



Hope Glimmers in the Stock Markets

By Ron Surz
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Introduction

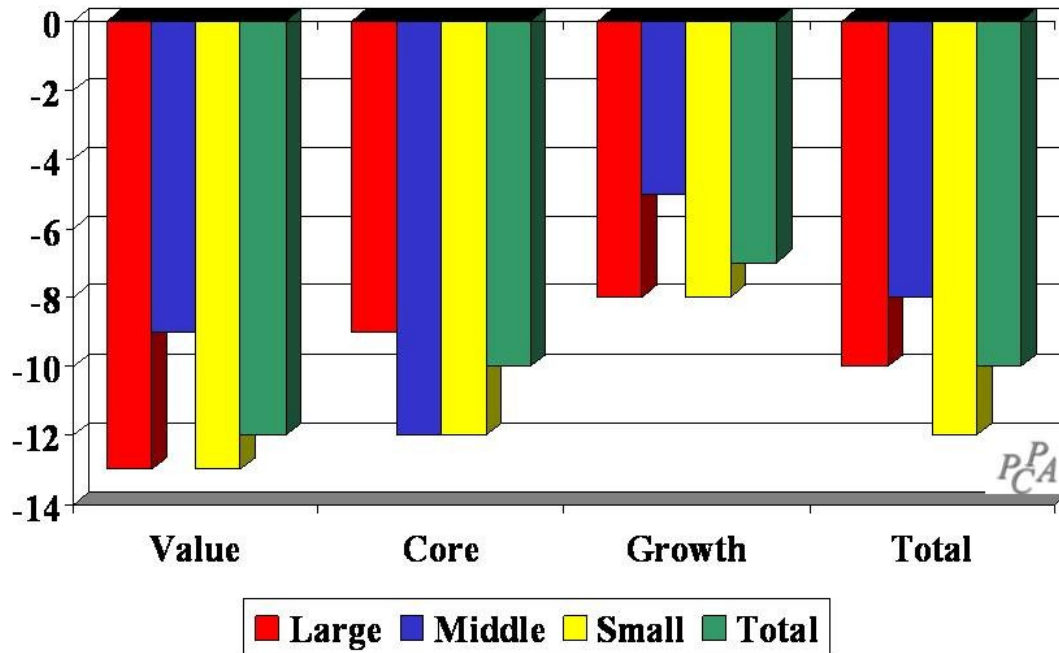
If losing less reduces market fears, we should all feel a little braver today than we did three months ago. Following 20%+ losses in the fourth quarter of 2008, 2009 started with “only” a 10% loss in the first quarter. Foreign markets fared a little better with an 8% loss in the quarter. The really good news, however, came in the last month of the quarter, when U.S markets rallied 9% and foreign markets returned 7.5%, including a 2% positive currency effect.

I will review first quarter stock market performance around the world. Then I'll turn our attention to the past decade, to understand what has happened and how we can deal with it. Then we look at a measure of fear to see if we can find a glimmer of hope. Finally, I offer some suggestions for fixing a few things that have been broken for quite awhile.

The first quarter of 2009

As the next chart shows, every US style lost in the first quarter. Mid-cap growth defended best, losing only 5%, while large and small value companies suffered most, losing 13%. Overall, growth companies lost least, which is somewhat of a surprise in a declining market. I use Surz Styles and Country indexes throughout this commentary, as described [here](#).

