

# A Decrepit Decade Just Keeps Getting Worse

By Ron Surz

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## Introduction

In April of this year I started writing about the miserable stock markets we've experienced in this first decade of the 21<sup>st</sup> century, suggesting that things might even get worse.

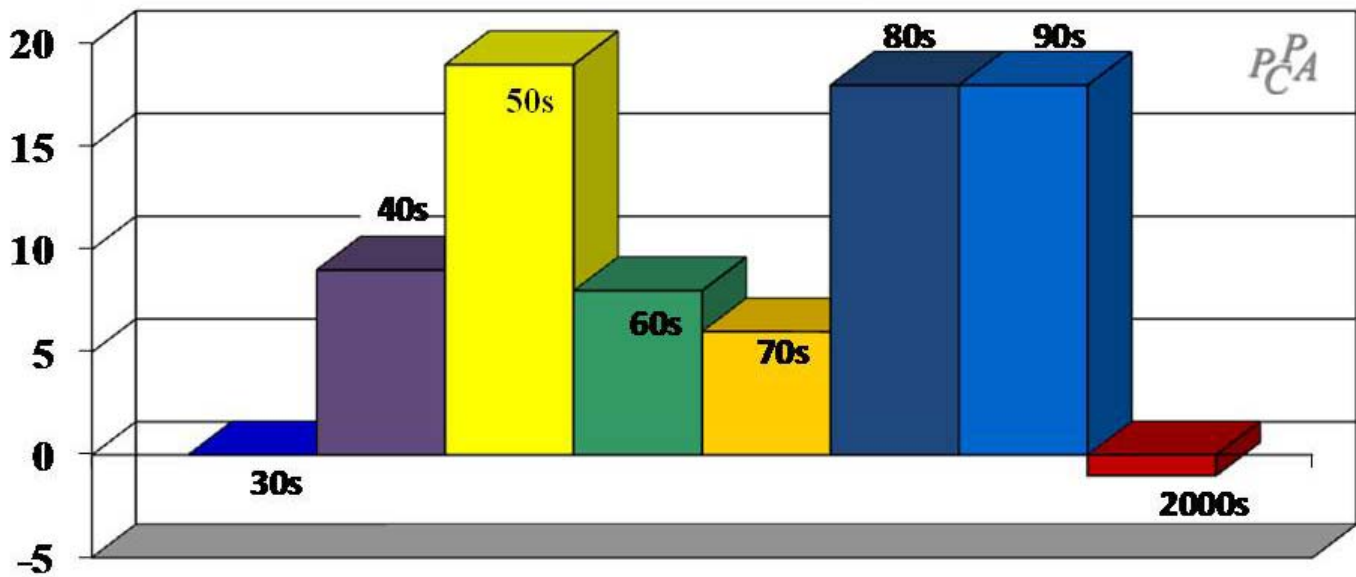
They have, big time.

We are experiencing the worst decade ever in stock market history, at least so far. In this 3<sup>rd</sup> quarter commentary I update both my 1<sup>st</sup> and 2<sup>nd</sup> quarter observations. If the following looks familiar to you, thanks for reading my earlier articles. The story told below is pretty much the same one I've already told twice this year, except things have gone from bad to much worse with each new revision. Frankly, I'm tired of telling this decrepit decade tale. Let's hope the 4<sup>th</sup> quarter version is more upbeat.

### It's taken all the running we can do to lose ground

Unless there's a significant rally in the next 15 months, the 2000s will prove to be the worst performing US stock market decade ever, actually losing money for the first time. The following chart shows the returns of the past 7 decades, and the 8.75 years to date through September 30, 2008:

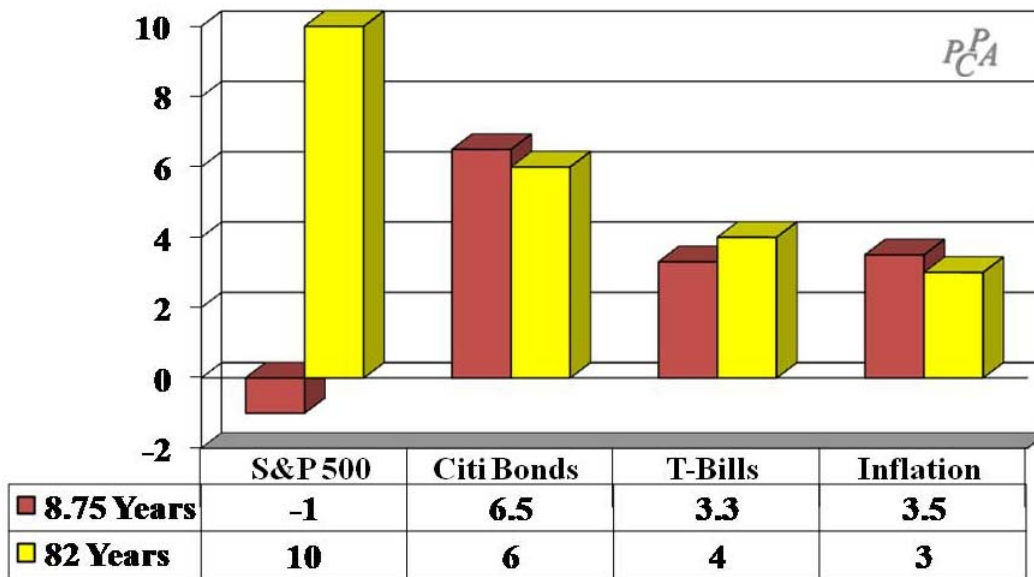
## Annualized S&P500 Returns by Calendar Decade



Here we are, 90% of the way into the first decade of the 21<sup>st</sup> Century, and US stock market investors have lost money. The S&P500 has lost 1% per year on average in the past 8.75 years, reminding us

what risk means. 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 15 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 8.75 years is foreign markets, which have returned more than 6% per year, although they too have suffered recent losses. 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 21<sup>st</sup> Century (8.75 Years Jan, 2000 – September, 2008)



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 11 months took all of that back, with the S&P plummeting 23% from 11/1/07 through 9/30/08.

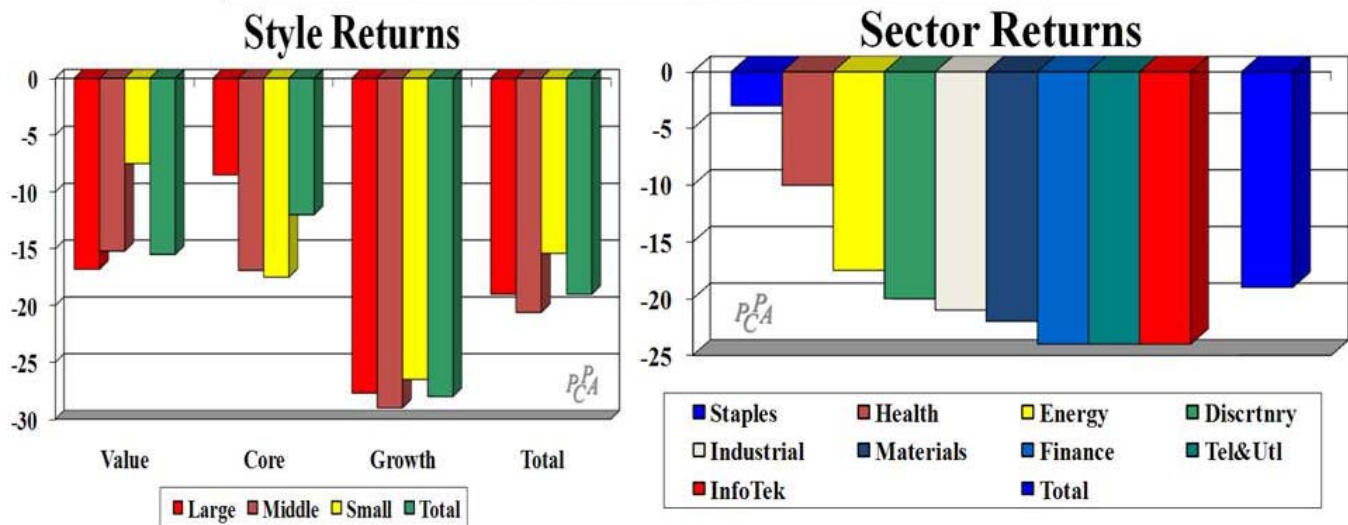
As painful as the last 11 months have been, we can still learn from this experience. This is the kind of period that serves to stress test those investments that are supposed to be good defensive plays, and to evaluate how well our professional investment managers have held up. In the following we review various market segments and strategies, to show 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 almost over. Recent lessons can help us deal with the past and plan for what is still left to come.

