

Lessons Learned - Again

2008 will likely be the most disappointing year for US stock performance since the 1930s. The suddenness and ferocity of this year's decline have reaffirmed some hard learned lessons from the past. Let's review some time tested truths that will make us older and wiser in 2009.

- **Fear is normal.** Sharp and sudden market declines are frightening and catastrophic journalism can unsettle even the most steadfast heart. I'm convinced that the media's Chicken Littles have played a part in exacerbating this year's decline. Unfortunately, the right things to do are not intuitive -- quite the contrary. Our natural instincts will cause us to make big mistakes in times of financial crisis. The evidence of history is that the long-term investor (by my definition, stock investing means long-term) should not allow fear to influence important financial decisions. For example, in the third quarter of 2002, investors withdrew more money from stock mutual funds than any previous time in history. The stock market bottomed in October of 2002 and then began climbing to a new all time high while many uneasy investors were sitting in cash on the sidelines. Not surprisingly, history is repeating itself again and equity mutual fund withdrawals have set new all time highs the last two months. Fear is normal; not acting upon it requires optimism and courage.
- **Leverage is a two headed rattlesnake -- with a head on each end.** When prices are rising nothing magnifies returns like leverage. When prices are declining nothing will ruin you quicker than excess leverage - except excessive leverage coupled with under-diversification. History books will call this period we are going through as the great deleveraging. Nothing attracts leveraged speculation more than the latest investment mania. Like the blind leading the blind, the smartest people in the world once again followed each other off the debt cliff. They used all the leverage they could get their hands on to buy "can't miss" assets that eventually became their downfall. Un-hedged hedge funds, housing speculators, commodity speculators, and BRIC (Brazil, Russia, India and China) investors are the 21st century's version of Holland's 17th century's tulip bulb speculators. Some things never change, no matter how smart we think we are.
- **Trend following will kill you quicker than a two headed rattlesnake.** The evidence shows that most investors get this wrong over and over again. Dalbar, a financial research firm, publishes an annual *Quantitative Analysis of Investor Behavior*. In the period from 1988 through 2007, they report that the S&P 500 Index rose at an annualized rate of 11.8% while the average equity fund investor earned just 4.5%. They identify performance chasing as the primary cause of this 7% shortfall. Investors shift money out of funds that have gone down recently into the latest hot performers -- which soon begin their own decline. Wall Street knows there is nothing easier to sell than last year's top performers, so it repackages yesterday's winners as today's can't miss opportunities. Consequently, investors invest in what's worked lately rather than what's always worked - often on the advice of their brokers.
- **Wall Street isn't your friend.** There is an illusion among investors that is kept fertilized and well watered by the Wall Street Promise Machine. It is that with enough number crunching, research, computer programs and chart gazing, uncertainty can be vanquished and market volatility can be sidestepped. But deep down inside, Wall Street knows that it cannot provide what clients want - high returns and safety. Risk management has always been the most important task for wise wealth managers. Unburdened by conscience and pretending to have its client's best interest in mind, Wall Street offers products promising high returns with an illusion of safety. How many unfortunate souls have followed the advice of Wall Street's (formerly) great brokerage firms and invested in what they did not understand on the advice of brokers more concerned about commissions than risk management?
- **The future is hidden from everyone.** Everyone was blindsided by the events of the past 18 months. Owning Wall Street's "can't miss" complex investments didn't protect investors. In fact, the most complex investments seem to be the biggest losers. The hedge fund meltdown that is starting to rear its ugly head

is showing once again that brainiacs with powerful computers still can't predict the future and complex mathematics will never be a substitute for prudence. Once again the suspicious experts were wrong. On July 4, no one was predicting that the price of oil would decline by two thirds by Thanksgiving Day. In fact, just the opposite was being proclaimed -- the inevitability of the price of a barrel of oil reaching \$200. The time and energy wasted watching CNBC, in reading "What to Buy Now" articles, scouring the Internet for economic commentaries or market prognostications were, and will always be, a waste of your time.

