



## **Perspectives on 2008 and Beyond**

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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.

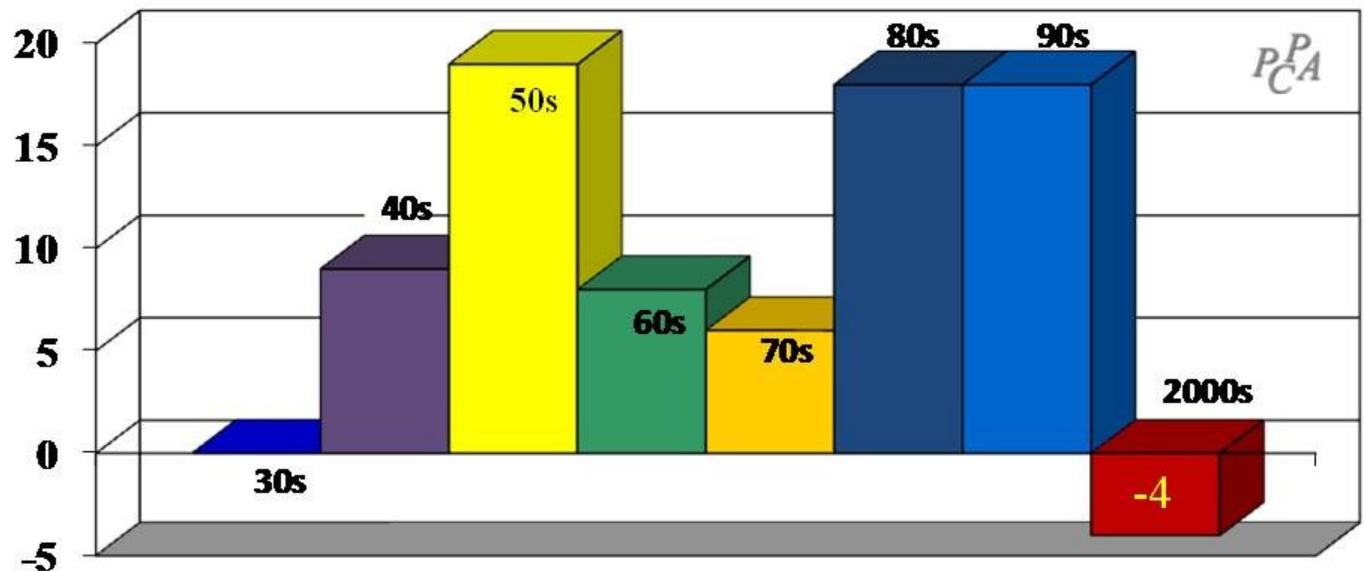
They have, big time.

We are experiencing the worst decade ever in stock market history, at least so far. In this end of year commentary, I update my earlier observations. The story below is pretty much the same as what I have been telling over the last several quarters, 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 seven decades, and the nine years to date through December 31, 2008:

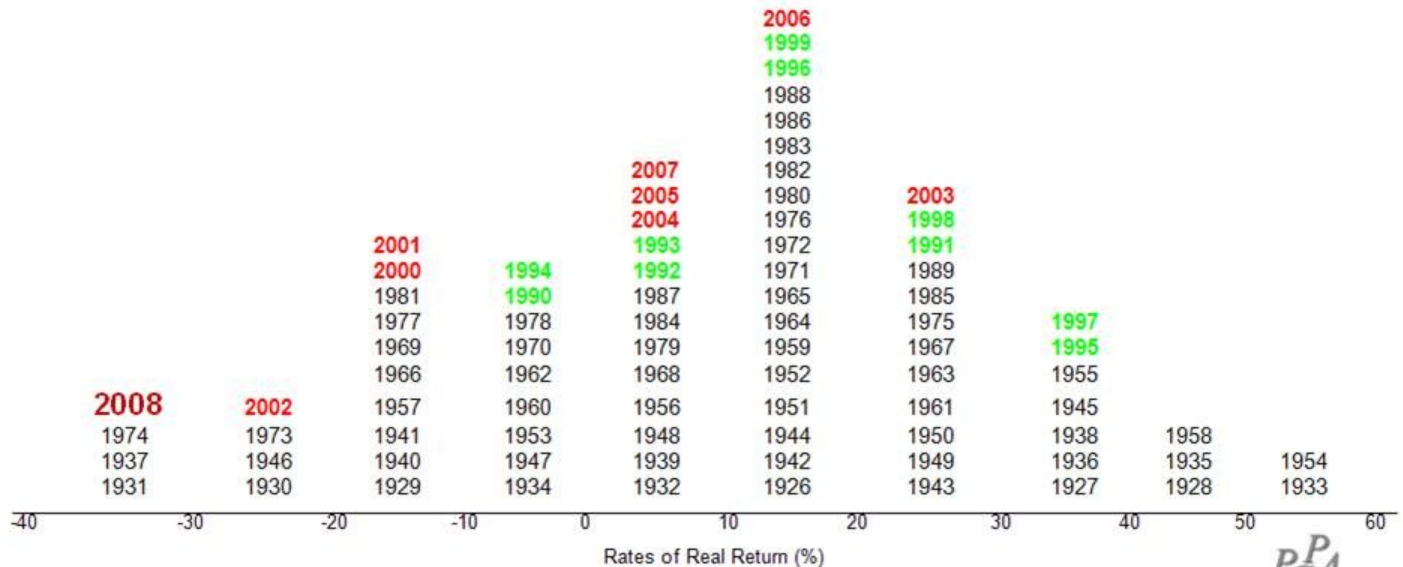
## Annualized S&P500 Returns by Calendar Decade



