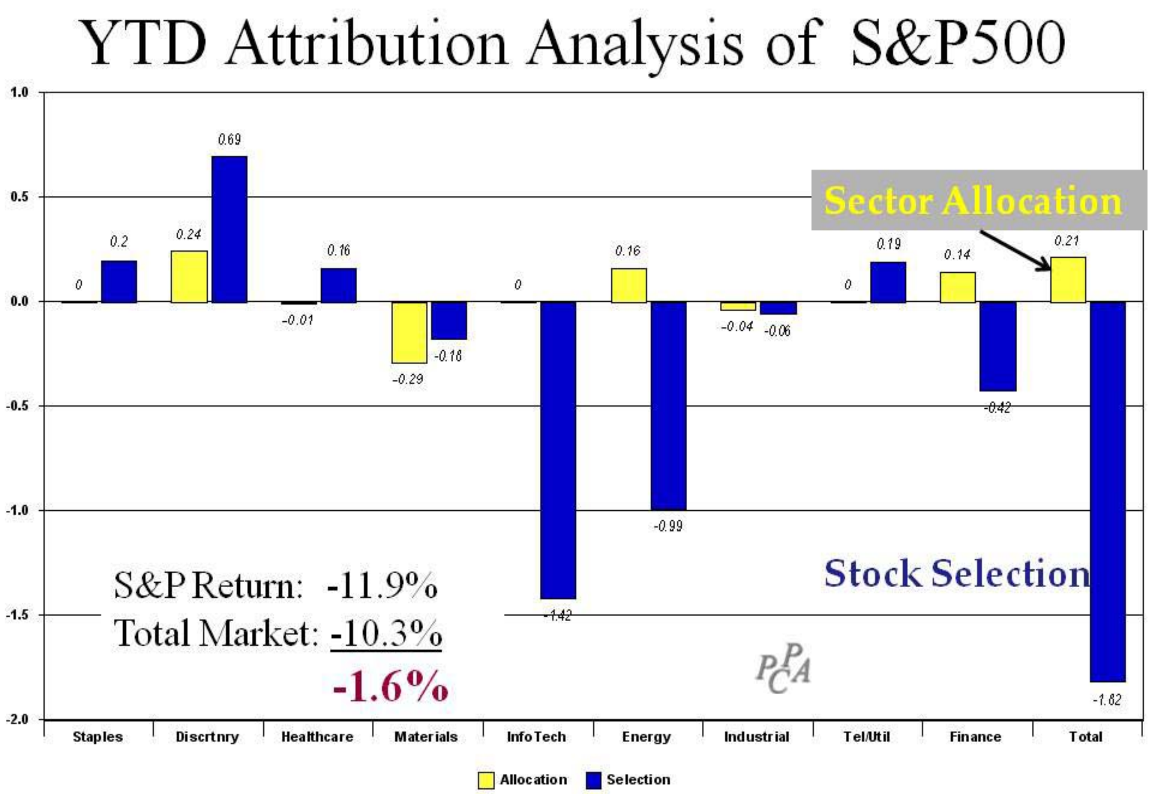
1Q: 3 months ending 6/30/08 2Q: 6 months, etc.

