It’s taken all the running we can do to stay in the same place

Here we are, a little more than 8 years into the 21st Century, and stock market investors have barely broken even. The S&P500 has returned a measly 0.4% per year on average in the past 8.25 years. The graph below puts this disappointment into perspective. Investors would have been far better off in bonds or Treasury bills than in stocks. In the late 1990s there was a debate about the near-term future of stock markets. Bob Arnott teamed with Peter Bernstein to forecast low single digit returns at best because we started the 21st Century at such a high point. They forecast that investors would pay for the excesses of the 1990s. Roger Ibbotson took the opposite side, arguing for continuation of somewhat normal markets, earning about 10% per year. Well history has spoken, and the winners of the best crystal ball contest are Arnott and Bernstein. What does your crystal ball tell you about the next 8 years?

Stocks, Bonds & Bills in the 21st Century
(8.25 Years Jan, 2000 – March, 2008)

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<th>S&amp;P500</th>
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<td>8.25 Years</td>
<td>0.4</td>
<td>7.3</td>
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<td>82 Years</td>
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The ride to disappointment has been very bumpy. First the bubble burst in the 3 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 5 months took all of that back, with the S&P losing 14% from 11/1/07 to 3/31/08.

As painful as the last 5 months have been, we can still learn from this experience. This is the kind of period that serves to stress test our perceptions of what investments are good defensive plays. In the following we review various market segments and strategies, identifying what has worked in the past 5 months and what has not worked. What sectors, styles, and countries have performed best and worst? Did hedge funds protect? 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 was no place to hide in the long-only equity markets. Every sector, style and country lost money, and there were substantial spreads between the best and worst performers / losers. On the style front, large core defended best, losing only 6%, compared to the hemorrhage that crippled small growth companies, losing 26% -- a spread of 2,000 basis points. 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. We use Surz Styles and Countries throughout this commentary, as described at [Surz Styles](#).

On the sector front, Consumer Staples almost broke even, losing only 0.4%, while both Financial and Information Technology stocks lost 22%, again a very large 2,200 basis point spread. It’s interesting to note that Consumer Discretionary stocks were also hard hit, presumably because the credit crisis portends decreased discretionary spending. Also of interest is the relative resilience of Chindia stocks, namely Energy, Materials and Industrials. While you couldn’t hide, you could alleviate some of the pain.
Fleeing the country didn’t help either. As the next exhibit shows, Latin America was your best hope, but even that relatively hot region lost 7%, about the same as large cap domestic core. The overall foreign market was down 12%, losing somewhat less than the 14% decline in the U.S. EAFE, on the other hand, lost the same 14% as the U.S. The worst performing region was Asia ex Japan, which includes China. This had been the best performing region for several years prior to this correction.
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 two years or more to find a timeframe where positive returns are winners. As the following exhibit shows, a 10% loss will win the performance race for those who are benchmarked against the S&P500, because a -10% return ranks in the top quartile for the two quarters ending 3/31/08. “Congratulations Mrs. Client your manager performed very well, losing “only” 10% of your account in the past 6 months.” The universes in this exhibit are created using an unbiased scientific approach described at 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.
Only the strong survive: Hedge funds

So how about hedge funds? Can we hide there? As the following exhibit shows, all hedge fund strategies delivered on the “hedge”, losing less than the market, with some even making a tidy profit. The average Global Macro manager delivered a terrific 10% return during the past 5 months, which contrasts to a 10% loss in the worst-performing Convertible Bond Arbitrage strategy. As noted in the previous section, a 10% loss puts you in the top quartile of traditional long-only managers. Also, the range of performance within hedge fund strategies is quite large, so it matters a lot who you use. For example one very good single strategy fund of funds is shown in the exhibit. The RCG (Risk-Controlled Growth) Global Equity Long-Short (GELS) fund-of-funds lost only 1% in the past 5 months, making it one the best performing funds in the Global long-short hedge fund space.

Yes, there was a place to hide, and it was in hedge funds, especially Global Macro hedge funds.
How about the old folks?

Recent losses can be especially devastating for those in retirement, who are living off their savings. An investment loss usually cannot 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 during the past 5 months, even more than the TDA benchmark. Target Date Analytics (TDA) has created benchmarks for target date funds. Importantly in this environment, the TDA benchmark 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

Most of the recent underperformance of these funds, in both absolute terms, and relative to the benchmark, is explained by aggressive equity allocations. The following exhibit 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.
Conclusion

These have been trying times, and there may be more of the same on the way. As long as we’re paying the price, we might as well learn as much as we can from the lessons of these markets.

[Graph showing Target Date Glide Paths with Average Mutual Fund and TDA Benchmark]

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