**What doesn't kill you makes you stronger**

As the following two exhibits show, there has been no place to hide in the long-only equity markets. On the sector front, every sector has lost value, with the best of the bad news coming in Staples, losing only 3%. The spread between the best performing Staples sector and the worst performing Information Technology sector is a whopping 2100 basis points. Sector allocations have mattered big time in the past 9 months. Not surprisingly, Finance was the worst performing sector in the first 6 months of the year, but the third quarter saw an unexpected recovery in Finance, rebounding a positive 2%. The third quarter was surprising in other ways as well. For example, Chindia infrastructure sectors – Energy, Materials and Industrials – were the big losers while Finance was a winner. It’s hard to figure out what was going on here, but it could be a reflection of deleveraging and opportunity – harvesting gains and capitalizing on cheap Financials.

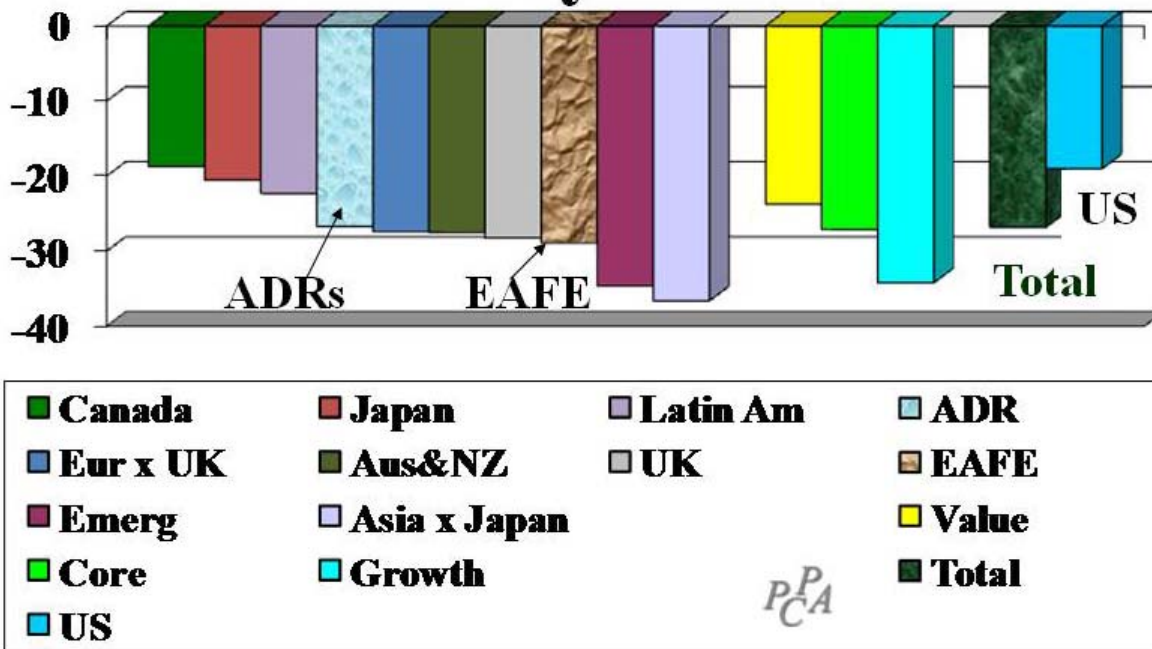
On the US style front, every style has also lost value, with the stuff in the middle surprising us by not performing in between. Mid cap has suffered more than large and small cap while large core has defended best, losing only 9%, versus 17% and 28% losses in large value and large growth, respectively. Our definition of “Core” is the stuff in the middle, between value and growth. Our style definitions are mutually exclusive and exhaustive, making them excellent for style analyses, both returns-based and holdings-based. Core tends to shine when investors lack conviction, unsure about which style to emphasize. We use Surz Styles and Countries throughout this commentary, as described in the Appendix. By contrast, both Russell and S&P show value stocks losing the same as growth stocks year-to-date, with both styles losing about 20%. Neither Russell nor S&P have Core, and this has distorted their results, so be forewarned. Any tilt toward core has benefitted performance, so you should find that aggressive growth managers have done worse than typical growth managers, and that ordinary value managers have done better than deep value managers. Off-the-shelf indexes only work on index huggers. Also, peer group classification biases should be particularly pronounced in year-to-date performance rankings, with most value managers outperforming their indexes and most growth managers trailing their indexes. This is not skill folks, or lack thereof.

