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## Lessons From 2008

**Overview:** Every year, Larry Swedroe takes a look back at the investing lessons the markets provided in the past year. Market conditions in 2008 certainly provided a challenge for investors, and there are many lessons that can be gleaned from the past year's experiences.

While the economic recession provided some expensive lessons for investors, hopefully these lessons will not be soon forgotten. Here are some of the lessons reinforced during the past year that investors should keep in mind in 2009 and beyond.

### Active Managers Cannot Protect Investors From Bear Markets

All crystal balls are cloudy, which is why Warren Buffett concluded: "The only value of stock forecasters is to make fortune tellers look good."<sup>1</sup> Active investment firms tout their ability to protect investors from bear markets, but some of the largest demonstrated they could not even protect themselves. If their money managers could protect investors, why did firms like Lehman Brothers and Bear Stearns go belly up and Merrill Lynch have to be rescued by Bank of America? As evidence of their lack of ability to forecast events, consider that in 2008 Lehman spent \$761 million buying back its own stock at an average price of \$49.60 and Merrill Lynch spent \$5.27 billion buying back its stock in 2007 at an average price of \$84.88.<sup>2</sup>

There is no reason to think that they would manage their clients' risks any better. Investors don't need to pay Wall Street big fees to have their money managed. Large fees are only likely to make managers rich, not investors.

Large individual funds fall in the same category. In 2008, the hardest hit sector was financial stocks. Financials comprise a significant portion of the asset class of value stocks, so let's look at the performance of some well-known actively managed value funds:

Value Mutual Funds	
Active Managers	%
Legg Mason Value Trust	-55.1
Dodge & Cox	-43.3
Dreman Concentrated Value	-44.9
Weitz Value	-44.9
Schneider Value	-55.0
Columbia Value and Restructuring	-47.4
Benchmarks	

Russell 2000 Value Index	-28.9
Russell 1000 Value Index	-36.9

Of course, some actively managed value funds beat the benchmarks. However, how would you have known ahead of time which ones they would be? As the SEC's required disclaimer states: Past performance is not indicative of future results. Thus, the prudent strategy is to use only passively managed funds.

### **Know Your Risk Tolerance**

Investors should never take more risk than they have the ability, willingness or need to take. Violating this rule is what led to the failure of Lehman, Bear Stearns, AIG and others. They all took on so much leverage (especially considering the risky nature of the assets) that they had to be right all the time, not just in the long run.

### **Diversification Is Key**

Low correlating risky assets have a nasty tendency to have correlations rise just when those low correlations are needed the most. Thus, investors should make sure their portfolios have sufficient high-quality fixed income assets to reduce portfolio risk to an appropriate level. Also, it is important to ensure the fixed income used in the portfolio is of the highest quality. Investors should stick only with Treasuries, bonds of government agencies and the highest rated municipal bonds (AAA/AA). Also, municipal bonds should be judged based on the underlying rating, not the credit insurance.

Other fixed income investments — such as high-yield (junk) bonds, convertible bonds, emerging market bonds and preferred stocks — should be avoided, as their risks do not mix well with equity risks and thus could have the risk show up at the wrong time. Those willing to take incremental risk should do so by increasing their equity allocation. The incremental expected returns can then be earned more tax efficiently, and the risks can be more effectively diversified.

### **Do Not Confuse the Familiar With the Safe**

Working for a company does not mean the stock is a safer investment because you feel like you “know” the company. Consider the following: A September article in *The Wall Street Journal* noted that employees of Merrill Lynch, Morgan Stanley and Lehman Brothers had lost significant amounts of their retirement holdings in 2008 because they held substantial amounts of their respective company's stock. When the article was published, Merrill Lynch and Morgan Stanley employees had lost an estimated \$400 million and \$500 million respectively in 2008, and Lehman Brothers employees had lost about \$200 million in the past year and a half.<sup>3</sup>

### **Uncertainty and Risk**

We live in a world of uncertainty (the odds of events occurring cannot be measured), not a world of risk (the odds can be measured). And investors much prefer risky bets to uncertain bets. Since we cannot calculate the odds of a bear market like the one we experienced in 2008 occurring, investors require a very large equity risk premium. That risk premium is why stocks have outperformed riskless Treasury bills by such a wide margin over the long term.

### **Do Not Treat the Unlikely as Impossible (or the Likely as Certain)**

Investors should remember that just because something has not happened, doesn't mean it cannot or will not. Forgetting such a lesson helped lead to Lehman Brothers and Bear Stearns demise.

### **Even Blind Squirrels Find an Occasional Acorn**

There is a great likelihood that each time there is a crisis, someone will have forecasted it with amazing accuracy. But that ignores two important facts. The first problem is that there are tens of thousands of these “gurus” making forecasts all the time. Given the number trying, we should randomly expect some to make accurate forecasts. For example, the crash of October 1987 was forecast with amazing accuracy by a little known analyst named Elaine Garzarelli. Having made such a prescient forecast, she was immediately elevated to guru status, and everyone started seeking her opinions. She never came close to replicating a call like that, despite repeated attempts. It also did not help her as a fund manager. While her 1987 forecast helped her fund outperform the market, the fund underperformed five of the next six years before it was folded into another fund.

