



S U M M E R 2 0 0 8

## Keeping It in Context

**Risk premiums. Risk and reward. Market risk. Willingness, ability and need to take risk.**

No investor can or should avoid thinking about the nature of risk. It is, after all, fundamental to basic investment theory.

When the markets and the economy are soaring, it can be tempting to mistake risk as simply another abstract concept. When the markets stumble, as they have of late, it becomes more obvious that risk is not just theory. Real-life risk can derail carefully laid plans, delay retirement or force retirees back to work, and increase emotions and stress.

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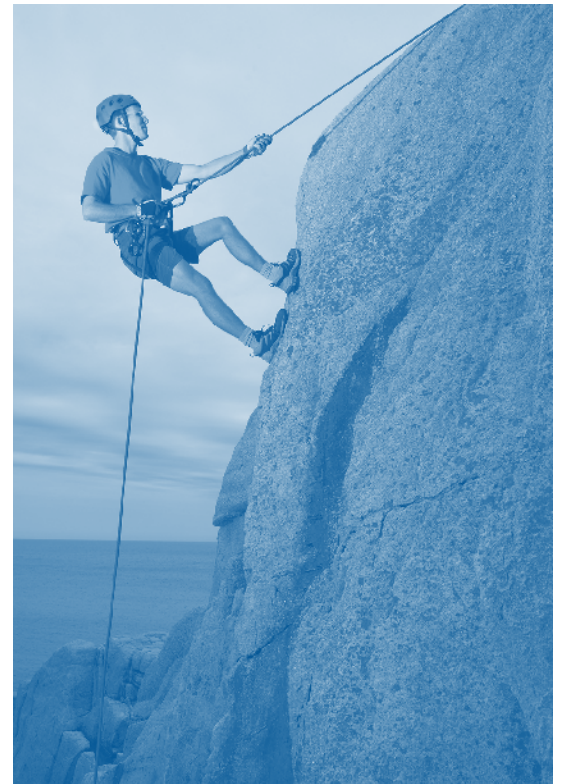
“ ‘Necessary evil’ is an undesirable event that is required to achieve a result. For example, having a cavity filled or paying taxes are necessary evils. So are bear markets. ”

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We encourage you to keep current market conditions firmly within the context of being a hurdle rather than a brick wall between you and your financial goals. As your advisor, we want to assist you in dealing with the challenges inherent in taking financial risk, while encouraging you to stay on course. Given the current state of the markets, we believe this is a good time to revisit many of the basic concepts of risk and being a prudent, long-term investor.

### **Equity Risk: A Necessary Evil**

“Necessary evil” is an undesirable event that is required to achieve a result. For example, having



a cavity filled or paying taxes are necessary evils. So are bear markets. Let’s explore why.

Financial theory is based on the premise that risk and expected return are related. Stocks are riskier than one-month Treasury bills (which is considered the riskless instrument), and over time they have delivered the higher return. But if they always did so, then they would not be riskier, and the higher expected return would disappear. In fact, in 29 of the 82 years from 1926 through 2007 — or more than a third of the time — the

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S&P 500 Index underperformed Treasury bills, sometimes at length and severely (see Figure 1). For example:

**S&P 500 vs. T-Bills**

Years	Underperformance
1929–1932.....	74 percent
1973–1974.....	53 percent
2000–2002.....	49 percent

Because investors have experienced such large losses, a risk premium is appropriately attached to the expected returns of stocks above the expected returns of Treasury bills. (Similarly, stocks carry a risk premium above CD returns, which are considered riskier than Treasury bills but still far less risky than stocks.) The equity risk premium was just over 8 percent from 1927–2007. If the losses that investors experienced had been smaller, the risk premium would probably also have been smaller. Thus, while bear markets are painful to endure, they are the “necessary evil” that creates the equity risk premiums from which we benefit during bull markets.

