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Oktoberfist: Digesting October's Sucker Punch

In April of this year I began writing about the miserable stock markets we've experienced in this first decade of the 21st century, recommending heightened due diligence and suggesting that things might even get worse.

They have, big time.

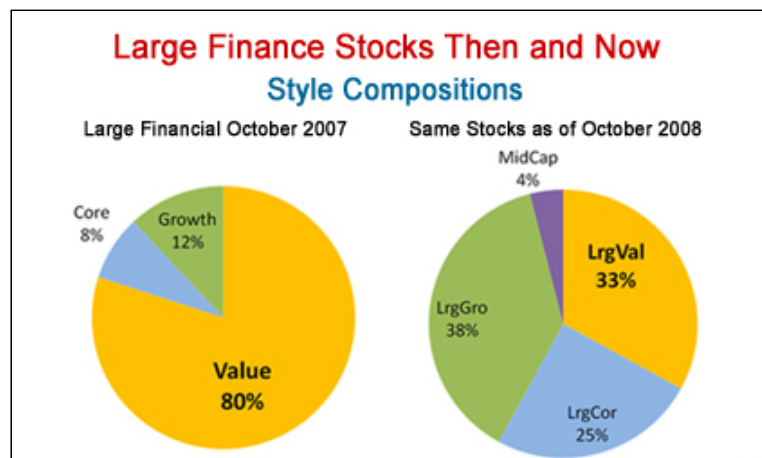
My last update on this mess was released on October 5 and covered the year to-date through September. Then toward the end of October I alerted readers to some serious problems in style indexes and target date indexes. Now this writing brings these latest two commentaries up-to-date through an ugly October. I normally wouldn't bother with a monthly commentary, but October 2008 was like a punch to the stomach by a giant fist - an October Fist. I'd like to help you and your clients get your wind back, so I've updated my suggestions and observations in the following. Please let me know what you think. These are tough times and I'm here to help.

But before I present these updates, let's take a close look at the decimation of the Finance sector, which is where this whole fiasco started. A lot has changed, and there's more on the way.

Decimation of the Finance Sector

What a difference a year makes. The Finance sector is down 47% for the year ending October 2008. Prices have fallen because earnings have fallen, transforming the characteristics of this sector in the process. To see this transformation we examine the fate of the 46 stocks that made up the large company finance sector one year ago, in October 2007. Details of these companies, then and now, are provided in the appendix. Good chance you'll find your own companies in this list. How have these stocks changed in the past 12 months? Some companies, 18 to be exact, have remained about the same, apparently unaffected by the crisis. These immune companies could come through this crisis as winners. Fifteen companies remain in the large cap category but their style has changed, generally moving from value to growth. Eight of these formerly large cap companies have moved into the mid cap range, and two - Freddie and Fannie - have become small cap. And 3 companies have ceased to exist.

The exhibit on the right shows the style make-up and aggregate characteristics of the October 2007 large cap Finance sector as it existed a year ago, and compares these to today's profiles for the same stocks. As you can see, 80% of the dollars in the 2007 Finance sector were classified as large value, whereas today only a third are large value, with much of the former value dollars moving to growth. Growth, at 38%, is now a larger component of



the 2007 large Finance sector than value. Also, the total market value of this sector has declined by almost \$1 Trillion, from \$2.6 Trillion to \$1.7 Trillion. Average capitalization has declined from \$56.4 Billion to \$38.8 Billion, while P/Es have increased from 12.3 to 20.2. Earnings have fallen faster than prices, with some firms posting negative earnings for the trailing 12 months.

In a nutshell, the decimation of the Finance sector has caused it to take on a smaller company, more growth orientation. You'd think the decrease in prices would have made these companies even deeper value, but earnings deterioration has more than offset the price erosion effect. In style space, these companies are priced to grow their way out of the current dilemma. This has significant implications for style specific portfolio managers and their evaluators. Most view Finance as a value play, but this is simply not the rule anymore, and may not be for some time. The game has changed, and the sooner we realize it the better. Index providers with annual June resets will ignore these changes for another 8 months, so the reader is forewarned.