Here we are, 90% of the way into the first decade of the 21<sup>st</sup> 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 risk means. The graph below puts this disappointment into further perspective. Years like 2008 have happened before, but fortunately not very often; 1931, 1937 and 1974 are the only other years with real losses in excess of 30%. The S&P500 was down 37% in 2008. Note also that only two of the past nine years (shown in red) -- 2003 and 2006 -- were reasonably good. By contrast, you can see how good the 1990s were, shown in green. Perhaps the good news is that the historical odds for earning that 40% in 2009 are a little better than the odds of seeing another 37% loss. We've had 5 years in the plus-40% column, versus 4 in the minus-30% column.



**83-Year Return History of S&P500 (Adjusted for Inflation): 1926-2008**  
**Average Annual Compounded Real Return = 6.4%**



Investors would have been far better off in bonds or Treasury bills than in stocks. Do you think the next year 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 nine years is foreign markets, which have returned more than 3% per year, although they too have suffered recent losses. Similarly hedge funds have also protected reasonably well, although they lost somewhat in 2008. In the following we focus on the more recent past, namely the year 2008, to manage and understand the recent pain.

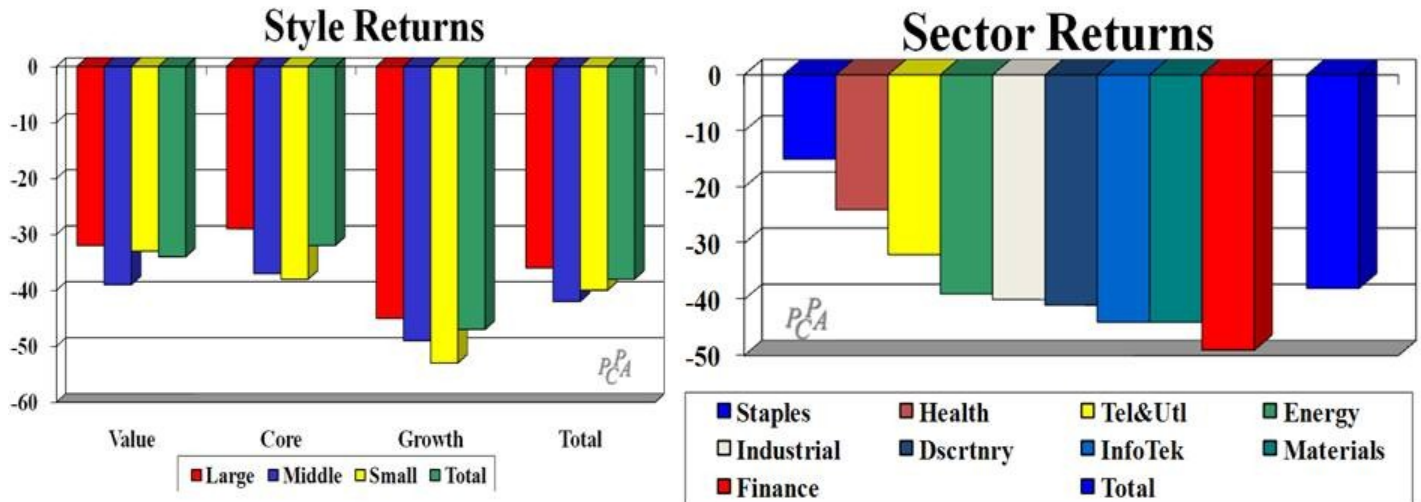
The ride to disappointment has been bumpy. First the bubble burst in the three years 2000-2002, and from there the stock market clawed its way back so that investors had earned a 3.5% per year return as of October of 2007. We were back even with inflation. But then the next 14 months took all of that back, and more, with the S&P plummeting 40% from 11/1/07 through 12/31/08.

