



So Far so Good: The Decrepit Decade Winds Down

By Ron Surz
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Stocks have reached what looks like a permanently high plateau
Irving Fisher, Economics professor, Yale University, 1929

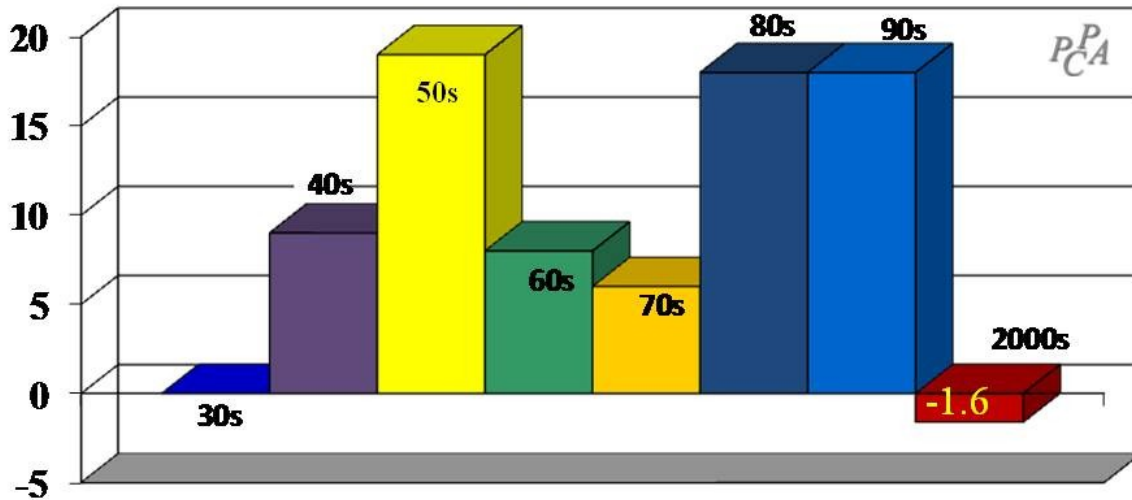
Introduction

As we near the end of what is likely to be the worst calendar decade on record, we might be inclined to say “so far so good” about the first nine months of 2009. As Irving Fisher would surely lament, we need to wait for the finale.

U.S. stock markets have returned 22% thus far in 2009, bringing the annualized return for the 9.75 years of the 2000s up to a loss of only 1.6% per year. As we entered 2009, the nine-year average annual loss stood at 4%. A return of 17% in the fourth quarter of 2009 would bring the decade to breakeven, and we would have posted a whopping 43% return for this year - exceptional but not unprecedented.

Five calendar years have had returns in excess of 40%: 1928, 1933, 1935, 1954 and 1958.

Annualized S&P500 Returns by Calendar Decade



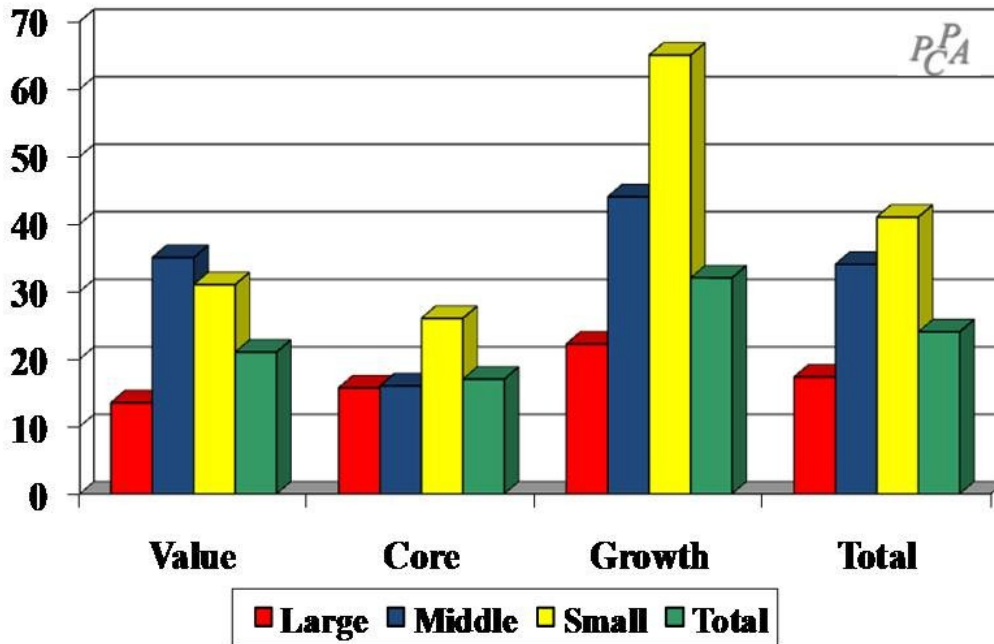
So what has been working so far this year? In the following, I review the past nine months in both the U.S. and the non-U.S. markets. Then I reveal a very important fact about style indexes: the choice of classification variable matters a lot, especially in this current mess.