### U.S. Performance for the 9 months 1/08 to 9/08



Fleeing the country has only made things worse, especially in the third quarter. Currency effects in the third quarter subtracted 8% from returns as the dollar strengthened. As the next exhibit shows, our neighbor to the north, Canada, has lost about as much as the US. All other regions have lost more. The overall foreign markets have lost 27% year to date and EAFE has lost somewhat more, declining 29%. The worst performing region has been Asia ex Japan, which includes China, down 36%. This had been the best performing region for several years prior to this correction. Fleeing the country has not ben a good move, leading some to observe that international diversification fails when it's needed most. It is indeed a world market.

## Country Returns



### 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 3 years or more to find a timeframe where positive returns are winners because that is when the S&P500 rises back to zero. The 3-year annualized return for the period ending 9/30/08 is 0.22%. As the following exhibit shows, a 15% **loss** will win the year-to-date performance race for those who are benchmarked against the S&P500, because a -15% return ranks in the top quartile for the 9 month period ending 9/30/08. "Congratulations Mrs. Client your manager performed very well, losing "only" 15% 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." You can use the chart below to get an early and accurate ranking of your own portfolio -- just plot your dot.

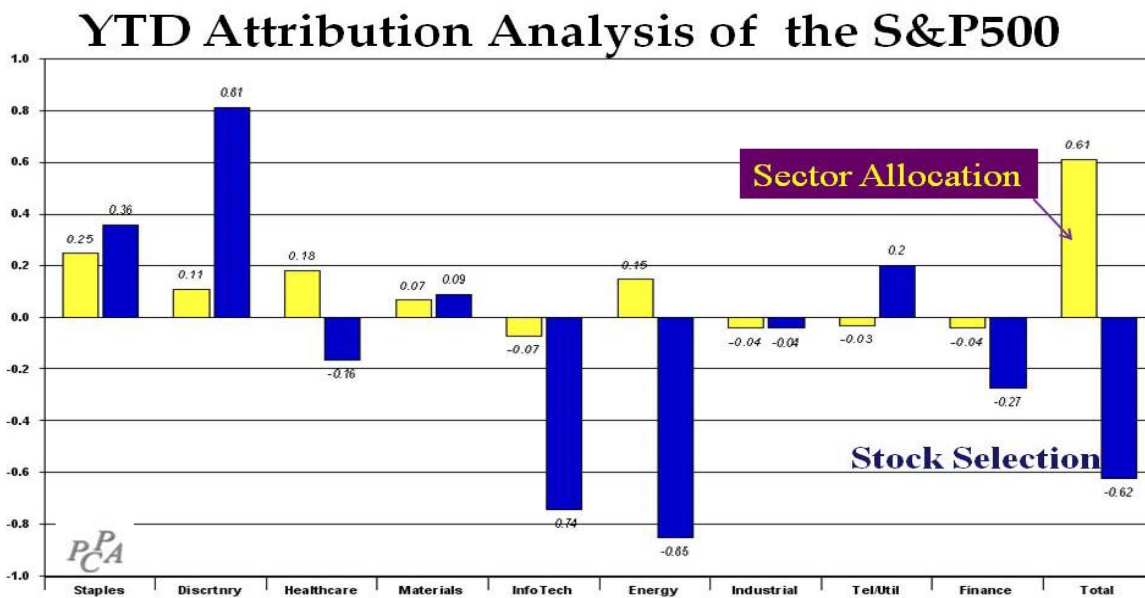


