

It Ain't Necessarily So

Unconventional investment wisdom

By E. Jeffrey Roof

As the economy and markets recover from the turmoil and panic that resulted in the second major stock market correction to be experienced during the last 10 years, lessons can be learned that will help investors become smarter and savvier going forward.

One investor resolution for 2010 should be not to repeat the same mistakes that left so many susceptible to the market's sharp decline. Here are the facts behind several oft repeated but erroneous investment "recommendations" often given by so-called experts that should help investors avoid stumbling into some of the previous pitfalls.

"Just ride it out, stocks will always come back."

While stocks often demonstrate remarkable price resiliency, remaining fully invested in equities throughout a period of chaos and uncertainty is foolhardy for all but the youngest investor with little to lose. Protecting downside exposure in your portfolio is critical.

For instance, a 30 percent portfolio loss (slightly less than what the S&P 500 equity index lost from September 30, 2008, to March 31, 2009, the worst of the downturn) requires a subsequent gain of nearly 43 percent just to return to the portfolio's original value.

The long term is even more sobering since a portfolio remaining in the S&P 500 from January 1, 2000, until January 1, 2010, would show a loss of -24.10 percent after 10 years. For that same timeframe, the Dow Jones Industrial Average registered a drop of -9.30 percent, with the NASDAQ declining -44.24 percent. Clearly, "just riding it out" is a misguided strategy.

The argument for remaining fully invested in equities often hinges on the futility of trying to "time the market" by rushing into stocks when the market has assumedly bottomed and then selling when a top is reached. Studies have repeatedly shown that market timing for most investors is very unlikely to add consistent, long-term value because at some point in the process, you will invariably be in the wrong place at the wrong time.

But trying to time the market is a far cry from controlling portfolio risk and improving portfolio returns by incrementally adjusting your allocation among asset classes in response to significant economic and market changes. These changes in investment allocation can benefit even high risk tolerance investors by limiting portfolio loss.

For example, by merely reallocating 25 percent of a portfolio invested in the S & P 500 index into intermediate bonds *after* October 2008's stock market plunge and then waiting until mid 2009 to return to 100 percent equities, nearly four months *after* the market bottomed, a portfolio's twelve month loss through September 2009 would have been halved.

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“Investment managers rarely do better than the indexes.”

In actuality, many managers have performed better than their comparative index. For the year ending 12/31/2009, 61 percent of large cap growth fund managers and 31 percent of large cap value fund managers measured by Morningstar outperformed the S&P 500 equity index. This mutual fund universe has 1,891 large cap growth funds and 1,334 large cap value funds with one-year performance history, so the percentages above represent a notable number of managers in each category. Even over 10 years, nearly 36 percent of large cap growth fund managers and 97 percent of large cap value fund managers exceeded the S&P 500's benchmark.

Similar to market timing, jumping in and out of funds chasing hot performance is bound to fail. However, incrementally leaning a diversified portfolio toward consistently top performing managers can add notable portfolio return.

“All mutual funds in a given category perform about the same.”

One might assume that mutual funds within the same investment category, such as large cap value, small cap growth, or long-term bond, would have similar performance. Nothing could be further from the truth, and the cost in lost potential return is significant.

Performance among category peers is an important measure of a mutual fund's effectiveness, but the difference in average annual return between top and bottom performers within the same peer category has remained shockingly wide.

As an example, among the funds in Morningstar's large cap growth category as of year end 2009, there was over a *6.5 percent per year* difference in performance between the median fund in the top quartile and the median fund in the bottom quartile based on a 3-year time frame. The gap between median top and bottom quartile performers was just as wide for the large cap value funds, over *6.2 percent annually*.

This disparity in returns is not limited to equity funds alone. Even the relatively staid category of intermediate-term U.S. government bond funds has shown the difference between median top and bottom quartile performers to be in excess of *3.5 percent per year* during the past 3 years, a huge variation by fixed income standards.

“Bonds always provide a safe haven when the stock market falls.”

It is true that absent a default, quality individual bonds will indeed eventually mature at full face value. However, this does not mean that bond prices will remain stable until maturity, particularly in a tumultuous economic environment. This fact was dramatically illustrated during the recent credit crisis when fixed income markets temporarily ground to a near halt as the underlying creditworthiness of many bond issuers was called into question.

Contrary to individual bonds, mutual funds comprised of bonds have no set maturity date, and investors in many fixed income funds experienced price volatility during the market meltdown that rivaled their equity fund counterparts.

Likewise, most investors were not aware of the underlying investments comprising their fixed income funds, and many found themselves unwitting holders of mortgage-backed securities and other toxic assets via their fund ownership. Even investors in several money market funds that did not research the composition and credit quality of the underlying fund investments were unpleasantly surprised by unexpected defaults.

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