

Perspectives on 2008 and Beyond

By Ron Surz January 5, 2009

Introduction

In April of 2008 I started writing about the miserable stock markets we've experienced in this first decade of the 21st century, suggesting that things might even get worse.

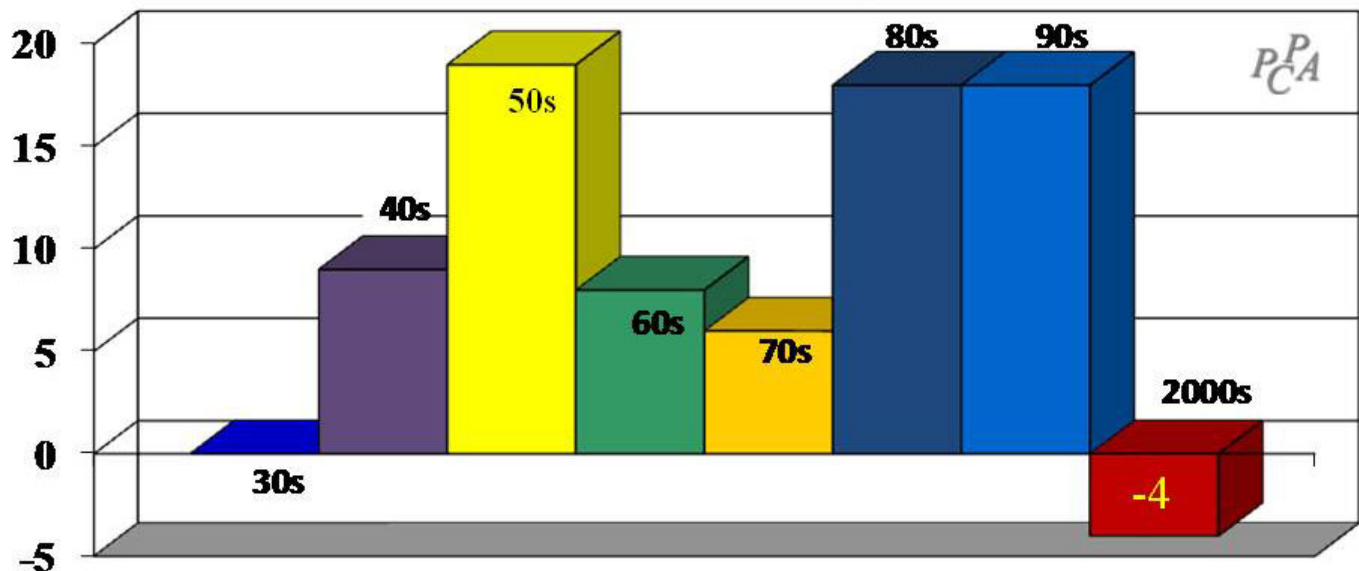
They have, big time.

We are experiencing the worst decade ever in stock market history, at least so far. In this end of year commentary I update my earlier observations. The story told below is pretty much the same one I've already told, 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 2009 is more upbeat.

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

Unless there's a significant rally in 2009, the 2000s will prove to be the worst performing US stock market decade ever, actually losing money for the first time. It will take a whopping 40% return in 2009 to make investors whole for the decade. The following chart shows the returns of the past 7 decades, and the 9 years to date through December 31, 2008:

Annualized S&P500 Returns by Calendar Decade



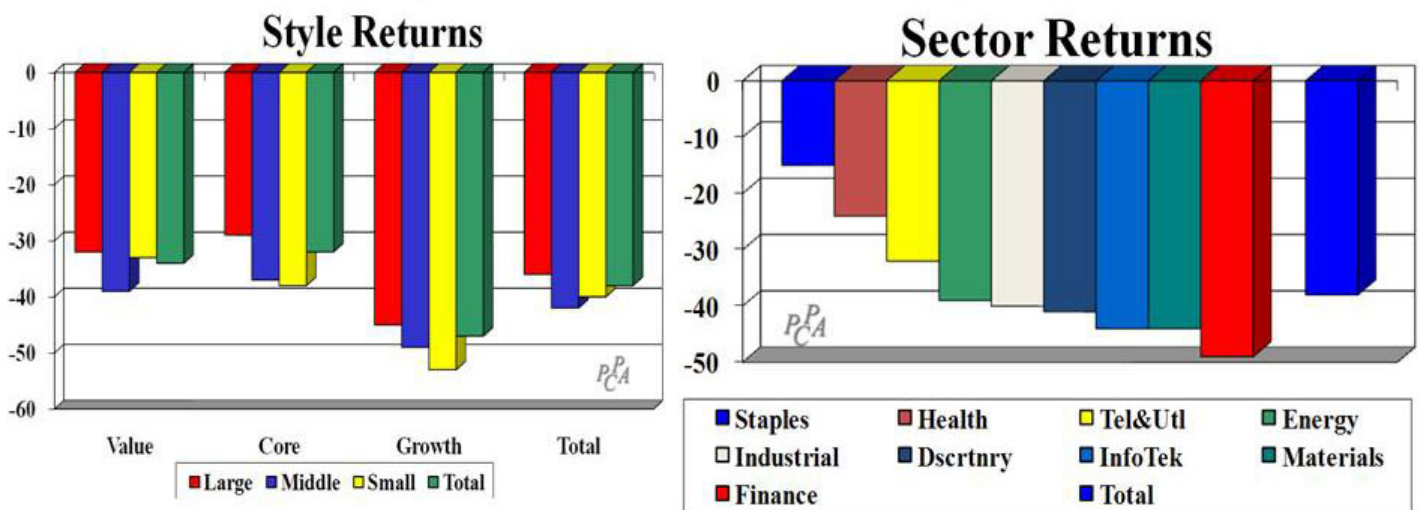
Here we are, 90% of the way into the first decade of the 21st Century, and US stock market investors have lost money. The S&P500 has lost 4% per year on average in the past 9 years, reminding us what

worked, but some market segments suffered less than others. And how about those poor old folks who are retired, and living off their savings?

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 15%. The spread between the best performing Staples sector and the worst performing Finance sector is a whopping 3300 basis points. Sector allocations have mattered big time in the past year. 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%, only to give it back in the 4th quarter with a 32% loss. 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.

U.S. Performance for 2008



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 29%, versus 32% and 45% 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.

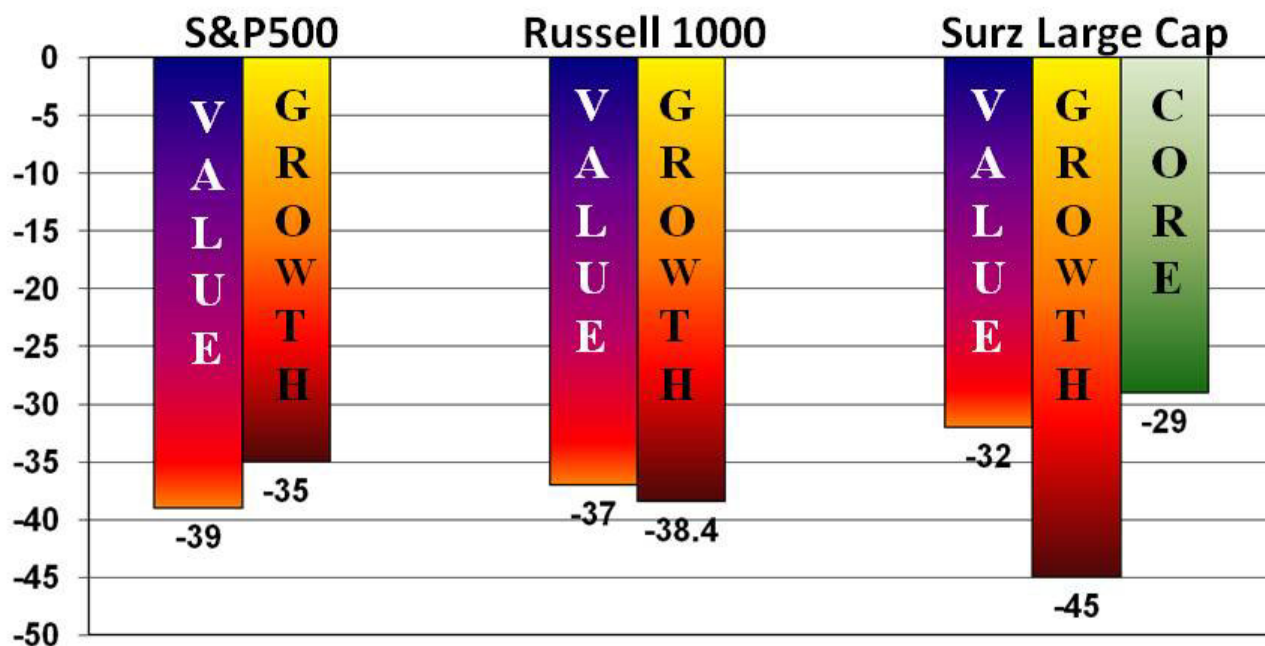
By contrast, S&P shows Growth outperforming Value while Russell shows just the opposite, Value outperforming Growth. Neither Russell nor S&P have Core, and this has distorted their results, so be forewarned. Any tilt toward core has benefitted performance, so you should find that aggressive growth managers 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.