[Update to A Decrepit Decade Continues](#)

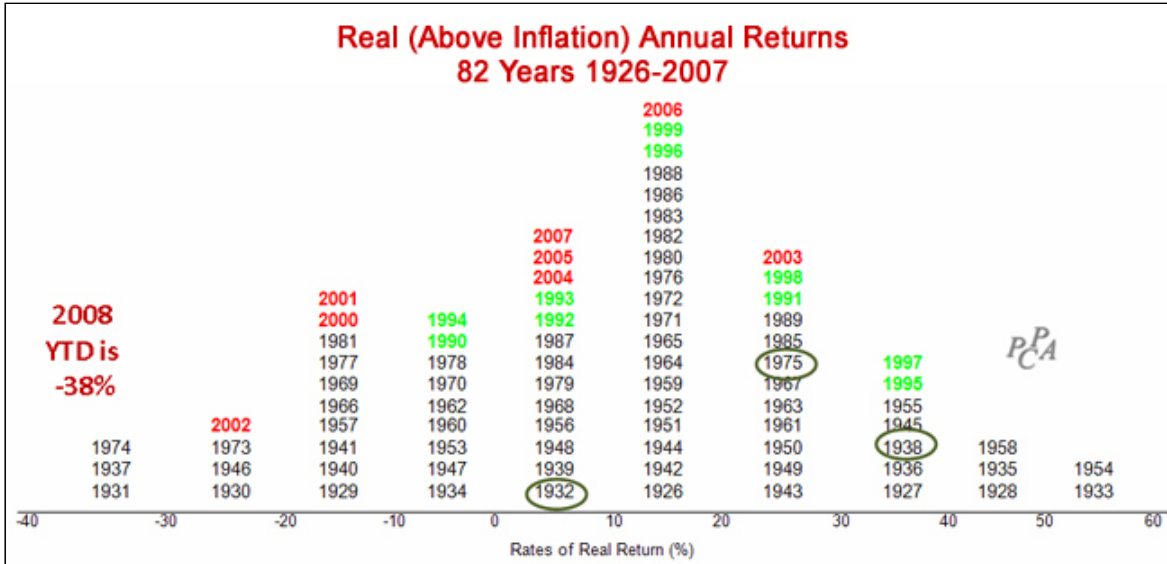
(Article available from www.pcca-inc.com/pdf/Decrepit_Decade_Continues-20081006.pdf).

We are experiencing the worst decade ever in stock market history, and it just keeps deteriorating. Because of the 17% October loss, the year 2008 could be legendary and could clinch the race for the worst decade as well. We are now down 34% for the year-to-date, in an inflationary environment that has increased 4% so far, so our real (net of inflation loss) is 38%. As shown in the following exhibit, there have been only 3 calendar years with real losses in excess of 30%: 1931, 1937 and 1974. There's some good news and some bad news about being in this infamous club.

First the good news. All three of these years were followed by years with positive returns, and 1938 and 1975 were particularly good, both returning about 30% real.

Now for the potentially bad news. Stock markets, as measured by the S&P500, have had 12-month periods with far worse losses than -30%-plus real returns of 2008. The worst 12-month return ever was for the 12 months ending June 1932, when the real loss was 68%, so the apparent 40% loss floor shown as the lowest return in the exhibit is not the true historic abyss. The 5-month real loss for June-October, 2008 exceeds 35%, so it's conceivable that losses in the next 7 months could put us in the record books. A further decline of 50% between now and May 2009, would set the record for a 12-month period. Seem unlikely? Let's hope.