## Putting it all together: Attribution Analysis

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 nine months, we attribute performance for the S&P500 using the total U.S. market as the benchmark. Why does the S&P perform the way it does relative to the total market? We use an attribution system called StokTrib, described at [http://www.pcca-inc.com/Stok\\_Trib/stoktrib.htm](http://www.pcca-inc.com/Stok_Trib/stoktrib.htm), to answer this question.

As shown in the following exhibit, the S&P500 has matched the performance of the total US stock market because of offsetting failures and successes: good sector allocations were offset by poor stock selections. The S&P usually performs differently than the total market, so this time period is unique. The value tilt of the S&P currently weights Staples and Health Care more heavily than the market, while underweighting Materials, all of which were beneficial. But the stock picks of the committee that selects those 500 stocks offset this benefit. 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.

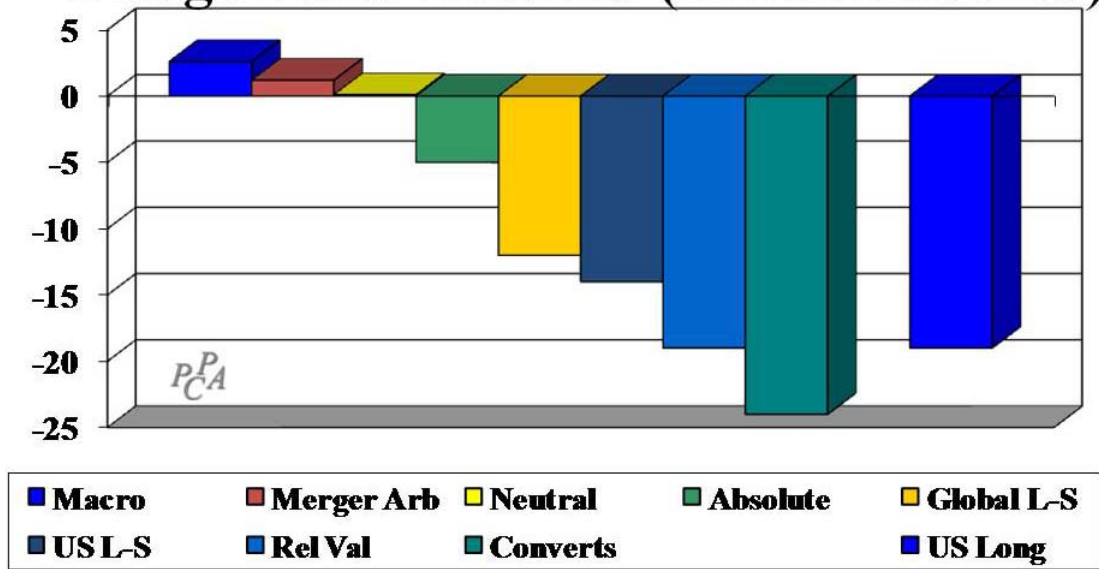


## Only the strong survive: Hedge funds

So how about hedge funds? Can we hide there? As the following exhibit shows, most hedge fund strategies delivered on the “hedge”, losing less than the market, with a few even delivering positive results. The average Global Macro manager delivered a 2.5% return during the past 9 months, which contrasts to a 24% loss in the worst-performing Convertible Arbitrage strategy. As noted in the previous section, a 15% loss puts you into the top quartile of traditional long-only managers. Six of the eight hedge fund strategies have lost less than 15% year-to-date. 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. Global Macro hedge funds are a disperse group with a general commonality of currency investing. Their good relative performance suggests that on average they got the US dollar right.

