



Stock Markets and a Sea of Change

By Ron Surz

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Never complain about what you permit.

Anthony de Mello, Author

Introduction

It's July and time to review market behavior in the first half of the year. I will do that here, but a lot of other things are changing that I'd like to discuss with you – changes that you may or may not want to complain about. As the quote above states, permission is approval.

In addition to my customary market review, this commentary also covers some changes that have occurred recently:

- The effects of the credit crisis on financial stocks and their styles. Do you view financial stocks as value or growth?
- The emerging interest in “core” investing. Are you using core in your portfolios? Which “flavor”?
- The congressional buck-passing to the SEC of the broker-fiduciary standard. Are you a fiduciary or a salesman?
- The SEC's unanimous approval of a proposal for target date funds. What does it mean?

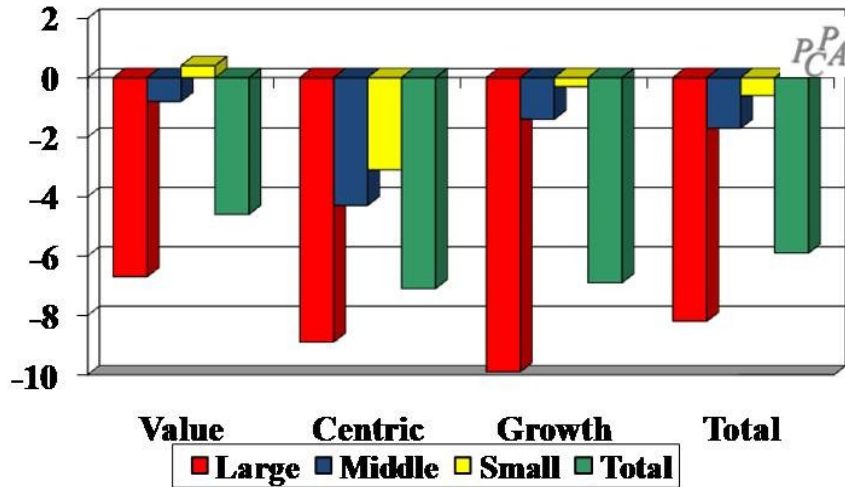
I'd really like to turn this discussion into a dialogue with you. Please let me know what you think.

Insights into the first half of 2010

The first half of 2010 has been an overall disappointment, with both domestic and foreign markets losing value, and almost no place to hide.

As the chart on the right shows, large-cap US companies lost about 8% in the first half of 2010. By contrast, mid- and small-sized companies lost only 2% and 1% respectively. Smaller has been better, which is somewhat surprising given the current angst about the economy; you'd think investors would feel safer with larger companies, and those companies would attract more capital. The fact is that smaller companies have now outperformed large for the past 18 months. Smaller companies led the 2009 rally.

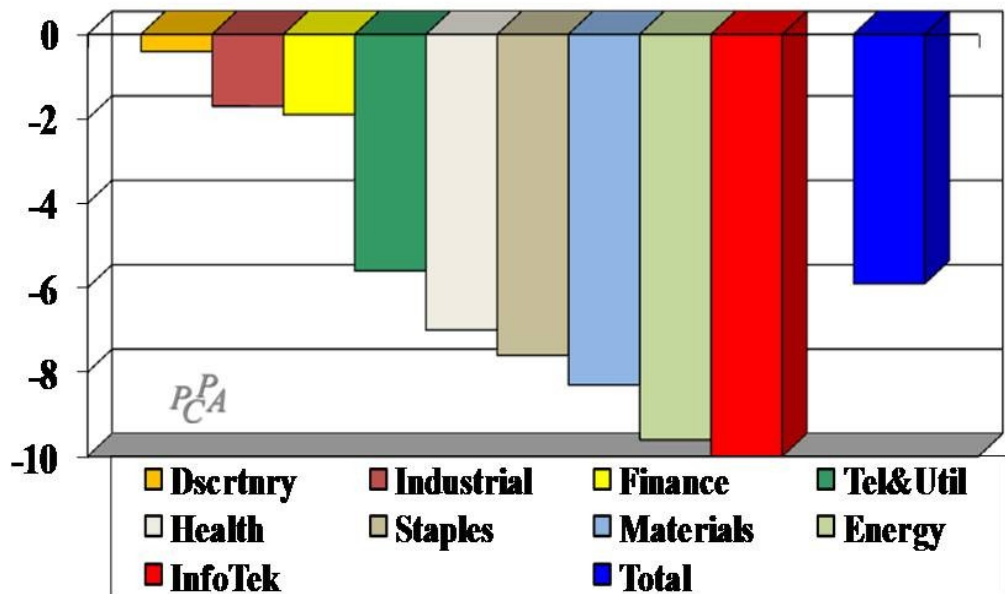
Style Returns for 1st Half 2010



What do you think is the cause of this smaller company dominance? Here's my belief. Investors perceive that larger companies are more exposed to looming pitfalls, like tax and inflation increases; "too big to fail" is no longer the order of the day. In this environment, revenue, not size, is king; more on this topic in the discussion below on financials.