I conclude with a plea for your help, which I'd really appreciate.

The first nine months of 2009

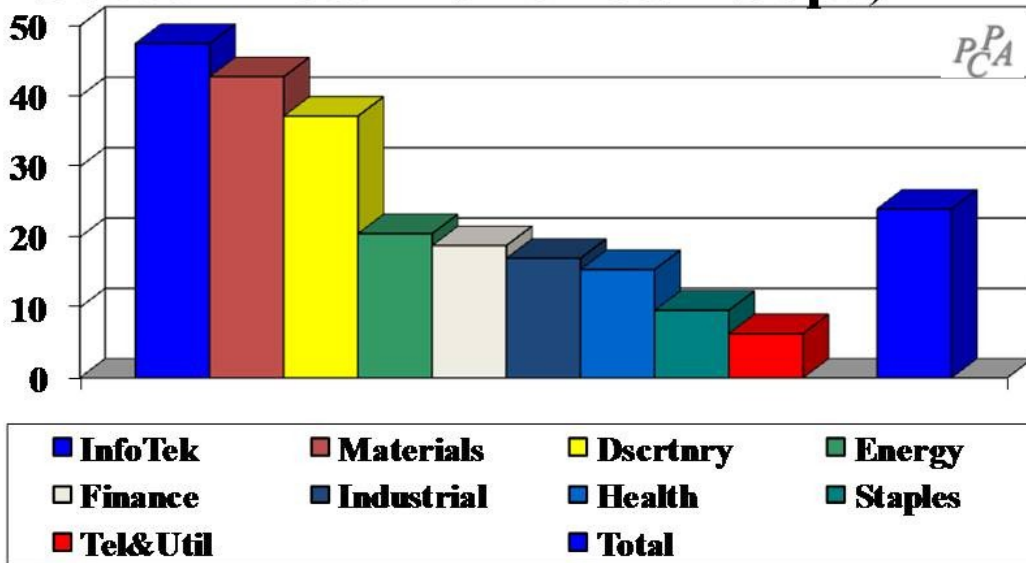
As the next chart shows, all US style posted double-digit returns for the first nine months of 2009, in stark contrast to the devastation in the second half of 2008. Smaller companies fared best, as did growth stocks, led by Information Technology. I use Surz Styles and Country indexes throughout this commentary, as described [here](#).