As painful as the last 14 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 worked in the year 2008 and what did not. What sectors, styles, and countries have performed best and worst? The bottom line: nothing 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 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 was a whopping 3,300 basis points. Sector allocations mattered big time in the past year. Not surprisingly, Finance was the worst performing sector in the first six 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 fourth 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 de-leveraging and opportunity – harvesting gains and capitalizing on cheap Financials.

## U.S. Performance for 2008



On the US style front, every style 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.

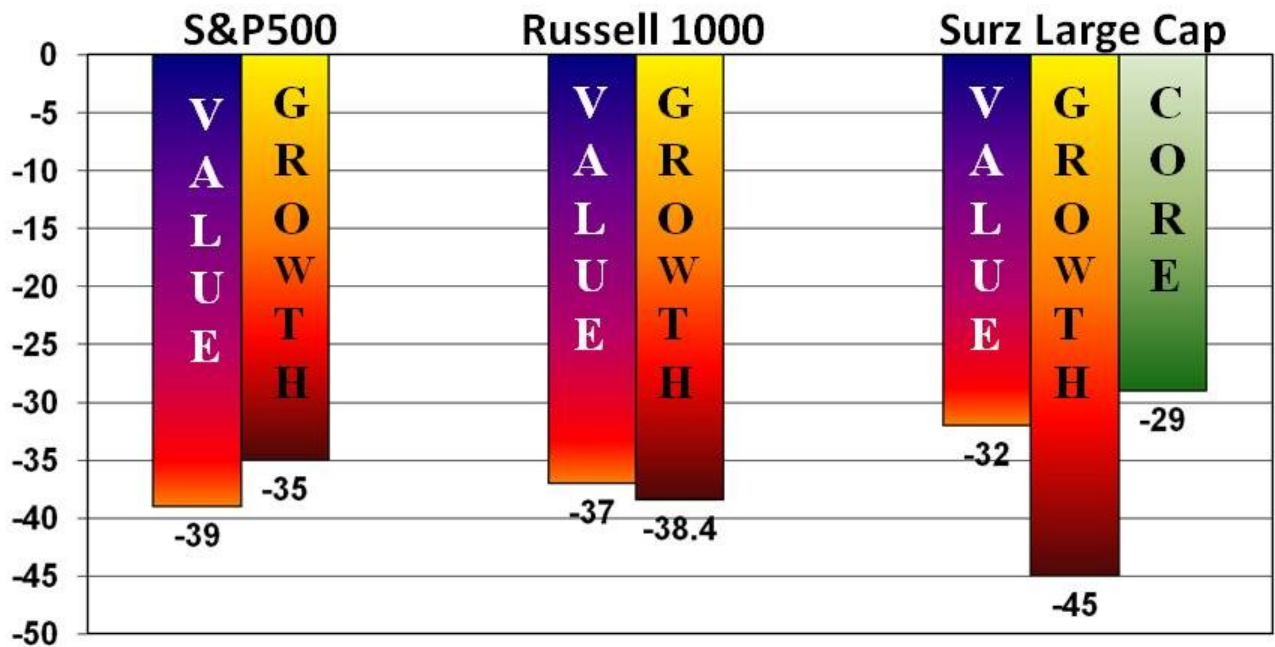
By contrast, S&P shows Growth outperforming Value, while Russell shows just the opposite, Value outperforming Growth. Neither Russell nor S&P have Core, and this has distorted their results, so be forewarned. Any tilt toward core has benefited performance, so aggressive growth managers have done worse than typical growth managers, and ordinary value managers have done better than deep value managers. It's easy to confuse style with skill but difficult to make good decisions once this mistake has been made. Comparisons and evaluations to off-the-shelf indexes only work on index huggers; for liberated managers we need to customize the benchmark by blending styles that are mutually exclusive and exhaustive. 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, or lack thereof. It is style.

