

the EDUCATED INVESTOR

FEATURE ARTICLE

January 2012

Lessons From 2011

Overview: Every year, Larry Swedroe takes a look back at the investing lessons the markets provided in the past year. In 2011, the markets offered investors a chance to revisit a few remedial courses by teaching lessons it had introduced in prior years. So, this year's list includes a few reminders that we are just as likely to lose our discipline in good times as we can in bad times.

Lesson 1: Ignore All Forecasts — All Crystal Balls Are Cloudy

Financial analyst Meredith Whitney made a forecast that caused quite a stir in December 2010, when she predicted “50 to 100 sizable defaults” in the municipal bond sector in 2011, totaling “hundreds of billions of dollars’ worth of defaults.” By May 2011, investors had withdrawn money from municipal bond funds for 24 consecutive weeks. Whitney’s prediction might join *BusinessWeek*’s August 1979 forecast of “The Death of Equities” among the worst of all time.

The massive scale of problems that Whitney had anticipated did not occur because governments have taken actions by cutting spending and raising revenues. Unlike the federal government, all states except one are required to balance their budgets. As a result, budget gaps have been closed by greatly reduced services, renegotiation of contracts with union members regarding wages and benefits, layoffs of public employees, and increased taxes and fees. These actions have gotten results. And intermediate-term municipal bonds were among the best-performing asset classes in 2011.

The following is another example of why all market forecasts should be ignored, no matter how revered the source. In February 2011, Bill Gross (dubbed the “bond king”) announced that the world’s biggest bond fund had reduced its U.S. government-related debt holdings from 22 percent in December 2010 to just 12 percent in January 2011, the lowest in two years.

By April, PIMCO had announced it had eliminated government-related debt entirely from its flagship fund, saying that bond yields had reached unsustainably low levels given the scale of government debt obligations and the chance of a correction when the Federal Reserve System ended its quantitative easing program.

In August, Gross admitted he had made a mistake. Interest rates continued to fall, defying the forecasts of the vast majority of professional investors, including those of the 16 primary dealers who make markets in government debt. A corollary lesson is that timing the market is just as much a loser’s game in bond markets as it is in equity markets.

Lesson 2: Make Sure Your Investment Plan Incorporates the Virtual Certainty That Crises Will Occur, and Will Do So With Great Frequency

We cannot know what form crises will take, when they will occur, how deep they will be or how long they will last. However, we do know they will occur. Therefore, you must be sure to avoid taking more risk than you have the ability, willingness and need to take. If you do not, you are likely to allow emotions such as fear and panic and the noise of the markets to cause your plan to end up in the trash heap. Once you sell, there is never a green light that will let you know that it is once again safe to invest.

While bear markets are painful, there is no good alternative to buy and hold except avoiding risk and accepting Treasury bill returns. Few investors can reach their goals by investing solely in Treasury bills. Timing the market is a mug's game.

Lesson 3: Last Year's Winners Are Just as Likely To Be This Year's Dogs as They Are to Repeat

The historical evidence demonstrates individual investors are performance chasers — they watch yesterday's winners and then buy (*after* their great performance) and watch yesterday's losers and then sell (*after* the loss has already been incurred). This causes investors to buy high and sell low — not exactly a recipe for investment success. This behavior is consistent with findings that investors actually underperform the very mutual funds they invest in by significant margins.

Using Dimensional Fund Advisors' passive asset class funds (as well as PIMCO's Commodity Real Return Fund), the following table compares the returns of various asset classes in 2010 and 2011. Sometimes, the winners of 2010 repeated, but other times, they became losers.

For example, emerging markets small-cap stocks, the third-best performer among asset classes in 2010, was the second-worst performer in 2011. Of the 14 asset classes shown, U.S. large-cap stocks finished 12th in 2010 and ranked second in 2011.

Fund	2010 (Rank)	2011 (Rank)
DFA U.S. Small Value	30.9 (1)	-7.5 (5)
DFA U.S. Small	30.7 (2)	-3.1 (3)
DFA Emerging Markets Small	30.2 (3)	-22.6 (13)
DFA Real Estate	28.7 (4)	9.0 (1)
PIMCO Commodity Real Return	24.1 (5)	-7.6 (6)
DFA International Small	23.9 (6)	-15.3 (9)
DFA Emerging Markets Value	22.1 (7)	-25.6 (14)
DFA Emerging Markets	21.8 (8)	-17.4 (11)
DFA U.S. Large Value	20.4 (9)	-3.1 (3)
DFA International Small Value	18.1 (10)	-17.5 (12)
DFA International Real Estate	18.1 (10)	-7.8 (7)
DFA U.S. Large (S&P 500)	15.0 (12)	2.1 (2)
DFA International Value	10.8 (13)	-16.7 (10)
DFA International Large	9.3 (14)	-12.3 (8)

While there are streaks in asset class returns, they occur randomly relative to expectations. The streaks have no more meaning than streaks at the craps table — a good (poor) return in one year does not predict a good (poor) return the next year.