Style Returns Jan-Sept, 2009



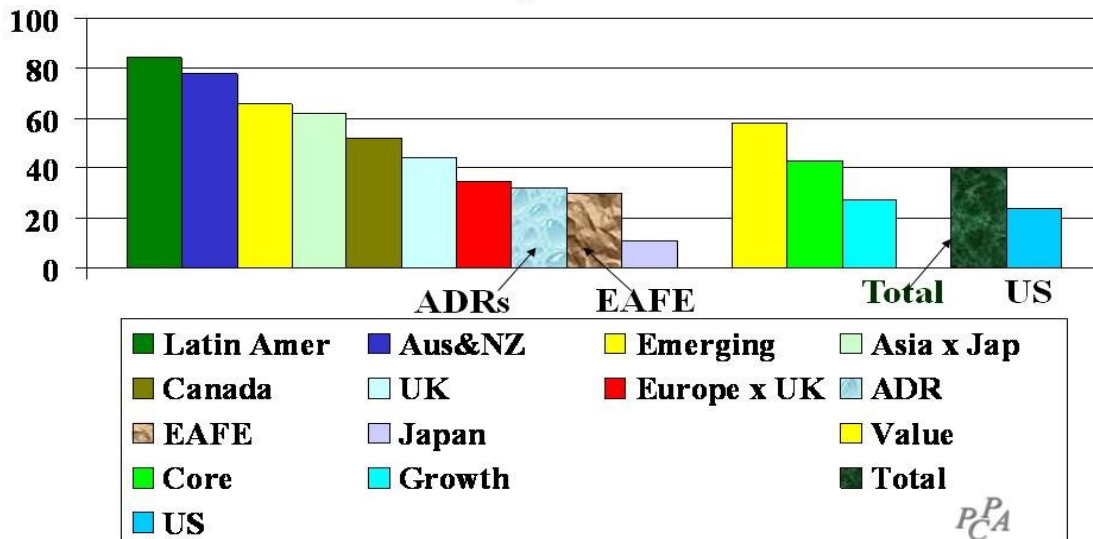
On the sector front, Information Technology delivered a terrific 47.5% return, which contrasts to the worst performing sectors - 6% and 10% returns in Telephones-&-Utilities and Staples respectively. Making a lot of money seemed easy, with every sector except Telephones-&-Utilities posting double-digit returns. But as we all know, the economic crisis is far from over, and we're still poorer than we were in June of last year.

Sector Returns for Jan-Sept, 2009



Now let's look outside the US, where market performance has almost doubled domestic returns - 40% in the year-to-date. The weakening dollar contributed 7% to this return. Latin America led the way with an astonishing 84% return, followed by Australia and NZ and Emerging Markets with 77% and 66% returns respectively. Japan lagged with an 11% return. Because of their hefty allocation to Japan, Japan performance dragged down EAFE to a 29.6% return and ADRs to a 32% return. On the style front, value has been in favor, which contrasts to the US where growth has fared best.

Country Returns





Observers will say diversification “worked” in the year-to-date because the definition of “works” has come to mean “foreign markets performed better than US markets.” Several articles have been written recently about the failure of diversification to “work” in the second half of 2008. A careful read of these articles reveals that “not working” has essentially come to be defined as not winning with better performance. That is, adding diversifying assets beyond US stocks did not produce a return in excess of US stocks in the second half of 2008.

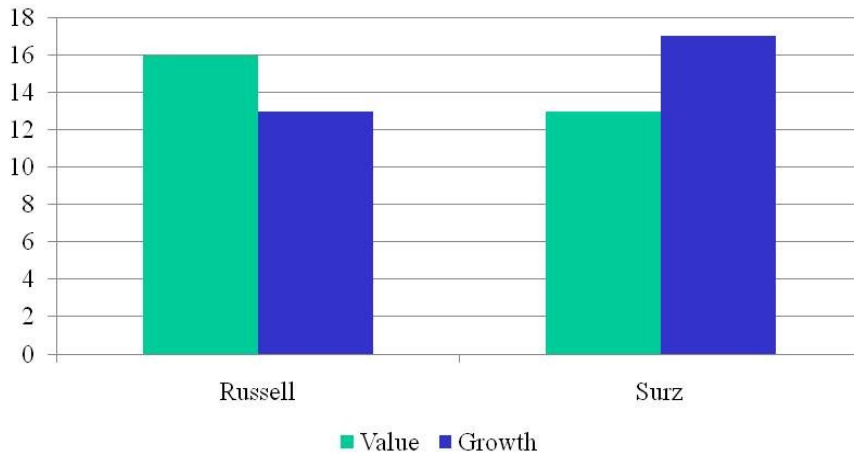
Interestingly, foreign markets have delivered a positive 6% annualized return in the decade to date, so diversification has “worked” over the long run. Although I do not agree, this is an interesting definition of diversification “working” and one that is likely to persist. I believe diversification combines disparate assets with varying return patterns to stabilize returns over a long period of time. It “works” primarily by lowering volatility, although it may also improve performance.