On the style front, large growth suffered more than large value, and smaller centric companies suffered more than smaller value and growth, where "centric" is the stuff in the middle in between value and growth. On a total market basis, value defended best, losing less than centric and growth. I

Sector Returns for 1st Half 2010

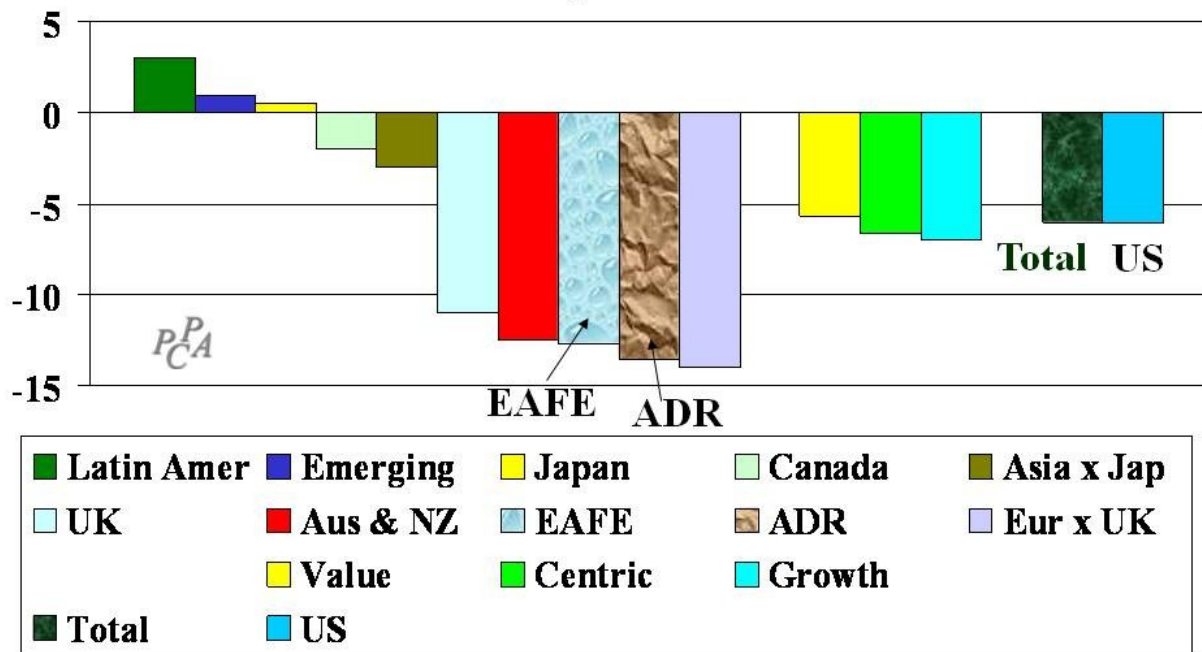


use Surz Style Pure® style and country definitions throughout this commentary, as described [here](#).

On the sector front, Consumer Discretionary stocks fared best losing only 0.4%, followed by Industrials with a 1.7% loss and Financials with a 1.9% loss. All other sectors have lost more than 6% so far this year. Industrials and Financials lagged in the 2009 recovery, so their relatively good performance is consistent with a catch-up, or regression toward the mean. By contrast, the good defense in the Consumer Discretionary sector is a continuation of good results in 2009, representing momentum and a modicum of investor confidence in the consumer.

Now let's look outside the US, where 2009 market performance far exceeded domestic returns. The first half of 2010 has been a different story, with foreign markets losing 6% (in US dollars) in aggregate, matching the US loss. Much of this loss was due to currency effects, as the dollar strengthened. Total foreign markets earned 1% in local currencies but the strengthening dollar subtracted 7%. Latin America led the first half of 2010 with a 3% USD return. The only other regions with positive returns were Emerging Markets and Japan. EAFE and ADRs lagged because of their large-company orientation. Large companies (not shown in the exhibit) lost 8% in the first half, while mid- and small-caps lost 3% and 1% respectively. Like the US, foreign large company returns have lagged smaller company returns.