Putting it all together: Attribution Analysis

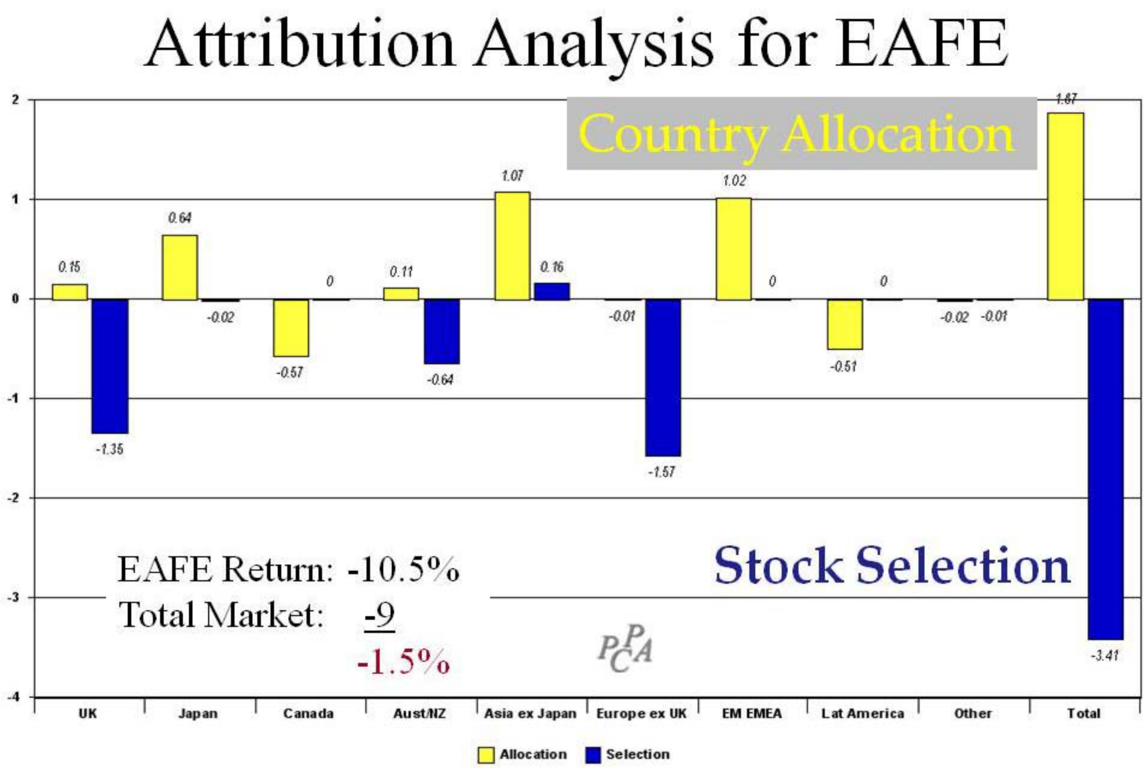
PODs create a fair performance competition, but regardless of whether you've won or lost this competition, inquiring minds want to know why. This is the purpose of performance attribution: identifying the reasons that performance is good or bad. Unfortunately, attribution analyses are frequently performed against a crazy reference, contrasting sector allocations and stock picks to the S&P500 even though the manager is nothing like this index. It's the old garbage-in-garbage-out, or GIGO, problem. If the benchmark is wrong all of the analytics are wrong. As a former acquaintance used to say, "I mean this in the kindest possible way: Stop this benchmark insanity. Please!"

To flip this craziness on its ear, and provide some perspective on attribution analyses in the past 6 months, we attribute performance for both the S&P500 and the EAFE using the total U.S. and foreign markets, respectively, as the benchmarks. Why did the S&P and EAFE perform differently than their total markets? We use an attribution system called StokTrib, described at http://www.ppca-inc.com/Stok_Trib/stoktrib.htm , to answer these questions.

As shown in the following exhibit, the S&P has underperformed the total US stock market by 160 basis points because of poor stock selection in both the Energy and Information Technology sectors. A closer examination reveals that this is due to 2 interrelated factors: the style of the S&P and the stock picks of the committee that selects those 500 companies. The S&P is currently tilted toward large value, which has been out of favor recently, as shown in the style exhibit above. Yes, the S&P is a managed portfolio, albeit managed by committee. Attribution analyses that are careless about the benchmark, using the S&P500 for all managers, will signal good stock picking in the Energy and InfoTech sectors because the S&P is easy to beat in these sectors. That is, investment managers will receive undeserved accolades.