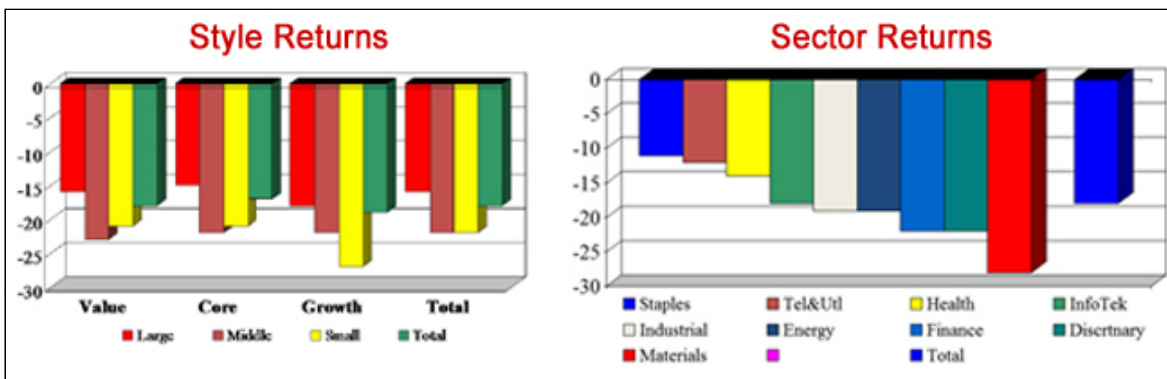
We are making history, albeit history we would rather not experience.



Since I covered the year-to-date through September in my earlier commentary, I'll limit this discussion to just the horrific month of October.

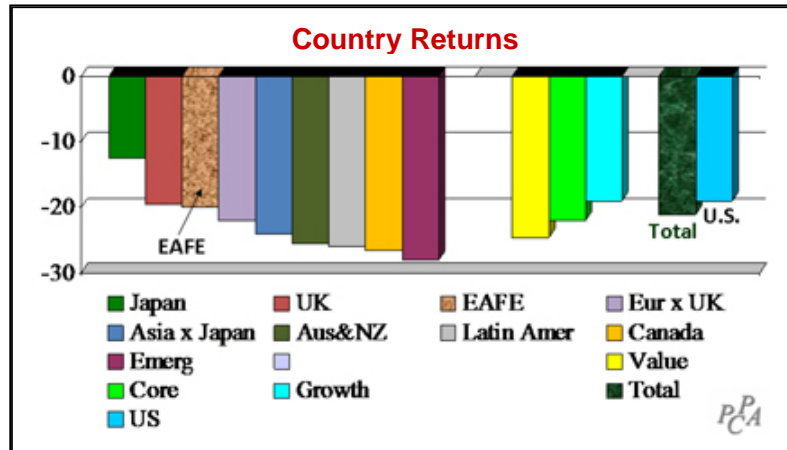
As the following two exhibits show, there has been no place to hide in the long-only equity markets. On the sector front, every sector has lost value, with the best of the bad news coming in Staples, losing only 11%. The spread between the best performing (Staples) sector and the worst performing (Materials) sector is a whopping 1,600 basis points - in just one month. Sector allocations mattered big time in October. Surprisingly, Finance was not the worst performing sector. The Chindia infrastructure sectors - Energy, Materials and Industrials - joined with Discretionary to all lose about the same as Finance. This clustering of losses can be explained by a combination of continued deleveraging, selling past winners, plus expected cutbacks in consumer spending.

On the U.S. style front, every style lost value, with the stuff in the middle surprising us by not performing in between. Large core has defended best, losing only 15%, versus 16% and 18% 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 at [Surz Style Indexes](#). See the section that follows on "Warning" for more on the importance of Core, especially this year.



Fleeing the country has only made things worse, especially in October. Currency effects in the month subtracted 5% from returns as the dollar strengthened, bringing the year-to-date currency effect to

minus 13%. Foreign markets have kept pace with the U.S. in local currencies. The overall foreign markets have lost 21% in October and EAFE performed somewhat better, declining 20%, due mostly to its absence of exposure to Emerging Markets and its overweight in Japan. The worst performing region was Emerging Markets, and the best was Japan. Fleeing the country has not been a good move in the current crisis, leading some to observe that international diversification fails when it's needed most. It is indeed a world market.