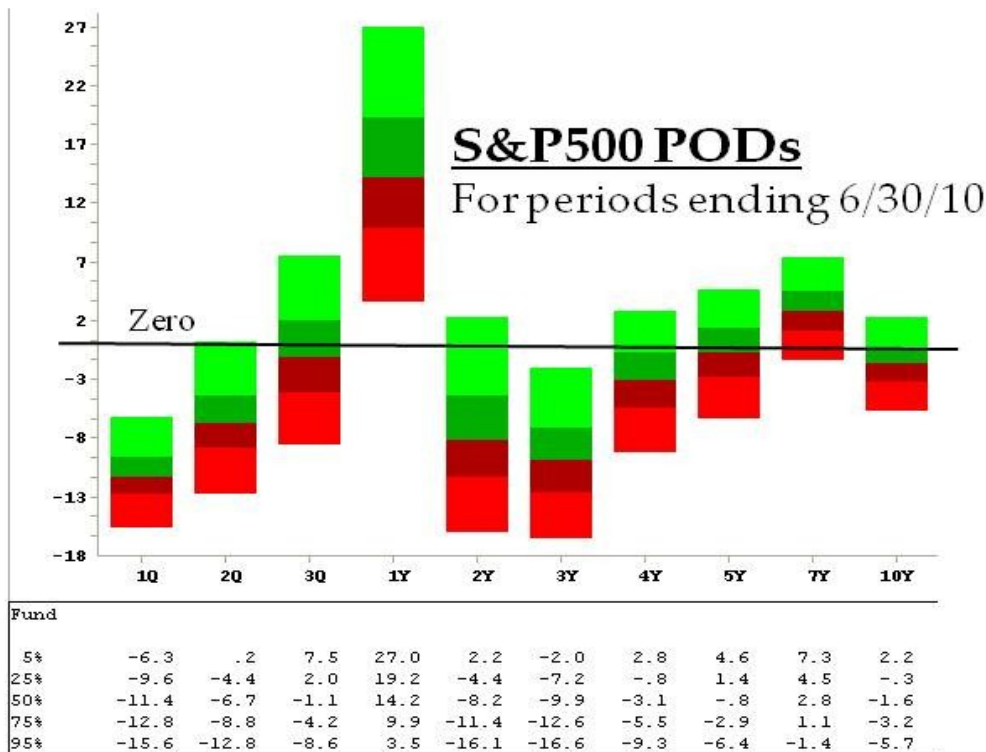
Country Returns





Some help for performance evaluators and those they evaluate

As usual, there will be challenges in fairly evaluating investment managers. Most advisors know that traditional peer groups are pathetic barometers of success or failure, but they still believe that there are no better choices. They're wrong. Portfolio Opportunity Distributions ([PODs](#)) represent all of the possible portfolios that managers could have held when selecting stocks from the indicated markets. In the following exhibit we provide PODs for the S&P500. PODs for periods ending 6/30/10 are available now, whereas most peer groups won't be released for a month. Use the table and graphic below in the meantime to evaluate your investment managers. Note for example that a return of 10% for the year ending June, which would appear to be good on its surface, is in fact bottom quartile. But examine any other time frame and a mere breakeven (zero) return is a winner, with the exception of the 7 years ending 6/30/10. It's been ugly.



Now let's move on to what has happened in the first half of 2010.