- **Saving, investing, and speculating are three distinct activities.** Saving comes first -- you must accumulate adequate cash reserves before you begin investing. Invest these reserves in fixed income assets of the highest quality. Never use long term assets, such as stocks, to fund a short term goal or act as your cash reserve.

Investing is a long-term activity. Personally, I believe that the often heard 5 year minimum holding period for stocks is too short. I much prefer a 10 year minimum holding period. The real gain in stock investing comes from receiving the dividends and appreciation in share value during long holding periods. Consider your equity holdings to be ownership in a business rather than ownership of shares of a stock.

Unfortunately, most of what we think of as investing is mere speculation. You can be a speculator without realizing it. How do I define speculation? If you use leverage - you're a speculator. If you invest for short-term gain - you're a speculator. If you listen to CNBC for investment ideas - you're a speculator. If you invest in an asset because it has performed well in the recent past - you're a speculator. If you invest in unhedged hedge funds - you're a speculator. If you try to time the market - you're a speculator. If you invest in individual securities that you think will outperform the market - you're a speculator. If you invest in something you don't understand on the advice of a broker - you're a speculator. If you own a market timing program - you're a speculator. That pretty much covers every non-client that I have ever met.

- **A portfolio with no financial plan is a rudderless ship in a gale.** I'm convinced that a written financial plan is the best tool to keep people from investing in fads and bubbles or selling in panic in bear markets. Your portfolio must be anchored by a written financial plan - one that reflects your risk tolerance, long-term goals and time horizon. This is a great time to get started. Today, every global equity asset class that you want to include in your portfolio is inexpensive. History shows us that the best way to obtain above-average returns comes, not by predicting the future, but by buying at below-average prices. You don't need a computer to figure that out.
- **Be patient.** History tells us that slow and steady wins the race and that the tortoise beats the hare. Consistent periodic funding of your long-term investments has always been the best strategy for financial success. Dollar cost averaging works best when prices are low. Historically, the stock market has risen 2 years out of 3. In the middle of a bear market it's often difficult to imagine that the market will ever recover. The time of maximum market angst is always just before it starts recovering. Be patient and focus on the long-term benefit of owning equities.

Earlier this year, Ned Davis Research looked at the 10 US recessions since the end of World War II. It found that the average market return 1 year after the market low point was a gain of 32%. The past is no guarantee of the future. But history shows us that recovery rallies are part and parcel of the market cycle. The point of recovery will be known only in retrospect so to ensure that I will be invested when it arrives, I'm staying invested today.

- **The past 10 years don't mean a thing.** It's all the rage now to call the last 10 years "The Lost Decade" because investors have received little or no gain from their US equity investments. The underlying assumption and fear is that this trend will continue. But if we look at history we see that disappointing decades of the past have been followed by a decade of acceptable returns. Don't fall into the "recency" trap of assuming that the last 10 years are a preview of the decade to come. Today, the yield on the 10-year U.S. Treasury bill is less than the dividend yield of the S&P 500. The issue is not what stocks have done the past 10 years but rather whether stocks are likely to outperform bonds and other fixed-income investments in the next decade. I vote yes.

This year's financial mess has once again reminded us that investing in common stocks is fraught with uncertainty. It comes with the substantial risk of large periodic loss of principal, as well as the substantial

benefit of large principal gains. Historically, principal losses have been temporary interruptions in a long-term upward trend of stock prices. Attempts at predicting market bottoms have been, and will continue to be, futile. The traditional brokerage system is fatally flawed and in a well-deserved state of collapse. Individual investors must decide if they are going to have an investment strategy based on the lessons of history or someone's guesses about what the future holds. Wall Street will offer you the latter, along with expensive investments and self-serving advice. Investors are best served when they work with a financial planner who can design an investment strategy based on the lessons of history. The distinction between these two investment models has never been clearer.

I'm confident that the best way to achieve financial success is by having an investment strategy based on the lessons of history, not on someone's opinion of what the future holds. Current woes aside, I believe that the worldwide expansion of the free enterprise system will continue. Around the globe, millions have been unchained from the bondage of poverty in the last two decades. This trend will continue as global living standards continue to rise.