In fact, great returns lower future expected returns and below-average returns raise future expected returns. Thus, the prudent strategy for investors is to act like a postage stamp. The postage stamp does only one thing, but it does it exceedingly well — it adheres to its letter until it reaches its destination. Similarly, investors should adhere to their investment plan (asset allocation).

Adhering to one's plan does not mean just buying and holding. It means buying, holding and rebalancing — the process of restoring your portfolio's asset allocation to the plan's targeted levels.

Lesson 4: Yesterday's Masters of the Universe Are Tomorrow's Cosmic Dust

Not that long ago, hedge fund manager John Paulson was hailed as a master of the universe. He was in a class by himself, generating returns of up to 600 percent in 2007 by betting against subprime mortgages.

In December 2011, Bloomberg reported that Paulson was “mired in the worst slump of his career.” In 2011, the Paulson Advantage Fund lost 36 percent. His gold fund lost 10.5 percent in 2011 even as gold marked its 11th-straight annual gain.

Bill Miller and the Legg Mason Capital Management Value Trust (LMVIX) provide the basis for the next example. After beating the S&P 500 Index for 15 straight years, the fund underperformed the S&P 500 from 2006–2008 by 9.9 percent, 12.2 percent and 18.1 percent, respectively.

However, after turning in a stellar performance in 2009, returning 40.7 percent, some in the media were reporting that Miller's “still got game.” In 2010, LMVIX underperformed the S&P 500 by 8.4 percent. 2011 was not much better. The fund lost 4.0 percent.

The third example is legendary investor Bruce Berkowitz, manager of the Fairholme Fund (FAIRX). Miller was named domestic stock fund manager of the year in 1998, while Berkowitz earned Morningstar's title of domestic stock fund manager of the decade in 2010. Berkowitz has said, “Beat the pack by breaking from it.” Of course, that is the only way to beat the pack — and it is also the road to underperformance. In 2011, FAIRX lost 32.4 percent, underperforming its benchmark by 31.7 percent.

The question for investors is this: Was 2011 just a bad year for Berkowitz (even Warren Buffett has bad years), or is he the next Bill Miller? Unfortunately, there is no way to know the answer to that question *today*. And because the evidence from research on the persistence of performance of active managers has demonstrated that even long streaks do not have predictive value (as Miller's case demonstrates), prudent investors have learned not to bet on the answer either.

Lesson 5: Conventional Wisdom Is Often Wrong

One bit of conventional wisdom is that the third year of the presidential cycle is great for stocks. In fact, there was not a single negative return for the S&P 500 during a third year since the 1930s. Since 1945, the S&P 500 has advanced in the third year of a president's term by an average of 15.9 percent. The year 2011 bucked that trend as the S&P 500 returned just 2.1 percent, well below the historical average.

Other U.S. equity asset classes produced not-so-great results in 2011. For example, a December 24 *Wall Street Journal* article reported that, according to a December 2011 Bank of America-Merrill

Lynch report, only 23 percent of U.S. stock-fund managers outperformed the large-cap benchmark for the year.

Lesson 6: Tactical Asset Allocation Is a Loser's Game

In September, Vanguard closed its second-worst-performing active balanced fund, Vanguard Asset Allocation Fund (VAAPX), and it fired VAAPX fund advisor Mellon Capital Management. Vanguard's plan: to transfer the remaining \$8.6 billion in assets to Vanguard's Balanced Index Fund (VBINX), which follows a passive investment strategy.

VAAPX underperformed its moderate risk target by almost 2.9 percent a year over its last 10 years. The failure of the fund to achieve its objective highlights just how difficult it is for active managers to generate alpha after the expenses of the effort. Vanguard is one of the largest money managers in the world. The cautionary tale for investors: Even with tremendous resources at its disposal, Vanguard failed to find a manager that would generate future alpha.

Lesson 7: Hedge Funds Are Compensation Schemes, Not Investment Vehicles

2011 was another year that demonstrated that calling hedge funds *absolute return* vehicles is an absurdity. For the year, the HRFX Global Hedge Fund Index returned -8.9 percent. It underperformed all the major domestic equity and bond asset classes, as well as international REITS, although it did outperform other international equity asset classes.

By comparison, an all-equity portfolio with 50 percent international/50 percent domestic, equally weighted within those broad categories, would have returned -7.0 percent. And a 60 percent equity/40 percent bond portfolio with those weights for the equity allocation would have returned -4.0 percent using one-year Treasuries, -0.4 percent using five-year Treasuries and 7.1 percent using long-term Treasuries.

Hedge funds often tout the freedom to move across asset classes as their big advantage, so one would expect that "advantage" to show up. The problem is that the efficiency of the market, as well as the costs of the efforts, changes that supposed advantage into a handicap.

Conclusion

2011 was a year in which the financial markets were seriously challenged by problems in the Eurozone and concerns over state and municipal finances. Like most years, 2011 provided many real-life examples that illustrate why one of the main principles of a prudent investment strategy is to build a globally diversified portfolio that reflects an investor's unique ability, willingness and need to take risk.

One key to achieving that objective is to ignore economic and market forecasters, the noise of the market and the emotions that noise can cause. Doing so should allow for more time to be spent on the important things in life, like family, friends and community.

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