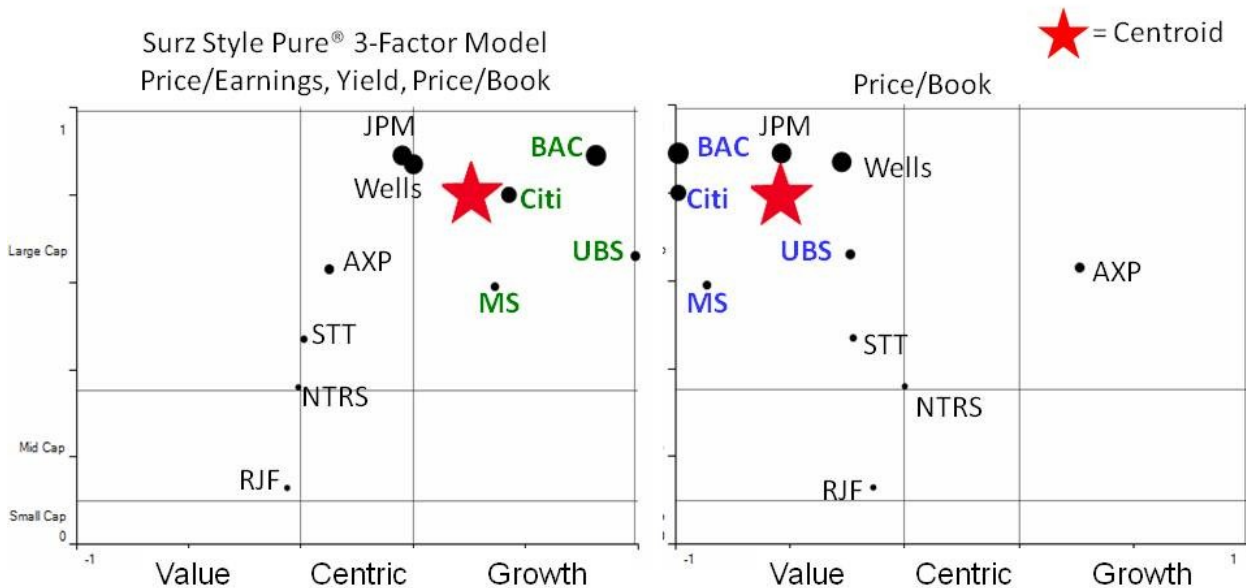
The effects of the credit crisis on financial stock styles

Financial stocks have been hit hard by the current economic crisis. As earnings have fallen the prices of these companies have also declined. Consequently style classifications have become debatable. Are financials now cheap (value) or speculative (growth)? What do you

think? Most of the name brand style classifiers use Price/Book ratio as their primary classification variable, which places fallen financials well into the value category. By contrast, Surz Style Pure® Indexes use 3 factors: Price/Earnings, dividend yield and Price/Book. The Price/Earnings measure places financials in the growth category. This disagreement has caused the performances of style indexes to differ dramatically, so it's become very important to know how these style sausages are made. The following exhibit provides some details.

Whose Style is it Anyway?

Becoming Style Conscious: Classifying Financials in Q2, 2010



PCA

Value or Growth?

**Your Style Definition Makes a Big Difference for
Bank of America, Citigroup, UBS, and Morgan Stanley**

The Price/Book definition “sees” the likes of Citigroup and Bank of America as deep value, whereas the Price/Earnings definition sees just the opposite, locating these companies as aggressive growth.

So which do you think is the correct view? Here’s some food for thought:

- **Book Value** is a stock variable that reflects the history of what the company paid for assets. It is a historical accounting artifact.
- **Earnings** are a flow variable that reflects the company’s current operating success.



	Price/Earnings	Price/Book	Yield
Bank of America	Negative	.78	.2
Citigroup	49	.83	0
UBS	50	1.4	0
Morgan Stanley	57	.9	.7

The X-Y style chart above uses 21st century style analysis called Style Scan. Literally "see" the styles of your favorite indexes and portfolios as they've never been seen before at [Style Scan](#). Every stock, and the total portfolio, is plotted in style space (large-small, value-growth). My gift to you is FREE access to this invaluable tool. Please use it. Feedback appreciated.

Please note the way "Centric" is defined in the chart above. Surz Style Pure® Indexes define a Centric Core that is the stuff in between value and growth, as opposed to the common definition of "blend", which brings us to the next topic that is a happening.

The emerging interest in "core" investing

Last month both Vanguard and Putnam announced the addition of "core" products to their suite of funds. In Putnam's press release President and Chief Executive Officer Robert L. Reynolds states *"In virtually all of Putnam's new product offerings since the start of 2009, the firm has sought to address investment needs and capture opportunity through fund vehicles that enable greater portfolio construction flexibility in a market environment that has little use for rigidity and convention."* Investors are indeed looking for better portfolio construction, but a blend of value and growth accomplishes little. It's like blending the halves of an Oreo cookie, while ignoring that the true sweet spot is the filling.

Centric core, defined as the stuff in between value and growth, is the version of core that investors should want because it is the best diversification complement to value and growth managers – no overlap.

Consider, for example the popular core-satellite investment structure. Most current core-satellite approaches use the S&P500 as the "core." The S&P500 comprises most of the U.S. stock market, so it includes both value stocks and growth stocks, in addition to the "stuff in the middle." It is a blend version of "core," with emphasis on the "blend." All blend versions of core, like the customary S&P500, dilute the decisions of the satellite managers, namely active value and growth managers. You dilute active growth decisions with passive growth allocations of the S&P, and ditto for value.