Whose style is it anyway?

As mentioned above, I use Surz Style Pure[®] (SSP) definitions, which combine Price/Earnings ratio (P/E), dividend yield and Price/Book ratio (P/B). Until recently, my index returns mostly agreed with Russell and S&P, except for the effects of my “Core” index, which comprises those fuzzy stocks in between value and growth. Neither Russell nor S&P utilize core to the same extent.

But that’s all changed, as shown in the next exhibit where Russell shows large value companies outperforming growth in the third quarter, whereas I show just the opposite.

Large Company Indexes in Q3/09 Finance Returned 23% in Q3



In a recent article published in *Advisor Perspectives* (see [here](#)), I question the wisdom of using Price/Book as a style classification indicator, which is the Russell approach. As Laurence Siegel states in a [CFA Research Foundation monograph](#), ***“Book value is mostly a historical accident. It is the accounting profession’s estimate of the company’s value; it reflects what the company paid for assets...includes the goodwill of companies acquired.”***

In the current financial crisis, the choice of factor largely dictates whether financial stocks are classified as value or growth. A P/B factor assigns most financials to value, whereas my alternative three-factor model assigns financials to growth. Because financials are 16% of the market, this style assignment conflict causes significant differences in performance between indexes. Prior to the current crisis, both classification approaches agreed that most financials were value stocks.

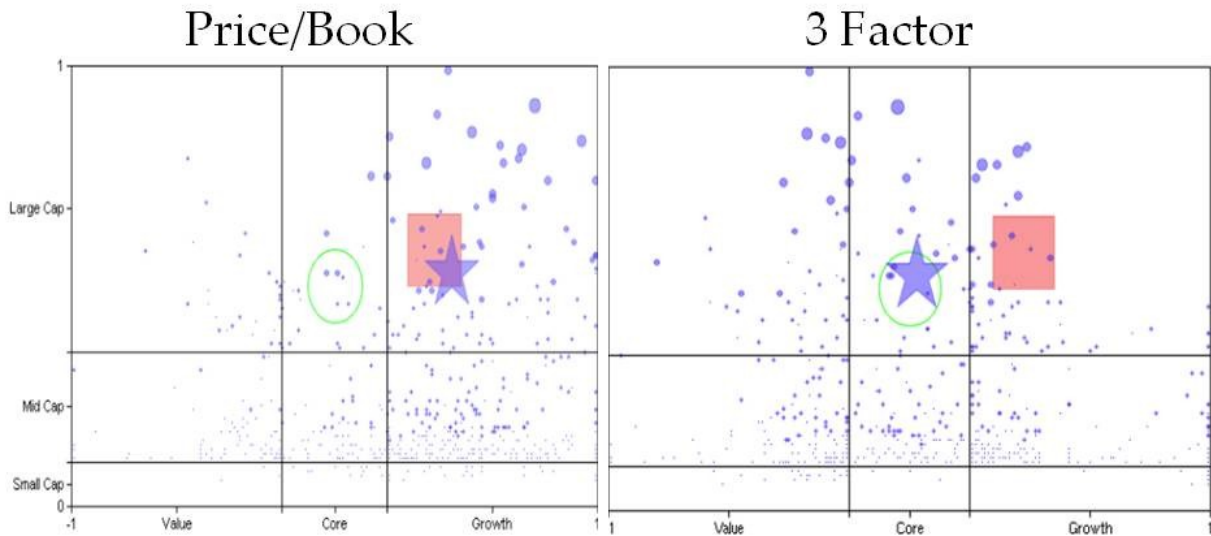
We can see the effects of the two different classification approaches by using Style Scan. Style Scan (see [here](#)) is a tool to visualize the stock make-up of individual portfolios. Every stock in the portfolio is plotted in two dimensions, where the x-axis represents value (left)-growth (right) and the y-axis represents company size (market capitalization). In this way, every portfolio has a unique “style signature” – the graphic display of each constituent based on these two dimensions. Style Scan shows that the style definitions that are used to scale the X-axis dramatically affect this signature. Specifically, many stocks have a significantly different X (value-growth) coordinate when using P/B versus the three-factor model.