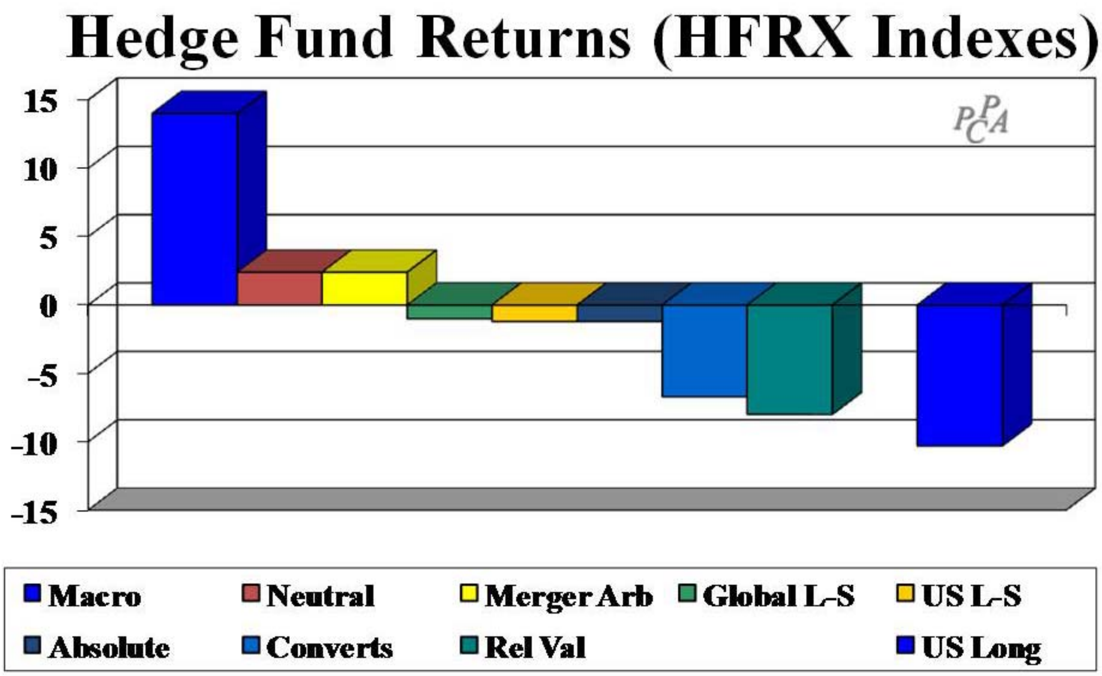
The picture outside the US is somewhat more complicated. As the next exhibit shows, EAFE has underperformed the total Foreign market by 1.5%, similar to the underperformance of the S&P relative to the total US market. But in EAFE's case there have been offsetting effects. EAFE's underweight in the 2 worst performing regions added more than 200 basis points to its performance, but its stock selections in Europe subtracted 300 basis points. EAFE is underweighted in Emerging Markets and Asia ex Japan, the 2 worst performing regions in the past 6 months. By contrast its large value orientation in Europe was not in favor. Like the S&P, attribution analyses that use EAFE as the benchmark need to be careful to confirm that the investment manager's approach is in fact like this index.



Only the strong survive: Hedge funds

So how about hedge funds? Can we hide there? As the following exhibit shows, all hedge fund strategies delivered on the "hedge", losing less than the market, with some even making a tidy profit. The average Global Macro manager delivered a terrific 14% return during the past 6 months, which contrasts to an 8% loss in the worst-performing Relative Value strategy. As noted in the previous section, an 8% loss puts you well into the top quartile of traditional long-only managers. Also, the range of performance within hedge fund strategies is quite large, so it matters a lot who you use within a specific strategy.

Yes, there has been a place to hide, and it's been in hedge funds, especially Global Macro hedge funds.



How about the old folks?