# Hedge Fund Returns (HFRX Indexes)



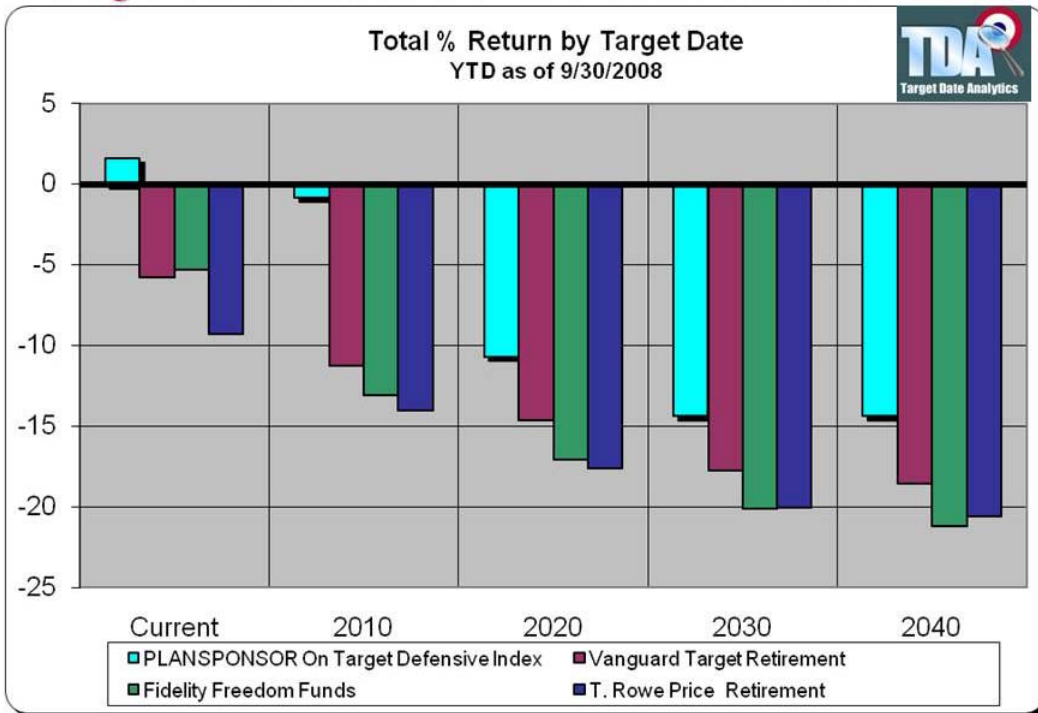
## How about the old folks?

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 9 months, and they’ve suffered much 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* 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](http://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.