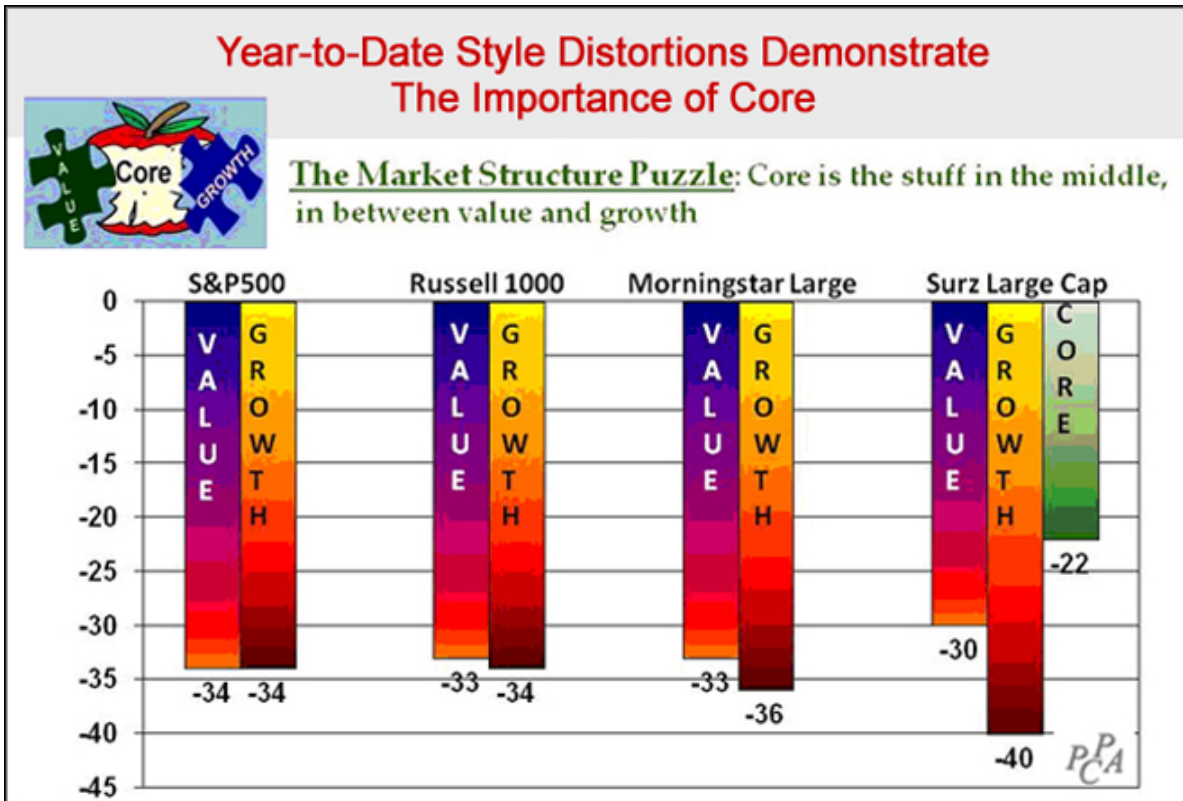


Update to [Warning: Market Meltdown Generates Index Mayhem](#)

(Article available www.pzca-inc.com/pdf/Warning-20081024.pdf.)

Toward the end of October I released a warning about the problems with indexes for styles and for target date funds. The following updates these warnings through October.

"It doesn't matter which style indexes you use because they're all about the same." We've heard this often enough and it would seem to be the case in the first ten months of 2008, but not so. As shown in the following exhibit, the most popular indexes - Russell, S&P and Morningstar - all agree that value and growth have lost about the same, roughly 34% year-to-date through October 2008. This concurrence should give us confidence that -34% is the right number, but both Russell and S&P are missing an important component of the market, namely the stuff in the middle, in-between value and growth, that I call **Core**. Morningstar does include this important Core component, but it uses different rules than Surz Indexes described below, so their results are materially different. Surz Indexes were launched in 1986 and are described at [Surz Style Indexes](#). Morningstar indexes were launched in 1997.



The inclusion of Core paints a dramatically different picture where Value has outperformed Growth, and Core has outperformed both Value and Growth. Morningstar's Core also outperformed its Value and Growth indexes, but their returns are different than Surz because their rules are different than Surz Index rules. Morningstar Core is down 28% year-to-date. Morningstar's definition of large Core is quite broad, representing more than 23% of the market, which is almost twice the 13% Surz definition.