The single-factor P/B-based framework renders a completely different signature than the three-factor model used by SSP. This is shown graphically in the next exhibit, which



contrasts the P/B-based style signature of the Russell 1000 Growth index to its signature using my three-factor model.

Russell 1000 Growth Index in Q3/09



As you can see, the single-factor P/B framework shows the constituents of the Russell 1000 Growth index clustering in the upper right of the graph, which is the large growth sector. The centroid of its constituents, indicated by the star, also plots toward the upper right. The square in the exhibit indicates where one would expect the star to plot. The green circle is the centroid for the entire market.

But the style signature of the stocks in the Russell 1000 Growth is completely different if we change the style classification rule, and use the three-factor model. This was not as dramatic an effect prior to the current financial crisis, and is caused by assigning negative P/Es to growth stocks, whereas P/B ratios are rarely negative.

You may choose your classification variable in Style Scan – P/B or three-factor – and I welcome you to share your opinion on which works best for you. You have my opinion.

I need your help. Please join my target date tribe

I've left Target Date Analytics LLC (TDA), a firm I co-founded with two partners in 2007, to gather a tribe around a new entity called Target Date Solutions (TDS).

**Ron Surz has Launched
Target Date Solutions**



Design and Implementation of Target Date Glide Paths

My mission is to gain acceptance for what I believe is the right way to manage target date funds (TDFs). I believe TDFs should all be “to” funds, designed to end at the target date, and they should emphasize safety, which I believe is the prudent thing to do for these Qualified Default Investment Alternatives (QDIAs).

Those of you familiar with TDFs know that all current offerings are “through” funds, designed to miss their target dates on purpose because they are target *death* funds. These funds are generally 30% or more invested in equities at the target date, so 2010 funds lost 25% on average last year because they are not safety-first offerings.

Have you seen Seth Godin’s work on “tribes” (see [here](#))? I believe there are like-minded fiduciaries who share my desire to create target date funds with the following objectives:

1. Deliver at the target date accumulated contributions plus inflation. Achieve this objective with a very high likelihood.
2. Grow the assets as much as possible without jeopardizing the protection objective. Achieve this objective with a reasonably high likelihood.

The only TDFs currently pursuing these objectives are SMART Funds® offered by Hand Benefits & Trust of Houston, so it is the number one brave of my tribe.

If you agree that plan participants need safety-first TDFs, please join my tribe. Just let me know that you support my views, and how you’d like to participate, even if it’s just an “attaboy.” Please e-mail me at ron@ppca-inc.com. Thanks.

Conclusion



I believe the US stock market is currently modestly overvalued. From a rearview mirror perspective, it would appear that the crash overshot its mark and the current reversal may have done the same in the opposite direction. Price/earnings ratios initially retreated from 26 to 16, which is in line with historical norms. But this past quarter has brought P/Es back up to 19, and it's done so in the face of great anxiety about a number of risks, like the solvency of the FDIC. Prices have risen faster than earnings on the hopes that the worst is over. Offsetting this concern however, America remains the leading economic power in the world, at least for now. We're too big to fail.

Clients should require, and are requiring, higher standards of practice from their consultants and investment managers. Almost any advice is good during good times, but these are not good times. Clients need and want better protection and assurances that risk will be rewarded. The focus has shifted from reward to risk. Clients want the best. Differentiation is the name of the game. Superior advice and guidance is the prize. It's a win-win.

A case in point is target date funds. Instead of dismissing the abysmal performance of TDFs during the 2008 meltdown as an aberration, we should learn from this painful experience that these very popular investments need to be much safer. Target date funds and custom glide paths have been sold, not bought, and the sooner fiduciaries recognize this the better it will be for plan participants. Safety matters more than procedural prudence; do what is right rather than what everybody else is doing.

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