Each crisis seems to produce another such guru. This crisis produced Nouriel Roubini, professor of economics and international business at NYU’s Stern’s School of Business, who was among the first to predict the current economic crisis. A problem with Roubini (and almost all forecasters) is that we don’t know how many other forecasts he has made and the track record of those forecasts. Perhaps the most interesting thing about Roubini is that, despite his forecast, his retirement account had a 100 percent allocation to equities. It seems that Roubini knows enough to ignore his own forecasts, as they are not likely to lead to abnormal profits.

When it comes to economic forecasts, investors should remember the words of William Sherden, author of *The Fortune Sellers*. He said that the First Law of Economics was that for every economist, there is an equal and opposite economist — for every bullish economist, there is a bearish one. His Second Law of Economics was that they are both likely to be wrong. Sherden’s research found no economic forecasters who consistently lead the pack in forecasting accuracy.<sup>4</sup>

### **Timing the Market Is a Mug’s Game**

Investment returns are not earned smoothly. The result is that most of the market’s returns come from short, but powerful, bursts of bull and bear markets. Consider that an investment in the stock market from 1900 through 2006 that missed just the best 100 days of market returns would have been worth less in 2006 than in 1900 (and this without even accounting for 107 years of inflation). On the other hand, avoiding the worst 100 days would have increased the investment’s worth 43,397 percent. Since a negligible proportion of days determines either a massive creation or destruction of wealth, the odds against successful market timing are simply staggering.<sup>5</sup>

### **Things May Not Be as They Seem**

One of Albert Einstein’s more famous quotations is: “Only two things are infinite: the universe and human stupidity; and I’m not sure about the former.” If Einstein had lived long enough, he may have considered adding a third: the ability of Wall Street’s investment bankers to create “innovative” products that exploit investors. Among the recent entrees are: accumulators, booster-plus notes, buffered notes, principal protection notes, reverse convertibles, structured repackaged asset-backed trust securities and super-track notes. These are complex derivative products, with the complexity designed to favor the issuer.

### **Be Prepared**

A critical part of the financial planning process is to develop “Plan B,” or the actions that will be taken if financial assets fall to such a great degree that the investor may run out of assets. Those actions might include remaining in the work force longer (or returning to the work force), reducing

current spending, reducing the financial goal or moving to a location with a lower cost of living. The use of Monte Carlo simulations can be valuable in determining what actions should be considered.

### **Don't Just Do Something, Stand There**

There are two good reasons to change a well-designed investment plan. The first is that the underlying assumptions upon which it was based have changed. For example, there may have been a job change, a birth in the family, a marriage or an inheritance. Each of these events can significantly impact the ability, willingness or need to take risk.

The other reason is if a sharp fall in the value of one's assets (both financial assets and home prices) uncovers that the investor has taken too much risk. This mistake may have resulted from the common trait of overconfidence. Or it may have resulted from treating the unlikely as impossible.

Even smart people make mistakes. However, once they discover the error, they neither repeat nor perpetuate the mistake. Before making any change to a financial plan, it is important to make sure the decision is being made by the head, not the stomach. In other words, any change should be based on analysis of the facts, and not based on fear and panic resulting from bear markets.

### **Trust but Verify**

The Bernard Madoff scandal — perhaps the largest in the history of the investment banking industry with losses reaching as high as \$50 billion — was avoidable. Relying on social connections and reputations is to rely on hope, and hope is not an investment strategy. Investors that followed the basic principles of prudent investing would not have been taken in.

Investments should only be made within the framework of a highly regulated industry where there is complete transparency. An obvious requirement is that there must be audited financial statements from a well-known and highly regarded CPA firm. Audits verify the financial statements of the money manager as well as check correspondence with the custodians, brokers and transfer agent of the funds to confirm reported trades and securities held. The fund's accounting should be performed independently of the money manager. And the fund's assets should be held with an independent, regulated custodian such as a bank or trust company.

### **Summary**

The key to successful investing is to stick to your well-developed plan until you reach your financial goal. And, if you don't have a plan, write one immediately. And make sure the plan includes the aforementioned Plan B — the actions you are prepared to take if the unexpected does happen.

<sup>1</sup> Warren Buffett, **Chairman's Letter**. March 1, 1993.

<sup>2</sup> Allan Sloan and Doris Burke, **A Turkey Roast**. *Fortune*, December 8, 2008.

<sup>3</sup> Jason Zweig, **Wall Street Lays Egg With Its Nest Eggs**. *The Wall Street Journal*, September 27, 2008.

<sup>4</sup> William Sherden, *The Fortune Sellers*, (Wiley, 1998).

<sup>5</sup> Javier Estrada, **Black Swans and Market Timing: How Not to Generate Alpha**. Working Paper, November 2007.

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