2008 Style Quandary

Demonstrates The Importance of Core

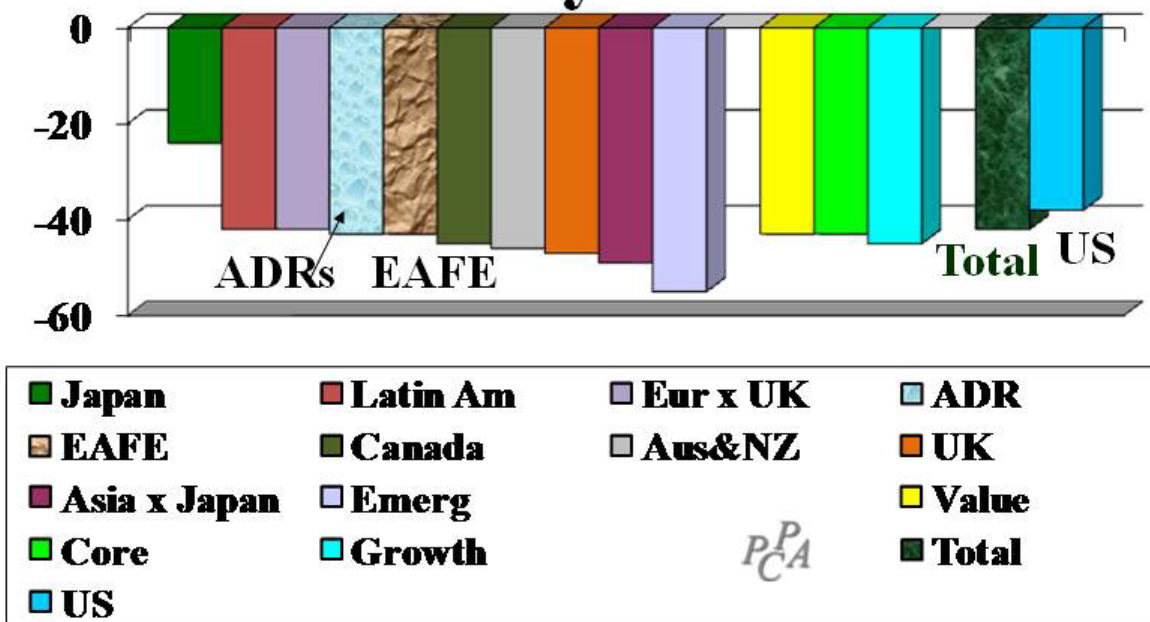


The Market Structure Puzzle: Core is the stuff in the middle, in between value and growth



Fleeing the country has only made things worse, especially in the second half of 2008 due primarily to a strengthening US dollar. Currency effects in the second half subtracted 13% from foreign market returns as the dollar strengthened. As the next exhibit shows, with the exceptions of Japan and Emerging Markets every region lost about 45% in 2008, as did every style. Japan defended best in the year, losing only 24%, while Emerging Markets were decimated with a 51% loss – a 2600 basis point spread. The overall foreign markets have lost 42% and EAFE has lost somewhat more, declining 43%. Fleeing the country has not been a good move, leading some to observe that international diversification fails when it's needed most. It is indeed a world market.