Style Returns

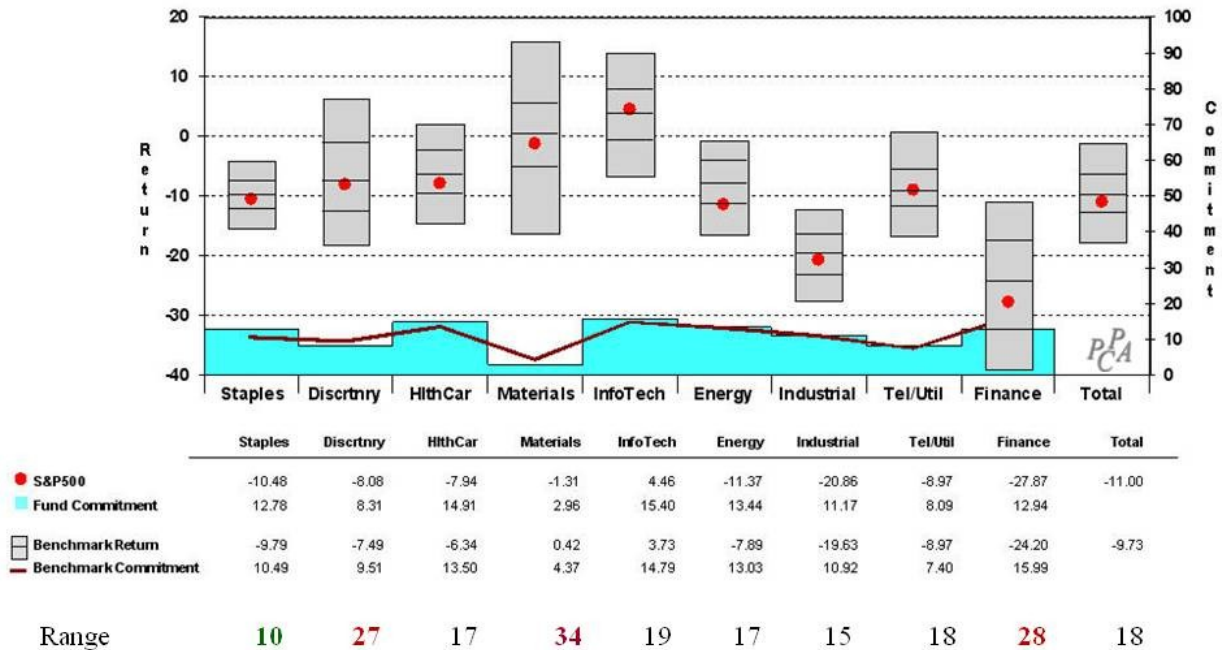


The real message continues to be market volatility, which is displayed graphically by sector in the next exhibit. The floating bars show the distribution of possible portfolio returns when selecting stocks from the indicated sector. This is not the range of stock returns; rather, it's the range of portfolio returns, using a simulation approach described at [PODS](#). For example, a really good result for a Materials sector portfolio is a positive 17%, which is the one-in-twenty (5th percentile) best portfolio return. By contrast, a really bad return in Materials is -17%. This spread of 34% indicates the wide range of risk and opportunities in this sector. The last row in the exhibit reports the ranges from the 5th to the 95th percentiles for each sector. A more typical range in a single quarter is about half that experienced in the first quarter of 2009.

Sector Performance Within Style Market for S&P500

Quarter Ending 3/31/2009

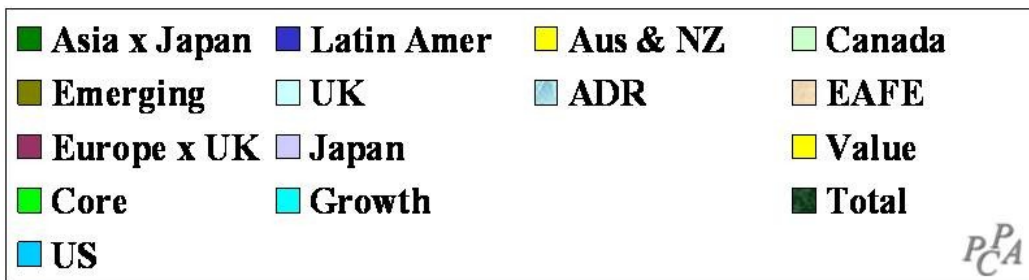
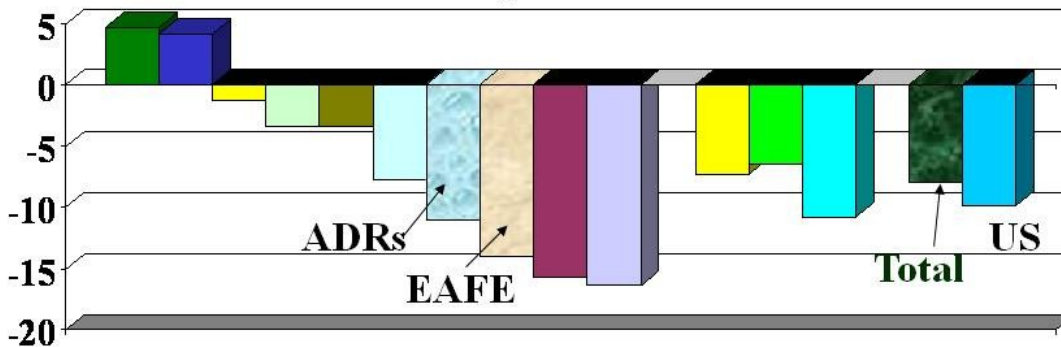
Surz Total Market



