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# Lessons From 2010

**Overview:** Every year, Larry Swedroe takes a look back at the investing lessons the markets provided in the past year. While 2010 was a fine year for the markets, that doesn't mean we can't learn a thing or two about investing. In fact, we can be just as likely to lose our discipline in good times as we can in bad times.

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**Diversification Is as Important as Ever**

The past financial crisis caused the correlations of all risky assets to rise toward one, leading many in the financial media to report on the "death of diversification." 2010 showed otherwise. Below are the returns of various asset classes. As you can see, there's a large dispersion of returns between the best- and worst-performing asset classes.

**Domestic**

- Large-Cap (S&P 500 Index) — 15.1 percent
- Small-Cap (MSCI US Small Cap 1750 Index, gross dividends) — 27.8 percent
- Large-Cap Value (MSCI US Prime Market Value Index, gross dividends) — 14.5 percent
- Small-Cap Value (MSCI US Small Cap Value Index, gross dividends) — 25.0 percent
- Real Estate (Dow Jones U.S. Select REIT Index) — 28.1 percent

**International Indexes**

- Large-Cap (MSCI EAFE Index, net dividends) — 7.8 percent
- Small-Cap (MSCI EAFE Small Cap Index, net dividends) — 22.0 percent
- Large-Cap Value (MSCI EAFE Value Index, net dividends) — 3.2 percent
- Small-Cap Value (MSCI EAFE Small Value Index, net dividends) — 18.9 percent
- Real Estate (MSCI Emerging Markets Index, net dividends) — 18.9 percent

**Fixed Income**

- Short-Term (Bank of America Merrill Lynch One-Year US Treasury Note Index) — 0.8 percent
- Intermediate-Term (Five-Year US Treasury Notes) — 7.1 percent
- Long-Term (20-Year US Treasury Bonds) — 10.1 percent

**Sell in May and Go Away Is the Financial Equivalent of Astrology**

One of the more persistent investment myths is that it's a winning strategy to sell your stocks in May and buy them back in November. It's true that stocks have provided greater returns from November through April than they have from May through October. However, that's the wrong way to look at returns. Since 1926, there still has been an equity risk premium from May through October. When

you sell out of stocks, your money has to go somewhere, and historically, your other options have underperformed stocks.

Here are the returns for various equity indexes for May through October. Keep in mind that holding assets in safe, liquid investments from May through October would have produced almost no return.

- S&P 500 Index — 0.7 percent
- MSCI EAFE Index, net dividends — 5.7 percent
- MSCI Emerging Markets Index, net dividends — 10.0 percent

The most basic tenet of finance is that there's a positive relationship between risk and expected return. To believe that stocks should produce lower returns than Treasury bills from May through October, you have to believe stocks are less risky during those months — a nonsensical argument.

**Harvest Losses for Tax Purposes All Year Long**

2010 served as a perfect reminder of why you need to look for opportunities to harvest losses throughout the year. The S&P 500 Index produced a positive return for the year, but it was down considerably by midyear: It closed 2009 at 1,115, but by July 2 it had fallen to 1,023. (Other asset classes provided similar opportunities.)

Let's say you owned an S&P 500 fund for all of 2010. If you had sold out and realized the loss, you could have used this to offset other gains. (And short-term losses can be the most valuable.) However, waiting until December to sell meant losing the opportunity as the losses turned into gains.

A loss should be harvested whenever the value of a tax deduction significantly exceeds the cost of the trades required to harvest the loss. Any proceeds should be immediately reinvested in a manner avoiding the wash-sale rule.

**When You Get Out, It's Hard to Get Back In**

If you decide to get out of the market when things get tough, you face two major obstacles:

- The first is knowing when to get out.
- The second is knowing when to get back in.

Investors who sold during the bear market found it very difficult to buy again. Despite the huge rally in 2009, mutual fund investors continued to pull money out of the equity markets, even into 2010. Equity funds saw six straight months of outflows from May through October.

The unfortunate truth is this pattern is often repeated as investors persistently get it wrong. They tend to buy after periods of strong performance and sell after periods of weak performance. This leads them to dramatically underperform the very funds in which they invest.

**Active Management Is a Loser's Game**

Bank of America Merrill Lynch called 2010 the "toughest year on record" for active managers. Only 25 percent of active managers beat their benchmarks. Looking deeper, about 33 percent of growth managers, 18 percent of value managers and 12 percent of core managers demonstrated outperformance.

When active managers outperform, it's attributed to their brains and hard work. When they underperform, it's usually outside their control. You don't hear costs or market efficiency named as reasons for underperformance. This allows investors to believe things will be different next year, as active managers account for these issues.

**Conclusion**

Like most years, 2010 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, which reflects an investor's unique ability, willingness and need to take risk. Investors can formalize that plan by creating an investment policy statement, including a schedule for regular rebalancing — and then take the important step of adhering to that plan.

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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