By contrast, centric core is exactly what was originally intended by those who designed core-satellite. Because of its non-dilutive properties, a little centric core serves as a concentrate, providing the same diversification as a lot of blend core, measured however you would like, such as correlation to the broad market; less is more.

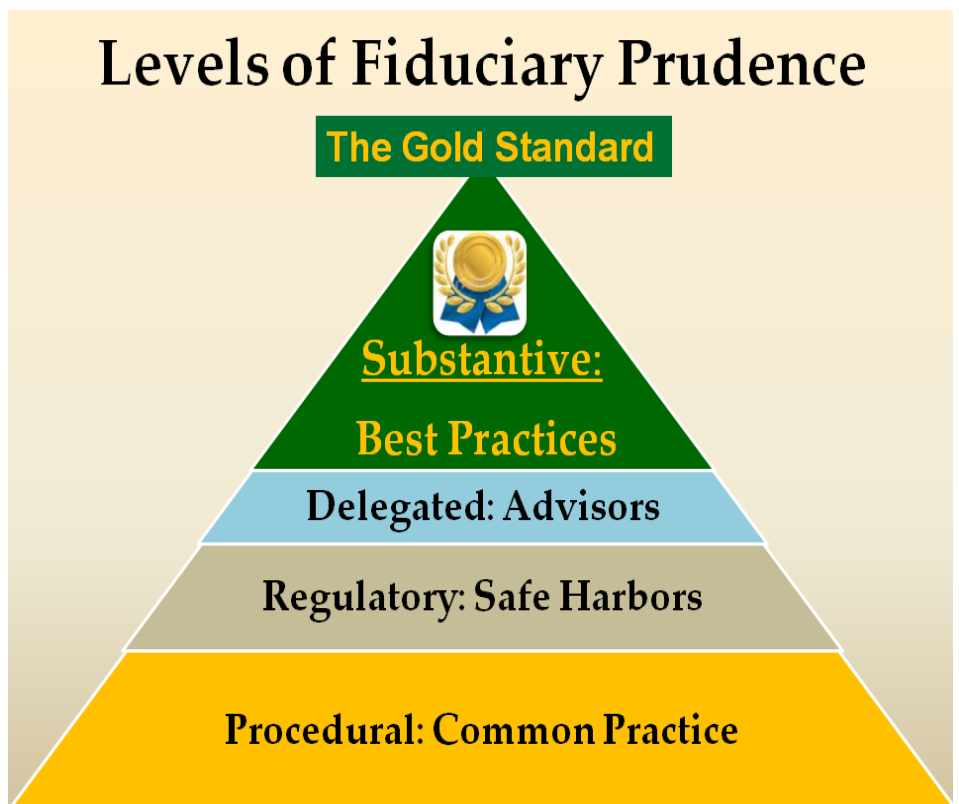
Research conducted by Dr Frank Sortino of the Pension Research Institute and Sortino Investment Management indicates that most multiple manager programs systematically underweight the middle of the market, centric core, because they are structured using value and growth manager assignments. This underweight is understandable in light of the scrutiny that most managers are under to maintain style consistency. Managers are incited to sell companies that drift away from their declared style. It's impossible to drift from value to growth or from growth to value without visiting centric core along the way, because it's the bridge that separates the two styles. But the journey usually ends before a stock becomes centric core. The result is an unintended bet in most portfolios away from centric core. This is a diversification mistake.

Until recently, centric core was just a concept, another index in the Surz Style Pure[®] 9 index family. Now centric core is available on several platforms, and more are being discussed. Surz Style Pure[®] Centric is now available on FolioDynamix, Adhesion Wealth Advisor, Carolopolis Fiduciary Counsel, and Capital Market Consultants.

Congress kicks the can down to the SEC

After more than a decade of debate among law-makers, the job of establishing a higher fiduciary standard for brokers now resides in the hands of the Securities and Exchange Commission (SEC). At the heart of the issue is the distinction between a salesman and a fiduciary.

Fiduciaries are held to the high standard of operating in the clients' best interests, whereas salesmen are held to a "suitability" standard, suggesting *caveat emptor*.



A case in point is target date funds (TDFs), discussed in greater detail in the next section. Are plan sponsors and their advisors meeting their fiduciary obligations when it comes to the selection of TDFs?