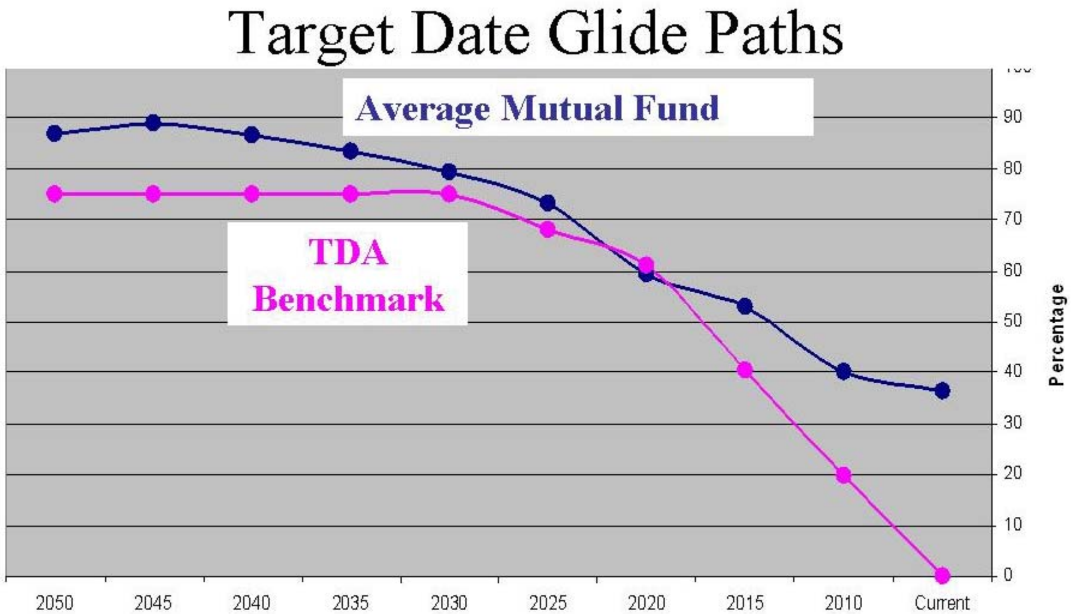
Recent losses can be especially devastating for those in retirement, who are living off their savings. An investment loss can usually not be made up by going back into the workforce, so the standard of living must adjust instead. Many retirees, as well as those who are saving for retirement, have invested in target date funds. These funds start out aggressively when the target date is distant and then become more conservative as the target date draws near. Those who have reached retirement are in "Current" funds, meaning the target date arrived sometime in the past. These are also sometimes called "retirement income" funds.

The following exhibit shows that investors in target date funds have indeed suffered during the past 6 months, even more than our benchmark. Target Date Analytics (TDA), in conjunction with PLANSPONSOR, has created benchmarks for target date funds. Importantly in this environment, the ***PLANSPONSOR On***

Target Index Series benchmark for current funds is invested entirely in inflation-sensitive safe vehicles, namely Treasury bills and Treasury Inflation-Protected Securities (TIPS). TDA believes that this is the appropriate allocation for the end of an "accumulation" fund, and that the investor should be making a second decision at retirement about appropriate distribution vehicles, such as annuities. For more information on target date benchmarks, please visit www.TDBench.com.

The exhibit shows the performance of the 3 largest target date families – Vanguard, Fidelity, and T. Rowe Price. These 3 providers currently dominate the target date fund industry, representing about 85% of this $200 Billion market.