**Small-Cap and Value Stocks**

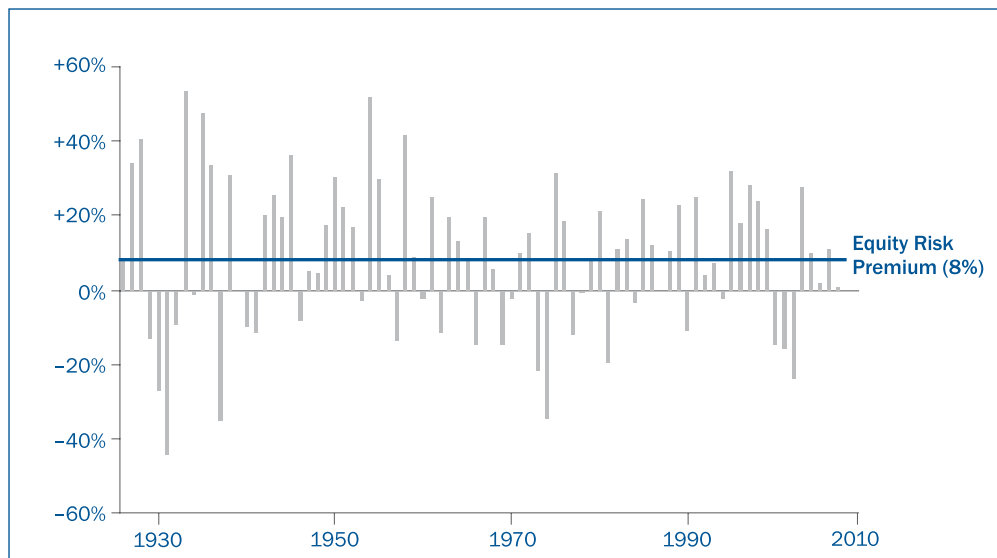
We can extend this logic to the additional risks of “size” and “style” equity investing. The stocks of small, distressed companies are generally considered riskier investments than those of large, thriving companies. Thus, small-cap stocks have delivered a risk premium compared to large-cap stocks and value stocks have delivered a premium compared to growth stocks. From 1927–2007, these annual risk premiums have been around 3 percent for small-cap stocks and 5 percent for value stocks.

But these asset classes do not always outperform. As with equities versus U.S. Treasury bills, small-cap (size) and value (style) stocks also have experienced lengthy, severe losses. For example:

**Small-cap vs. Large-cap**

Years	Underperformance
1969–1974.....	47 percent
1986–1990.....	33 percent
1994–1998.....	30 percent

**Equity Premium — Annual Returns**  
**S&P 500 Index Versus One-Month U.S. Treasury Bills**  
 1926–2007



**Figure 1: Market risk is a “necessary evil” in seeking higher expected returns.** Comparing the annual returns of the S&P 500 Index versus one-month U.S. Treasury bills: (1) there are many years in which equity underperforms, sometimes significantly, and (2) annual performance is random, unpredictable. Because investors have experienced these losses, a risk premium has been attached to the expected returns of stocks versus riskless investing. In exchange for tolerating the risk, disciplined equity investors have been rewarded with an approximate 8 percent annual risk premium over time.

## Value vs. Growth

Years	Underperformance
March 1934–March 1935.....	43 percent
June 1998–February 2000.....	44 percent

## Risk Premiums and Investment Discipline

The bottom line is that there are real risks involved when seeking to capture the outperformance of stocks relative to Treasury bills, small-cap stocks relative to large-cap stocks (size), and value stocks relative to growth stocks (style).

While it is almost certain that the downside of risk will periodically appear, it is uncertain when, how severely or for how long it will manifest itself. It is during these periods of underperformance that investor discipline is tested.

Unfortunately, the evidence suggests that many investors fail the test. Consider the results of a study by Morningstar. In all 17 fund categories examined, individuals' returns were below the returns of the very funds in which they had invested. For example, among large-cap growth funds, the 10-year annualized dollar-weighted return was 3.4 percent less than the time-weighted return (the return reported by the fund). For mid-cap growth and small-cap growth funds, the underperformance was 2.5 percent and 3.0 percent.<sup>1</sup>

Studies on behavioral finance have indicated that investors tend to behave like generals fighting the last war. They observe yesterday's winners and jump on the bandwagon, buying high. Then they observe yesterday's losers and abandon ship, selling low. There have been several explanations provided for this outcome. To name a few:

- ▲ Investors allow emotions to impact their investment decisions. In bull markets, greed and envy overcome us and risk is forgotten. In bear markets, fear and panic reign.
- ▲ Investors are overconfident of their ability to deal with risk when it inevitably shows up. They convince themselves that they can stomach significant losses and still remain adherent to their plan. Academic as well as circumstantial evidence indicates otherwise.
- ▲ Investors tend to treat the likely (stocks have outperformed Treasury bills) as if it were certain, and the infrequent bear markets as if they will never happen.

Jason Zweig's excellent book, *Your Money & Your Brain*, examines these and many other phenomena related to the raw, human emotions behind investing. By charting the brain's actual responses to various stimuli, neuroeconomic

studies have indicated that reactions to financial events are often driven unconsciously by ingrained survival behaviors, triggered by our most basic "fight or flight" instincts.

For example, Zweig explains: "There's not much difference in the brain between having a rattlesnake slither across your living room carpet and having some stock you own go down 40 or 50 percent. Basically it's the same response, which is, 'I'm in trouble; how do I get out of here alive?' It's incredibly rapid."