## 2008 Style Quandary

### Demonstrates The Importance of Core



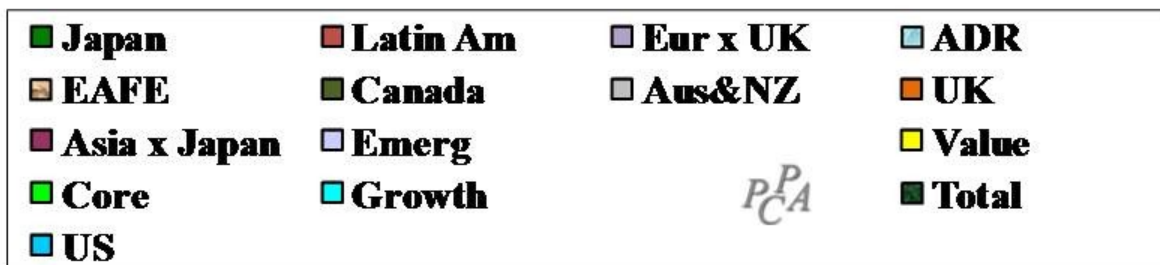
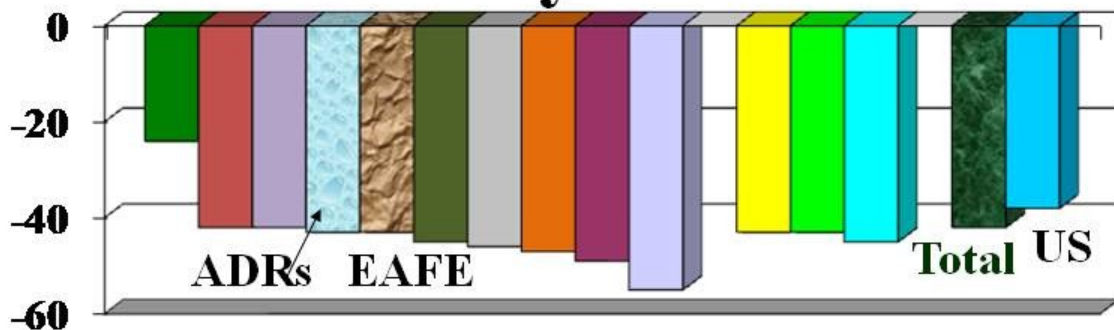
The Market Structure Puzzle: Core is the stuff in the middle, in between value and growth



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 2,600 basis point spread. Overall, foreign markets lost 42% and EAFE lost somewhat more, declining 43%. Fleeing the country has not been a good move, supporting the claim 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.





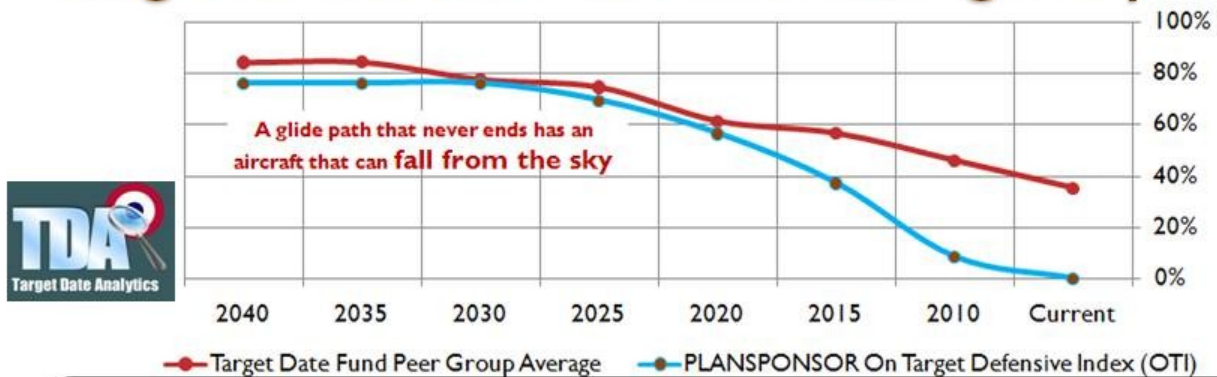
## How about the old folks?

Recent losses can be especially devastating for those in retirement and 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 Target Date Analytics (TDA) benchmark. 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 three largest target date families – Vanguard, Fidelity, and T. Rowe Price. These three 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 – especially those in near-dated funds - should be disappointed because these funds failed to protect. Near-dated funds are held mostly by the first Baby Boomers, now in their 60s. Using the rule of spending only 5% of savings each year, a 25% loss robs these folks of 5 years of retirement dignity since its 5 years of spending at the previous asset level. This is 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 three major fund families, plus another 35 fund families, are available in “Popping the Hood III”, the third 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 and it is readily affordable through [www.TDBench.com](http://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, here are a few of the lessons:

1. The standard deviation of monthly bond returns in 2008 (22.48) exceeded that of stocks (20.86), camouflaging the huge daily volatility in the stock market
2. Bonds were more “efficient”, delivering more returns per unit of risk, than stocks in the first 41 years, but they have been about as efficient in the most recent 42 years. The Sharpe ratio for bonds is .69 versus .36 for stocks in the first 41 years, but the Sharpe ratio for both is about the same in the more recent 42 years.
3. The past decade has been the worst for stocks across the past eight consecutive 10-year periods.
4. Average inflation in the past 42 years has been three times that of the previous 41 years.



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 the target date industry has entered into a performance race, and is exposing investors to too much risk, especially near the target date. The timing of these moves to higher risk was bad for investors, and it will be even worse if we don't learn from this lesson: target date funds should defend better near the target date.

I am as challenged by these markets as the rest of us. Global stock markets plummeted when the bailout plan was not approved and when it was 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 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."

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