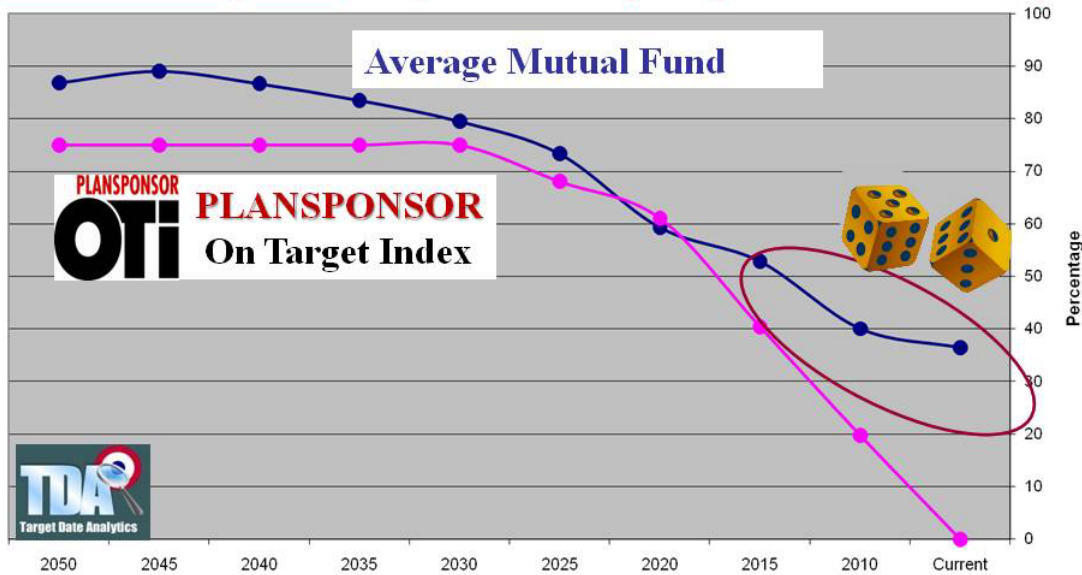
## Target Date Fund Investors Should be Better Protected



As you can see, investors in near-term current and 2010 funds have lost 6% and 13% respectively in just the past 9 months, and those in longer-dated funds have lost 20%, underperforming our benchmarks by about 10% across the board. Investors should be disappointed because these funds have failed to protect, especially those in near dated funds. Near dated funds are held mostly by the first Baby Boomers, now in their 60s. Using the 5% rule, a 15% loss robs these folks of 3 years of retirement dignity; it's a shame that is likely to be felt and paid for by future generations. But the real shame is that these losses should have been avoided. 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.

## Equity Commitment

### Glide Path Comparison: Why is The Average Target Date Fund So Risky?



Detailed analyses of the 3 major fund families, plus another 35 fund families, are available in “Popping the Hood III”, the 3<sup>rd</sup> 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](http://www.TDBench.com).

## Conclusion

These have been trying times, and may be a harbinger of more to come. As long as we’re paying the price, we might as well learn as much as we can from the lessons of these markets.

Here are a few lessons from this decrepit decade that can help us going forward:

1. Investors are entitled to be concerned about recent capital market behavior. It’s been awful. “Staying the course” just hasn’t cut it, and might not going forward. But there’s a penalty for us all running to the door at the same time. The biggest risk we face is a panic-induced Pogo predicament: “We have met the enemy and they are us.” These are very tough decisions.
2. Moving to certain styles, sectors or countries may help defend but hedging has worked best. Of course, investors can hedge on their own through the use of derivatives, or moving to cash.
3. This is a good time to stress test managers for skill. You know that stuff about what the tough do when the going gets tough. But it is absolutely critical that the benchmark is accurate. Some will get fired for the wrong reasons, and then their replacements will get hired for the wrong reasons too. Clients need to know what a “fair” loss should be, given what the manager does. Hint: off-the-shelf indexes only work on index huggers.
4. Selecting target date funds is currently problematic because this industry as a whole has entered into a performance race, and is exposing investors to too much risk, especially near

target date. The timing for these moves to higher risk was bad, but it will be even worse if we don't learn from this lesson: target date funds should defend better near target date.

If you're looking for my opinion about the future and practical courses of action, I am as challenged by these markets as the rest of us. Global stock markets plummet when the bailout plan is not approved and when it is approved. Munis yield more than taxables. Gold goes down with everything else. Finance outperforms. TIPS tank. It's like the god of random punishments is toying with us. There are opportunities in these dislocations, but they're not for the squeamish or the amateur. I do foresee high inflation in the not-too-distant future. We've been spending beyond our means for a long time. Inflation benefits debtors, the biggest of which is the US government, and this debtor has the ability to print money.

### **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."