The exhibit uses an investment performance attribution approach described at [StokTrib](#). In this exhibit I analyze the performance of the S&P500 using a benchmark that is the entire US stock market, similar to the Wilshire 5000. The bottom of the chart contrasts the S&P's sector allocations to those of the total market, and shows that they are pretty close. For performance, the red dots show the rankings of S&P stocks within sector. Note that S&P performance is near median except for Energy and Finance, indicating that the stock picks of the S&P committee were not good in these sectors. As a result, the S&P underperformed the total market, losing 11% versus 9.73% for the total market. Yes, the S&P is a managed portfolio; it's just managed by committee.

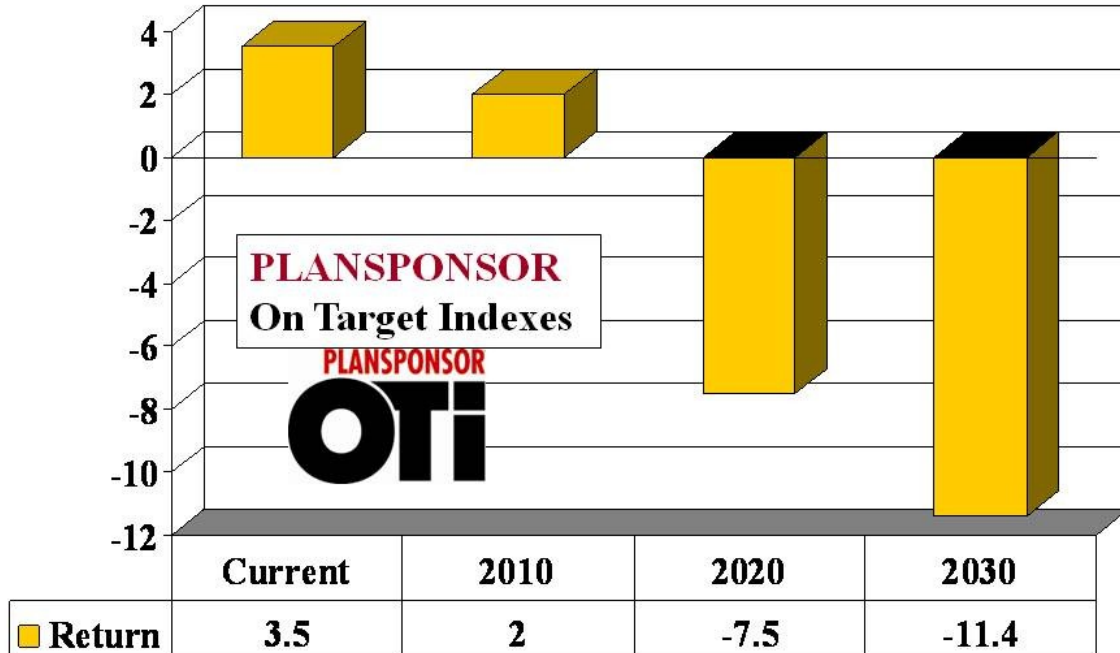
Now let's turn our attention outside the US, where some regions actually delivered positive returns in the quarter, as shown in the next exhibit. As you can see, Asia ex Japan and Latin America returned 4.7% and 4%, respectively, in the quarter - another reason for a glimmer of hope. Overall, the total foreign market lost less than the US, declining only 8% in the quarter. However the popular EAFE index lost more than the US, declining 14%, due to its concentration in Japan and the UK, the worst performing countries in the quarter.