More of the Same

One of the most irritating things I've had to endure this past year is listening to the assertions that the buy and hold strategy is dead and index investing does not work in a declining market. The notion is that a portfolio must be in the sure and steady hands of active management when navigating stormy waters. Wall Street promotes this misconception and it seems like a reasonable assertion - if you ignore the historical data on the performance of portfolio managers. The financial press is a willing accomplice to this message since much of their advertising revenue comes from proponents of active management. Everyone cannot excel through active management. Before expenses, half of investors will be below and half will be above the average market return. Once expenses are deducted, the majority of investors must underperform market averages - and thus underperform index funds. This is middle school arithmetic. Sadly, only 12% of individual investors' assets are invested in index funds.

S&P reports that from 2002 through 2007, 72% of all large-cap domestic mutual funds underperformed the S&P 500 Index. Proponents of active management reply, "Indexing worked because we were in a rising market." Morningstar has reported that so far this year, 71 of the 100 largest actively managed equity mutual funds have underperformed their benchmark index. Buying and holding a portfolio of diversified index funds may not be the best investment strategy ever devised but it is the best one I know of - having produced superior returns to almost all others.

Consider the case of Bill Miller, who was the only mutual fund manager in the last 40 years to outperform the S&P 500 Index for 15 consecutive years (1991 through 2005). To his credit, Miller was less impressed with his success than many of his admirers. He was always quick to add that luck played a big part in his achievement. But when you live by the active management sword you also die by the active management sword. Miller's horrible performance the last 3 years has now left his investors (as of 9/30/08) trailing the S&P 500 Index for the past 10 years. Did he suddenly start taking stupid pills in 2006? Of course not. His small portfolio of stocks performed well when he made some good picks but is ruining his performance now that he has made some bad ones. Simple as that.

Those of us who are UAL pilots have the choice of 6 actively managed Russell funds in our PDAP/401(k) - 2 bond and 4 stock funds. The PDAP performance report sent by Russell for the period ending October 31, 2008 shows the performance of the 6 actively managed funds for 7 different time periods. So, in effect, we have 42 "matches" pitting the performance of Russell's 6 active managers against their benchmark index in each of the 7 time periods. How did they do? Here's a chart showing the number of "victories" for the 6 managed funds in each of the time periods -

Timeframe	Year To Date	1 Year	2 Years	3 Years	5 Years	8 Years	10 Years
Russell Wins	0	0	0	0	1	3	2

Russell claims to have the ability to find the most skillful fund managers, yet they won only 6 of 42 matches (14%) with an average winning rate of return only 0.2% higher than the benchmark index. At this year's convention of the Financial Planning Association, I struck up a conversation with a Russell representative at

their display booth. I told him that as a United pilot I was familiar with their product but as a financial planner I was a passionate index investor. He replied, "Over the long term, we pretty much match index returns." I was stupefied by the honesty of this fellow's admission. He was saying, in essence, that all fees charged by Russell for active management produced no long-term benefit for their clients; rather the fees go directly into Russell's pocket.

Skillful managers do exist but in many cases investors do not reap the benefit of their skill once costs are deducted. The long-term data indicates that in any given year, 30% of active managers will beat their benchmark index. However, this percentage is closer to 15% after 5 years and 10% after 10 years. Unfortunately for investors, there is no consistency among the winners. Most years, top performers owe their success to being invested in an asset class that is booming, not their uncanny ability to pick stocks or time the market. The most common characteristics of perpetually bad funds are high annual fees and excessive portfolio turnover. Therefore, it's easier to predict which funds will be poor performers in the next decade than to predict the 10% that will be standouts.

To achieve adequate investment returns is easier than most people think. To achieve superior returns is more difficult than most people can imagine. If Russell Investments cannot be relied upon to find exceptional managers, what chance does an individual investor have to find actively managed mutual funds that will outperform index funds? Somewhere between slim and none.

Another year has come and gone and this is the 50th issue of *Vectors*. Not bad, considering that I started out with only 3 ideas in my head. Hopefully, I have been able to give the readers of this newsletter some nuggets of wisdom. There's only one thing left to say in 2008 -- Merry Christmas to all and to all a good night.

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