Why is this Core-Value-Growth performance ranking important? Because investment managers compared to the popular indexes will be misjudged at this very critical time of high investor anxiety. Core typically outperforms when investors lack conviction, favoring neither value nor growth. Also, Barry Mendelson, president of Capital Market Consultants, has recently written about his belief that investors should prefer the stocks in the middle during the current crisis - they are Goldilocks stocks, not too extreme in cheapness or expensiveness.

Now more than ever it's important to get the benchmark right. Otherwise, today's faulty decisions will undermine future performance.

This type of index discord, while infrequent, is explained by differences in methodology that can be best understood by considering how stocks in the gray area, between Value and Growth, are treated by index providers. There are degrees of value and growth, so some growth stocks are more aggressive growth than others, and some value stocks are deeper value than others. And some stocks have characteristics that are not clearly value or growth - they're the stuff in the middle. Russell deals with this issue by pro-rata allocating these fuzzy stocks into both value and growth. S&P ignores the problem altogether by drawing a hard line that divides half of the market's value between value and growth. By contrast, both Surz and Morningstar deal with this stocks-in-the-middle issue by defining a separate category called "Core". I'll describe the Surz classification rules so you can see how it works.

Surz indexes break out value, core, and growth stock groupings within each market cap by establishing an

aggressiveness measure that combines dividend yield, price-to-earnings ratio, and price/book 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. The result is a family of indexes that are mutually exclusive and exhaustive, making them perfect for style analyses, both returns-based and holdings-based style analysis.

Core usually performs in between value and growth, but about a third of the time it does not, like the current year to-date. **It is during these unusual times that Surz indexes, as an alternative to Russell and S&P, provide conspicuously valuable insights.** Surz indexes have been around for more than 20 years, long enough to have stood the tests of time. A list of stocks classified as core is available upon request.

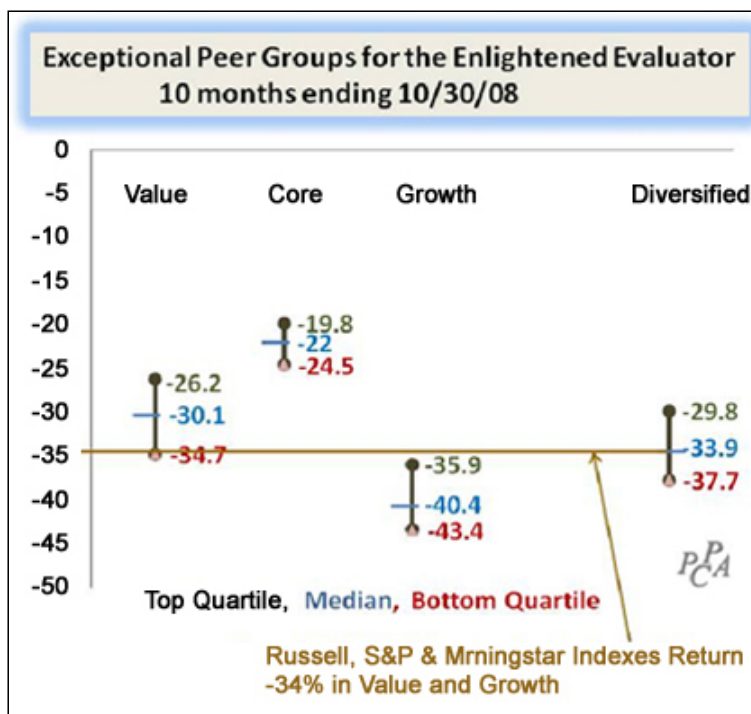
So, what can you do to take advantage of this insight? Obviously, you can use the index results above, but I'm giving you something even better - the gift in the next exhibit, which provides superior peer groups for your ranking pleasure and enlightenment. Just plot your fund's return against the appropriate group. As you can see there is very little overlap in the intra-quartiles, so misclassifying a manager will lead to erroneous evaluations. Also, classification bias in traditional peer groups is likely to be problematic in the 10 months to-date. For an entertaining and informative discussion of this little known bias please visit [Classification Bias](#).