Country Returns



Bonds and cash continued to protect in the quarter, as exemplified in the next exhibit, showing the performance of the PLANSPONSOR On Target Indexes (OTI). “Current” target date funds are designed for those currently in retirement. The OTI for “current” is entirely in TIPS and T-Bills. As we move to longer dated funds equity exposure increases, so for example the 2030 OTI is entirely in a broadly diversified basket of risky assets. For more details please go [here](#).

Target Date Funds



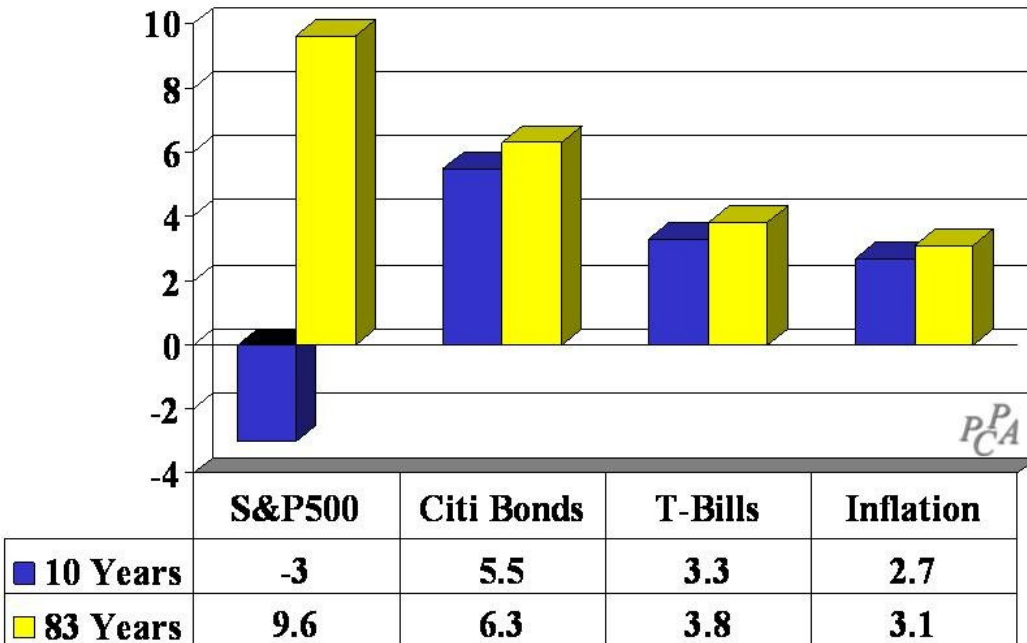
Defending in the quarter spared the investor an 11.4% loss in risky assets and delivered a 3.5% gain to the most conservative investor - a 15% spread in a single quarter. In other words, the exhibit provides a reference for risk and reward in the quarter, or more appropriately risk and punishment. This brings us to our next topic of asset class returns during the past decade.

The Decrepit Decade

In my previous commentaries, I've referred to the past ten years as the "Decrepit Decade," and that message keeps getting worse. The following exhibit puts asset class returns during the decade into perspective by comparing them to one another and to the longer run 83-year market history dating back to 1929.