Here's what I think is going on, as summarized in the exhibit on the right. TDFs are a Qualified Default Investment Alternative (QDIA). Plan sponsors think any QDIA is a safe harbor, so they're all good – regulatory prudence. Or if they are concerned about picking a particular TDF, how can they go wrong with the name brands everyone else uses, like Fidelity, T. Rowe & Vanguard-- procedural prudence. Also, *Plan Sponsor* magazine has determined that most plan sponsors base their TDF selection on their advisor's recommendation – delegated prudence.


But at the highest level either plan sponsors, or their consultants, but preferably both, need to care about substantive prudence – picking the best. This is where consultants need to sign on as either a fiduciary or a salesman, and most know which they are, but if you would like some guidance the following exhibit exemplifies the choice.

Target Date Fund Choices for Consultants: Fiduciary or Salesman

(1) **Best** or **Worst** practices
 (2) Paid by investment firm (**Fee** or **No Fee**)

Objectives	
Best	Worst
1) Safety First to Target Date	Growth to Death (Longevity risk)
2) Growth	

Policies	
Best	Worst
Liability-driven investing	Growth focused using closed architecture
Broad diversification	US-centric mostly stocks
Low costs	High fees and sales commissions
Financially engineered glide path	Ad hoc rules, like "some # minus age"



Salesman/Suitability

Worst, Fee
 Worst, No Fee
 Best, Fee
 Best, No Fee

Advisor/Fiduciary
 3(21), 3(38) ...

SEC unanimous approval of a proposal for target date funds

On June 16 the SEC unanimously approved a proposal to incorporate ending asset allocation into the names of target date funds. For example, a 2020 fund might be rebranded as “2020 / 50% Stocks – 20% Bonds – 30% Cash”. This is a good move because it may sensitize fiduciaries to the wide disparity in equity allocations at the target date. The selection of a target date fund is a risk decision that matters most at and near retirement. For the most part this selection is made by plan fiduciaries. Generally speaking, participants do not choose target date funds, and when they do their choice is limited to funds that are made available by the plan sponsor.

Importantly, fiduciaries should be held accountable for defaulting participants into anything other than safe assets as they near retirement, since this is the most critical time for locking in lifestyles. We all set our individual courses as we enter retirement, and develop mindsets of comfort with our plans. Disruptions to these plans create extreme anxiety.

**Fiduciaries need to choose between
the Safe Landing Glide Path[®] and the Red Baron Fly-By.**

The Red Baron may be more fun, but is it worth the fiduciary risk?



Red Baron Fly-By



Safe Landing Glide Path[®]



Accordingly, there's a lot of fiduciary downside (and no upside) to the common practice of 30-65% in equities at target date, especially since most people withdraw their accounts at retirement. Before current common practices can change, fiduciaries need to feel comfortable moving away from the current industry leaders, not necessarily because they are bad, but rather because there are better products. It's the distinction between procedural prudence and substantive prudence.

Fiduciaries need to choose between the Safe Landing Glide Path[®] and what I call the "Red Baron Fly-By." The Red Baron is a legendary German ace aviator, **Baron** Manfred von Richthofen, who flew his bright red plane heroically in World War I, and who was satirized by Charles Schulz in his popular *Peanuts* comic strip in "Snoopy vs. the Red Baron." I can just see the Red Baron intimidating his enemies with a fly by, but can find no justification for it in target date fund glide paths. The Red Baron may be more popular and fun, but is it worth the fiduciary risk?

The Safe Landing Glide Path[®] (SLGP) is an ideal I've deigned to achieve two critical objectives: (1) Deliver to the participants at target date their accumulated contributions plus inflation, and (2) Grow assets as much as possible without jeopardizing the first objective. You can visit an interactive asset allocator for the SLGP[®] at [SLGP Allocation](#); it's fun and informative. This glide path has been followed by the Hand Benefit & Trust SMART Funds[®] for some time now. The 2010 fund was down only 4% in 2008, contrasting to a 25% loss for the typical 2010 fund. How can we not learn from this lesson? *"If history repeats itself, I should think we can expect the same thing again."*

- Terry Venables.

To learn more about target date fund best practices please visit www.TargetDateSolutions.com.

Endnote

To reiterate the hope expressed in the Introduction to this commentary I'd really like to turn this discussion into a dialogue with you. Please let me know what you think. I can be e-mailed at Ron@PPCA-Inc.com. Also, I have started discussion forums on these topics at [here](#) and [here](#)

Thanks.

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