Country Returns



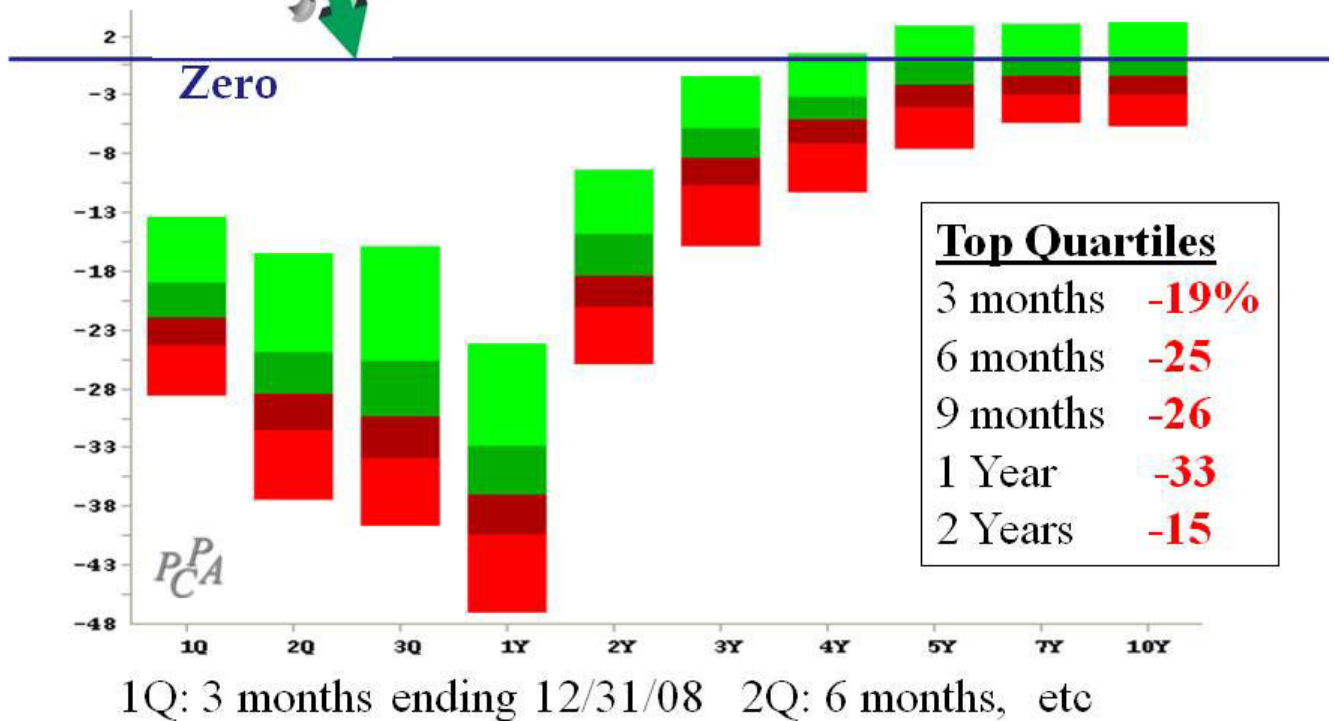
Make lemonade when the market gives you lemons: Winning the Losers Game

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 more than 10 years to find a timeframe where positive returns are winners because the 10-year annualized S&P500 return for the period ending 12/31/08 is -1.4%. As the following exhibit shows, a 33% **loss** will win the annual performance race for those who are benchmarked against the S&P500, because a -33% return ranks in the top quartile for the year ending 12/31/08. "Congratulations Mrs. Client your manager performed very well, losing "only" a third of your account in 2008." 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.