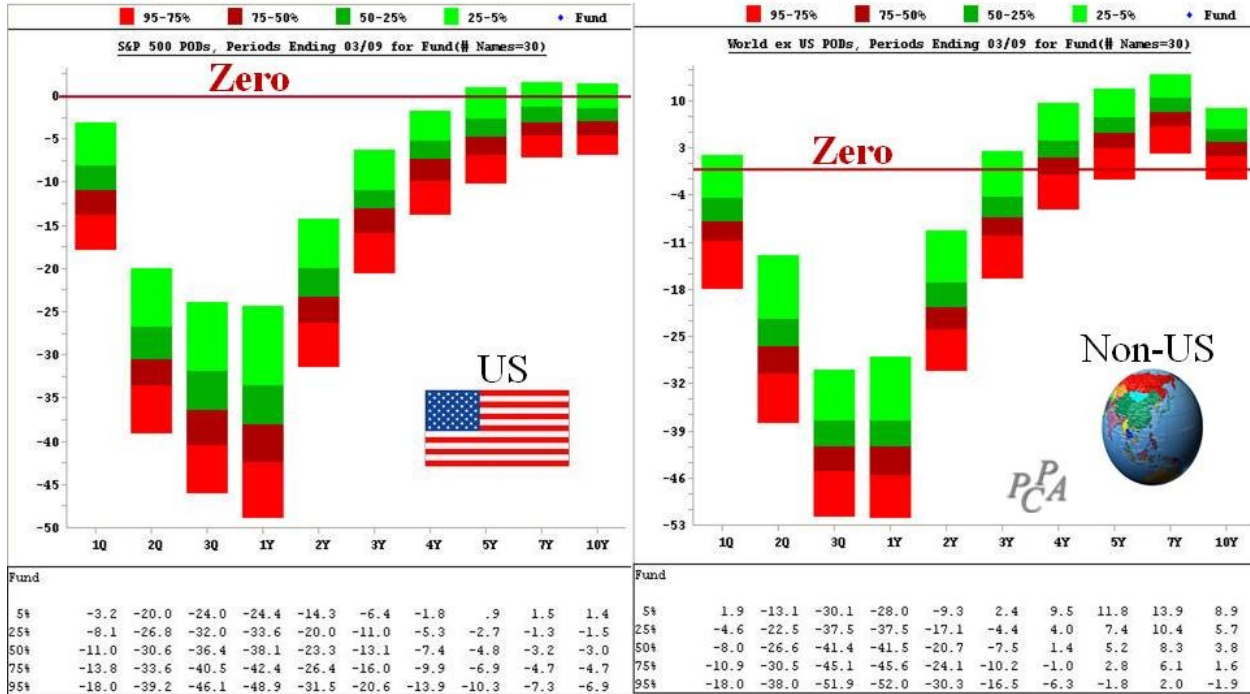
This decade's performance has caused some to question the slogan "Stocks for the long run." These skeptics argue for a move to bonds. It's helpful to remember, however, that in 1999 market observers Robert Arnott and Peter Bernstein predicted a dismal decade ahead for stocks based on price/earnings multiples having risen to the sky. Similar arguments hold for bonds today, since it's unlikely that bond yields, especially on government bonds, can go much lower. I am confident I am not alone in that belief.

A Decade of Stock, Bond & Bill Returns (Apr, 1999 – March, 2009)



Recent stock market losses present challenges to the job of evaluating long-term equity performance. How bad is good? Investment managers are supposed to be evaluated over long enough timeframes to be given a fair chance. But in this current 10-year timeframe a successful stock manager will have lost less than some standard, but what standard? And is there any chance that a really good stock manager could have delivered a positive result over the past decade? The following exhibit addresses these questions and provides another glimmer of hope. It uses the [PODS](#) simulation approach described above.

Virtual Peers for Periods Ending 3/31/09



The rightmost bar of the left panel shows that managers benchmarked to the S&P500 are expected to have lost 3% per year over the past decade, which is the return on the index. A top quartile manager will have lost half that amount, or 1.5% per year, and an excellent manager (in the top 5%) would have eked out a positive 1.4% return per year. The panel on the right, for foreign investing, is brighter. Managers of foreign stock portfolios should deliver a positive 3.8% per year return, which is the return on the Surz total foreign market index, broader than EAFE. An excellent (top 5%) foreign stock manager will have delivered a return of 8.9% per year. You can use this exhibit to rank your own managers.

The “V” shapes in the two panels in the exhibit provide another glimmer of hope. Even though we’re still losing money, we’re losing it at a decreasing rate. The exhibit also shows that international diversification has paid off in the long run, with foreign markets outperforming domestic, even though recent foreign market losses are in line with domestic losses.