Only by accepting how prone we are to such subconscious behaviors are we likely to overcome them, to chart an investment course based on intelligence instead of on instinct.

## Three Keys To Investing: Planning, Positioning and Patience

The first key to successful investing is to have a carefully built plan that includes an understanding of the true nature of investment risk. Your plan should include:

- ▲ Accepting that bear markets are inevitable and must be built into your plan.
- ▲ Staying the course even when — especially when — the media is filled with stories of economic doom and gloom and everyone around you seems to be abandoning ship.
- ▲ Understanding that "staying the course" means more than simply buy and hold. It includes rebalancing your portfolio when appropriate to maintain your desired asset allocation, buying stocks during bear markets and selling them during bull markets. It can also mean looking for tax-loss harvesting opportunities that take advantage of down markets.

This brings us to the second key to success. Academic research has determined that almost all of the risk and return of a portfolio is determined by a portfolio's asset allocation. But it is perhaps equally as critical for investors to adhere to their carefully chosen allocation, regardless of what that allocation is. Thus, it is important to understand your own ability, willingness and need to accept market risk, and avoid taking on more or less than makes sense for you.

The third key to success is avoiding the temptation to time the market (trading based on where you think the market is headed). Consider the evidence from two studies. Tactical asset allocation (TAA) is just a fancy name for market timing. For the 12 years ending 1997, while the S&P 500 Index rose 734 percent on a total return basis, the average return for 186 TAA mutual funds was a mere 384 percent.<sup>2</sup> Just as

1. Morningstar *FundInvestor* (July 2005).

2. David Dreman, *Contrarian Investment Strategies*.

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impressive are the results of a study on the performance of 100 pension plans that engaged in TAA. Not one of them benefited from their efforts.<sup>3</sup>

## What You Can Do About It and How We Will Help

The good news is that you are not alone. Following are steps that we can take together in ensuring your continued investment success through markets thick and thin.

**Risk Tolerance Assessment** — We can revisit your risk profile with you, making adjustments carefully and cautiously, if and when appropriate. For example, even if you are willing and able to accept every bit of risk that the worst bear market can throw at you, you may not actually need to do so. For some investors the utility of added wealth might be minimal. Growth in your portfolio over the past decade may well have changed your need to take risk moving forward. If so, it might be appropriate to reduce your risk profile to match. We can help you assess all components of risk management within your portfolio.

**Continued Diversification via Disciplined Rebalancing** — We can ensure continued or broadened diversification within your portfolio, playing with rather than against the market to judiciously rebalance your portfolio. Buying low during bear markets and selling high during bull markets helps position you to adhere to your investment plan. It also helps you avoid worst-case scenarios during market downturns, and benefit from often swift and unpredictable market upswings.

**Tax Management** — We can tax-loss harvest when opportunities present themselves and we can continue implementing tax-management techniques.

3. Charles Ellis, *Investment Policy*.

**Objective Planning** — We can revisit your long-term objectives (using Monte Carlo simulation tools when appropriate) to determine whether market performance has significantly impacted your goals. If so, we can help you assess prudent actions for remaining on or returning to your course. For example, investors in the accumulation phase can actually view bear markets not just as a necessary evil, but as a long-term benefit. Bear markets provide those investors (at least those who adhere to their plan) with the opportunity to buy stocks at lower prices, increasing expected returns. In contrast, investors such as retirees in their withdrawal phase may face challenges and potentially difficult decisions as spending and withdrawal decisions must be weighed against expected abilities to maintain one's desired portfolio value. There is no one-size-fits-all solution, but your advisor can help you try on adjusted plans that seem right for you.

**Ongoing Strategizing** — Last but decidedly not least, we can continue to remind investors why they are taking on the investment risk to begin with, as described above, and why abandoning a carefully built plan is expected to cause more harm than good. Consider these comments from Jason Zweig:

Despite everything most market pundits say, investing is not a struggle, a battle, a game or a contest; it is a continuous process that lasts a lifetime. Whether you are winning or losing at any given moment is beside the point. ... The only thing that matters is whether you prevail in the end — and the factors that determine long-term victory are the exact opposite of the ones that tend to create short-term success.

## Our Basic Tenets

Our objective is to design portfolios using passively managed funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:

- Fee-based investment management
- A disciplined investment strategy
- Access to institutional no-load passive asset class funds
- Fixed income expertise
- An investment approach based on research by Nobel Prize-winning economists
- Continued access to academic research
- A tax-efficient focus, with valuable tax and estate-planning ideas
- Risk tolerance assessment
- Periodic portfolio rebalancing
- Regular communications and state-of-the-art reporting

**MOST IMPORTANT ... A TRUSTED ADVISOR RELATIONSHIP**



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