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 their respective indexes. In essence, hypothetical monkeys expand an index into a peer group by simulating all the portfolios that could have been formed from stocks in that index. By contrast, 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 POD universes were available on October 2, many weeks before the "real" biased peer groups. As John Stossel says on ABC TV News: "Give me a break." Please visit [Virtual Peer Groups](#) for more details on this important breakthrough.

Target Date Funds

Unlike the dozens of U.S. stock indexes, there are only three target date fund indexes. Dow Jones introduced their indexes first, in April 2005. Then my firm, Target Date Analytics (TDA), introduced our indexes in October 2007. And Standard and Poor's (S&P) just announced the creation of their new indexes. PLANSPONSOR magazine adopted the TDA indexes in August of this year and re-branded them as the PLANSPONSOR On Target Indexes (OTI).

These three indexes differ substantially in composition and philosophy. Let's discuss philosophy first:



- The S&P indexes are industry averages, reflecting common practices among current target date fund offerings. S&P describes this construction as follows:
Each index is representative of the investment opportunity available to investors for the corresponding target date horizon, with asset class exposures driven by a survey of available target date funds for that horizon."
- The Dow indexes have a stated objective to:
"measure the performance of a lifecycle portfolio that seeks to grow and preserve real value over time."
- The PLANSPONSOR On Target Indexes have two objectives:
"(1) Protect the purchasing power of contributions with a very high probability, and (2) Grow assets with a reasonably high probability, without jeopardizing the primary protection objective."

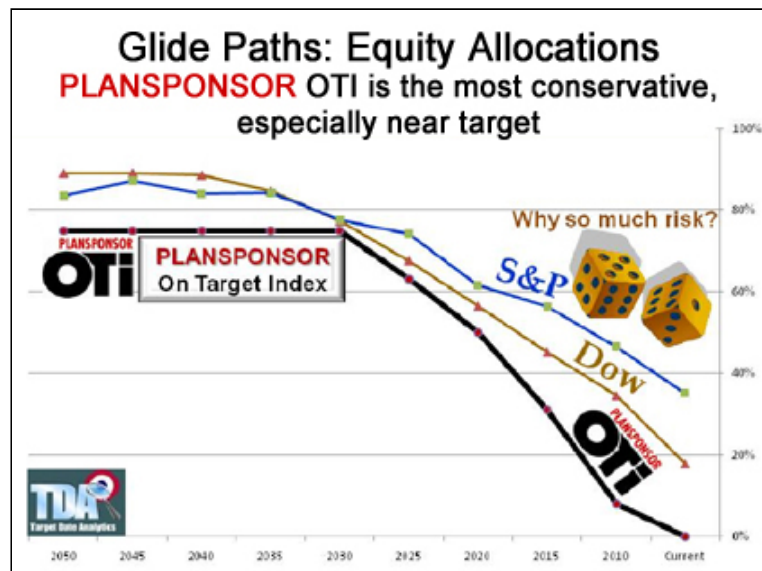
The major difference between the Dow and OTI objectives is priority. Dow places equal emphasis on preservation and growth whereas OTI emphasizes preservation over growth. **In summary, the OTI and Dow indexes are standards - the way target date funds should be managed - and the S&P indexes are common practice aggregates.** Unfortunately, we find common practice woefully lagging both the Dow and OTI standards. Target date funds are a great idea with awful execution, at least so far.

These differences in philosophy and objectives lead to materially different index compositions and results. The exhibit on the right summarizes composition differences at the broad equity allocation level. As you can see, as the target date approaches the S&P indexes are the most aggressive, followed by the Dow, and then the PLANSPONSOR OTI are the most defensive. All 3 indexes are quite similar in equity allocation at the more distant dates.

There is an ongoing debate raging in the target date industry regarding the purpose of target date funds. So far it's TDA versus the industry. We at TDA believe that target date funds should be limited to the accumulation phase of a participant's lifecycle, and that the distribution phase is best served by vehicles designed for this purpose, like annuities.