A more direct way to look for that glimmer of hope is described in the next section.

Rate the pain

At some point in our lives, most of us have had the unfortunate experience of rating the pain: “On a scale of one-to-ten, with ten being the highest, how bad does it hurt?”

A barometer of fear, and in this case pain, in the US stock market is the index of implied volatility on the S&P500 index, called the VIX index. This index is derived from option prices on the CBOE (Chicago Board Options Exchange). The VIX provided an excellent indication of the fear that generated the fourth quarter of 2008 flight to cash. As you can see in the next exhibit, a typical level for the VIX is around 20, but in October of last year it skyrocketed to 80, signaling panic. More recently the index has calmed a bit, declining to 42, providing another glimmer of hope. If a VIX of 20 is zero pain, and 80 is a pain rating of 10, the current level of 40 is a pain rating of three. Do you feel it?

Implied Volatility of the S&P500 Index: VIX



Recent volatility of the VIX shows investors are still jittery. It doesn't take much to scare us. These are extraordinary times. So what should advisors do?

Fixing what is broken

As usual, asset allocation is the key in this mess, and we're all tempted to call the next market bottom, but this time the stakes are exceedingly high. Should those in retirement double down and increase exposures to risky asset classes to recoup their losses? Is



now a once-in-a-lifetime buying opportunity for equities, or are we in for an extended period of pain?

Of course, no one knows the answers to these questions, but we do know that clients are now seeking the very best advice they can get. Choosing an advisor is easy when everyone is winning. Clients now want to know if any advisor can win under adverse conditions. The advisor game has changed, and this should lead to improvements.

“We’re all good. We all do the same thing. Just pick the people you like best.” A successful investment consultant, who of course is very likable, has used this sales line effectively for years. In today’s crisis, however, “same old, same old” doesn’t cut it. It’s what got us into this mess. Clients want better protection and assurances that risk will be rewarded. They want the best.

“Don’t fix it if it ain’t broke” is still a true statement, but there is a lot that needs fixing in the investment consulting profession, and those who move first will get the greater benefit. Differentiation is the name of the game. Superior advice and guidance is the prize. It’s a win-win. Sure, it’s still nice to be likable, but better matters more.

The following table provides some examples of what needs fixing and why. Now is the time to separate from the herd. There are lots of misperceptions in the investment consulting industry, and we own them.

Misperception	Reason	Reality & Articles
Tracking error is risk	Index huggers have sold this notion, especially Barclays	Alpha comes with tracking error. See “R-squared and Alpha Are from Different Alphabets,” available on request
Volatility is risk	Standard deviation is the accepted risk measure	Risk is the possibility of loss. See Sortino’s book “Managing Downside Risk”
Diversification doesn’t work	Increase in correlations during calamities	Diversification benefits are better returns or less risk or both. Measure by comparing portfolio return & risk with & without the asset class.
Style boxes work	It’s convenient to structure portfolios that allocate to the 4 style corners in market weights.	Liberated, non index-hugging, managers cannot function in a box. Plus there is space in between value & growth that can’t be ignored. See Getting all the Pieces of the Puzzle
Indexes and peer groups are the only way to identify success or failure, &	30 years of faulty thinking. Old common practices have survived	Indexes only work on index huggers. Peer groups have never worked on any manager. See A Fresh Look at Investment Performance Evaluation:



ultimately skill	because of ignorance and laziness.	Unifying Best Practices to Improve Timeliness and Reliability , which is among the top most read papers on SSRN
Target Date Funds serve past retirement until death	Fund companies want to keep the assets.	Even the best glide path has to end at the target date, because no glide path can adequately deal with all of the issues in the de-accumulation phase. See The Target Date Emperor Has No Clothes
Mumbo jumbo engenders confidence	Complexity is good	Simplicity is actually better, like holdings-based analysis rather than returns-based. See Style Analysis: How and Why

Conclusion

I believe that there's light at the end of this tunnel but, like the rest of you, I don't know what news lies ahead. Hopefully it will be good news. In the meantime, now is a good time to embark on self-improvement programs because differentiation is the name of the game. Winning has become a lot harder.

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