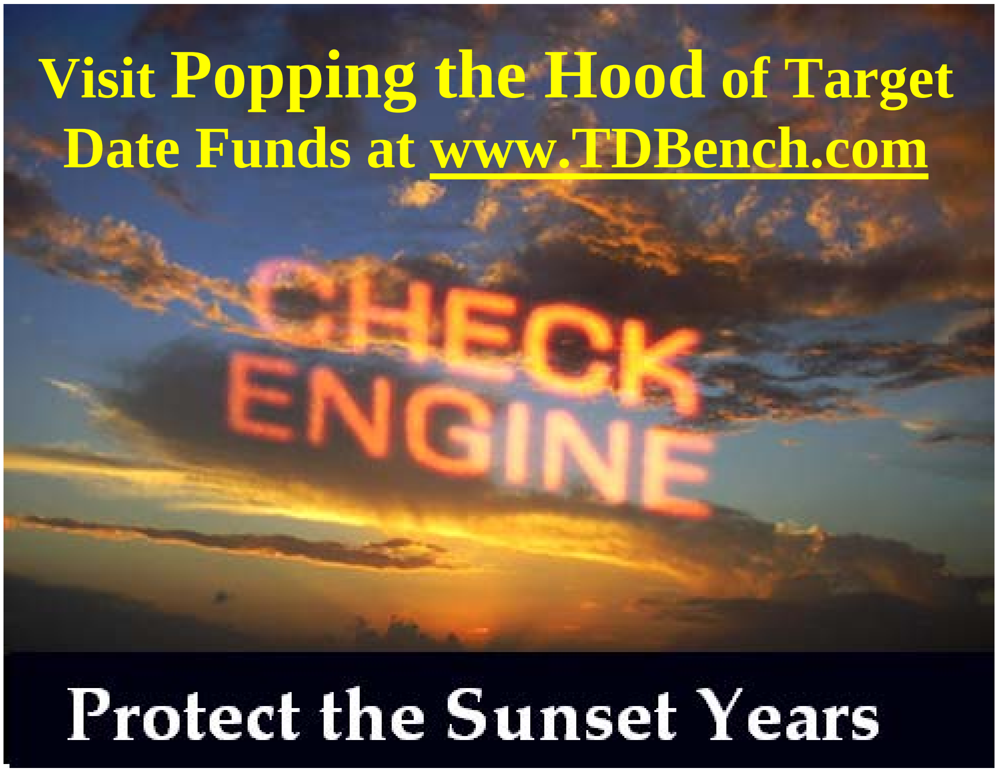
As you can see, investors in near-term current and 2010 funds have lost 2% and 6% respectively in just the past 6 months, and those in longer-dated funds have lost more than 9%, underperforming our benchmarks by about 5% across the board. Most of the recent underperformance of these funds, in both absolute terms, and relative to the benchmark, is explained by aggressive equity allocations. The following exhibit contrasts the "glide path" of the typical mutual fund to that of the benchmark. The glide path is the allocation pattern through time, especially the allocation to equities.



Detailed analyses of the 3 major fund families, plus another 35 fund families, are available in "Popping the Hood III", the 3rd installment of an annual comprehensive review of a growing list of target date fund families. This year the cost of the study has been substantially reduced so it is readily affordable by just about any serious target investor who visits www.TDBench.com .

Conclusion

These have been trying times, and there may be more of the same on the way. As long as we're paying the price, we might as well learn as much as we can from the lessons of these markets.



APPENDIX: Surz Styles

Style groupings are based on data provided by Compustat. Two security databases are used. The U.S. database covers more than 6000 firms, with total capitalization exceeding $18 trillion. The non-U.S. database coverage exceeds 15,000 firms, 20 countries, and $31 trillion -- substantially broader than EAFE.

To construct style groupings, we first break the Compustat database for the region into size groups based on market capitalization, calculated by multiplying shares outstanding by price per share. There are 3 regions maintained in our system: U.S., Foreign and Global. Beginning with the largest capitalization company, we add companies until 65% of the entire capitalization of the region is covered. This group of stocks is then categorized as "large cap" (capitalization). There are generally about 200 companies in this group for U.S., 800 for Foreign, and 1000 for Global. The second size group represents the next 25% of market capitalization and is called "mid cap". There are generally about 1000 companies in this group for U.S., 2700 for Foreign, and 3500 for Global. Finally, the bottom 10% is called "small cap". There are generally 5000 U.S. securities in this group, 10,000 Foreign, and 15,000 Global.

Then, within each size group, a further breakout is made on the basis of orientation. Value, core, and growth stock groupings within each size category are defined by establishing an aggressiveness measure. Aggressiveness is a proprietary measure that combines dividend yield and price/earnings ratio. The top 40% (by count) of stocks in aggressiveness are designated as "growth," while the bottom 40% are called "value," with the 20% in the middle falling into "core."