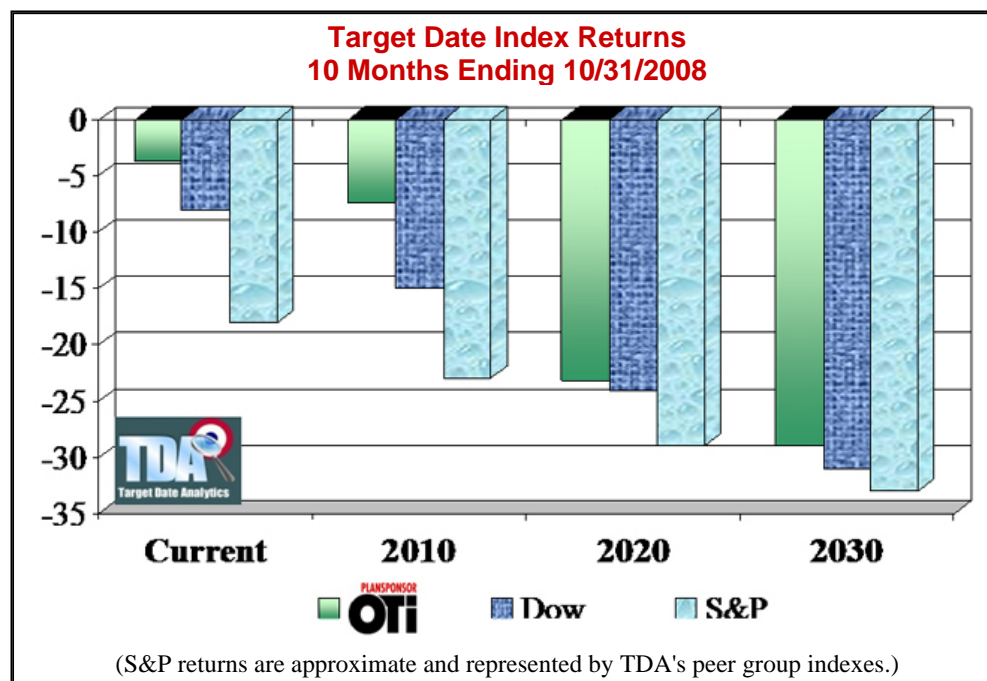
Vehicles designed to address longevity risk should be employed post-retirement because there is no glide path that can handle this life-long task.

Accordingly, we believe that target date funds should be entirely in safe non-risky assets at target date, waiting for the participant to move to the next phase, which they should be thinking about long before retirement. But the industry doesn't see it our way. The target date fund industry sees target date funds continuing beyond the target date. Some see accumulation funds morphing into distribution funds at target date and continuing on, in some cases to death. This is akin to viewing the target date as a small speed bump on the highway of life. Truth in advertising dictates that funds taking this extended view should be re-labeled so the investor knows their intended lifespan. For example, 2010 funds that are intended to serve the investor for 30 years beyond retirement date should be re-labeled 2010-to-2040 funds. But not all fund companies extend their glidepaths. Some fund companies roll their target date funds into "Income Funds",



which have the objective of throwing off reliable income while preserving principal, rather than managing longevity risk. Both approaches extend the investor's participation beyond target date. What do you think the role of target date funds should be? Should they continue beyond target date?

These composition and philosophical differences have significantly impacted target date index performance in the year to-date, as shown in the next exhibit. The recent meltdown has been a wake-up call for the target date industry and gives TDA an "I told you so" that we wish we didn't have. Our greatest concern is for investors in near-dated funds, who are at or near retirement, and have the most at stake both emotionally and monetarily. For the most part these 60-plus year-old investors are in target date funds as a default option in their 401(K) plans, since target date funds are one of three qualified default investment alternatives (QDIAs). Do you suppose any of these folks were prepared for the kind of disastrous loss that has occurred in both the S&P and Dow indexes? Did they know the risks they were exposed to? That is, what is the better standard?