S&P500 Opportunity Distributions



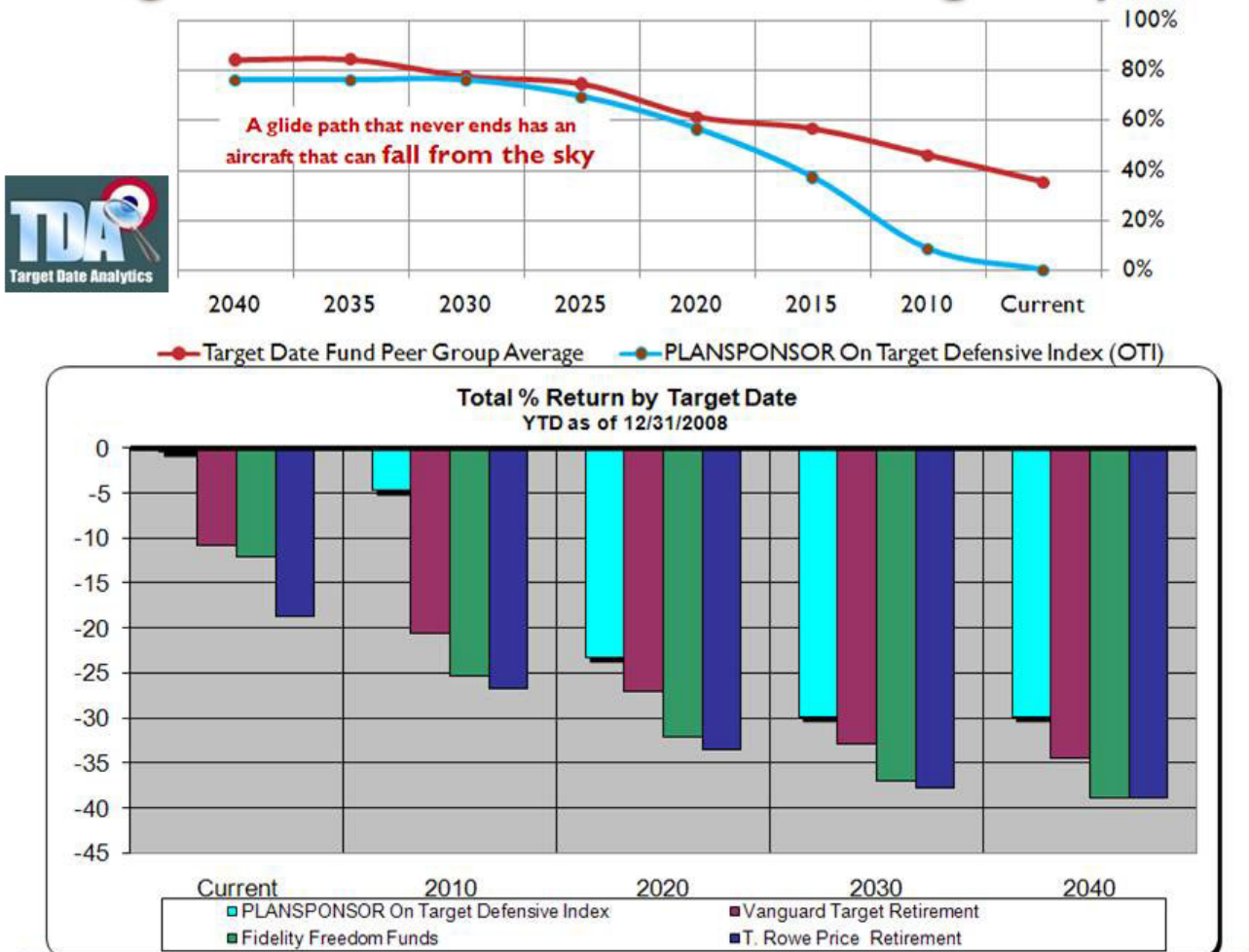
How about the old folks?

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 in 2008, 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.

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 funds need better glide paths



As you can see, investors in near-term current and 2010 funds have lost 12% and 25% respectively in just the past year, and those in longer-dated funds have lost more than 35%, underperforming our benchmarks significantly. 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 25% loss robs these folks of 5 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 exhibit above 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.

Risk-reward History

To add further perspective the following table shows the history of risk and return for stocks (S&P500), bonds (Citigroup High Grade), T-bills and inflation. There are many lessons in this table, so it’s worth your time and effort to review these results. For example, the standard deviation of monthly bond returns in 2008 exceeded that of stocks, camouflaging the huge daily volatility in the stock market.



Risk-return history for Periods Ending December 31, 2008

	stocks			bonds			t-bills		cpi	
	RETURN	STNDEV	SHARPE	RETURN	STNDEV	SHARPE	RETURN	STNDEV	RETURN	STNDEV
2008-2008 (1 YRS)	-37.22	20.86	-1.84	9.28	22.48	.33	1.70	.23	.66	3.03
1926-2008 (83 YRS)	9.62	19.17	.29	6.15	7.27	.32	3.75	.88	3.07	1.86
1926-1966 (41 YRS)	9.88	22.49	.36	4.43	3.98	.69	1.59	.42	1.54	2.27
1967-2008 (42 YRS)	9.36	15.27	.21	7.85	9.40	.20	5.90	.80	4.58	1.20
1929-1938 (10 YRS)	-.89	37.95	-.05	7.93	4.65	1.45	1.02	.43	-1.95	2.55
1939-1948 (10 YRS)	7.26	17.98	.39	3.58	2.16	1.50	.30	.08	5.56	2.94
1949-1958 (10 YRS)	20.06	11.98	1.50	2.38	5.40	.13	1.68	.21	1.86	1.33
1959-1968 (10 YRS)	10.00	11.64	.54	2.35	4.30	-.26	3.52	.29	2.07	.65
1969-1978 (10 YRS)	3.17	15.91	-.17	5.79	7.90	-.02	5.94	.42	6.67	.99
1979-1988 (10 YRS)	16.31	16.46	.40	10.85	13.14	.12	9.15	.82	5.92	1.37
1989-1998 (10 YRS)	19.19	13.40	.98	9.89	5.68	.74	5.49	.52	3.22	.62
1999-2008 (10 YRS)	-1.39	15.17	-.30	6.85	9.64	.35	3.36	.51	2.71	1.38

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."