Your choice of index makes a big difference in your evaluation of target date fund results. Choose the index that is most in line with the plan participants' understanding of what target funds should be.

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.

APPENDIX: Large Finance Companies Then and Now

Source: PPCA Inc.

	0710			0810			
	Styl	Capzn	P/E	Styl	Capzn	P/E	
ACE LTD	Valu	19.9	7.6		18.0	10.4	
BANK OF AME	Valu	223.0	11.3		159.7	30.2	
BB&T	Valu	22.2	14.0		20.9	12.8	
FRANKLN RES	Core	31.3	17.9		20.7	13.1	
BLACKROCK	Grow	20.1	26.5		22.8	23.8	
BERKSHIRE A	Grow	183.3	15.1		202.3	17.9	
CHUBB CORP	Valu	20.6	7.8		19.5	10.0	
CME GROUP I	Grow	20.5	41.3		20.3	24.1	
CAPITAL ONE	Valu	25.6	9.6		19.8	10.6	
GOLDMAN SAC	Valu	86.2	8.4		50.5	7.3	
METLIFE INC	Valu	51.8	13.8		39.8	11.5	
MANULIFE	Valu	62.7	17.5		54.8	13.1	
SUN LIFE FN	Valu	29.7	14.4		19.8	16.7	
SUNTRUST	Valu	26.3	12.6		15.9	13.9	
STATE ST CP	Core	26.2	17.6		24.5	12.9	
TRAVELERS C	Valu	32.5	7.1		26.5	8.7	
U S BANCORP	Valu	56.1	12.3		63.2	17.9	
VORNADO RLT	Core	16.6	32.7		14.0	26.9	
Style Changes	--	Large					
AFLAC INC	Core	27.8	17.7	Lgro	28.0	19.5	
ALLSTATE CP	Valu	32.8	6.8	Lgro	24.7	121.4	
AM EXPRESS	Core	69.4	17.0	Lval	41.1	12.1	
BROOKFIELD	Core	22.5	19.1	Lgro	16.0	23.1	
BANK OF NY	Valu	50.3	18.4	Lcor	37.4	18.0	
CITIGRP	Valu	232.5	12.4	Lgro	111.8	-4.8	
JPMORGAN CH	Valu	153.9	9.6	Lcor	174.1	22.6	
MERRIL LYNC	Valu	61.3	14.7	Lgro	40.5	-1.0	
MORGAN STAN	Valu	66.9	7.8	Lgro	25.5	104.6	
PNC FINL SV	Valu	23.0	13.1	Lcor	26.0	19.5	
PRUDNTL FIN	Valu	45.0	11.9	Lgro	30.7	23.3	
SCHWAB (CH)	Valu	27.0	25.7	Lgro	29.9	24.3	
SIMON PPTY	Core	22.3	42.0	Lgro	21.8	46.0	
UBS AG	Valu	102.8	9.1	Lgro	49.7	-1.6	
WELLS FAR	Valu	118.4	13.3	Lcor	124.5	18.4	
Style Changes	--	MidCap					
AM INTL GRP	Valu	174.5	11.0	Mgro	8.9	-6	
FIFTH THIRD	Valu	18.0	15.6	Mval	6.9	250.0	
FANNIE MAE	Valu	59.1	16.7	Sgro	1.6	-2	
FREDDIE MAC	Grow	39.0	-40.4	Sgro	1.1	-2	
HARTFRD FNL	Valu	29.0	9.4	Mgro	12.3	-9.3	
LINC NATL	Valu	17.9	11.9	Mval	11.0	13.8	
NYSE EURONE	Grow	20.9	43.5	Mval	10.4	12.4	
REGIONS FIN	Valu	20.6	12.1	Mval	6.6	9.5	
SLM CORP	Grow	20.6	28.4	Mgro	5.8	-3.0	
WACHOVIA	Valu	95.3	11.0	Mgro	7.5	-2	
Gone							
LEHMAN BROS	Valu	32.7	7.8				
LOEWS CORP	Valu	25.9	11.9				
WASH MUTUAL	Valu	30.7	12.8				
		46	56.4	12.3	43	38.8	20.2

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