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MANAGEMENT

"HELPING YOU MAKE SMART CHOICES ABOUT YOUR MONEY"

THOSE WHO TRY TO TIME THE STOCK MARKET GET NIPPED BY BLACK SWANS

Investors suffering during major bear markets are tempted to "time" the market: to sell and avoid the downturn, and then reinvest before the inevitable recovery.

It now seems obvious to these investors that anyone with half a brain should have foreseen last year's credit crisis and massive worldwide fall in asset prices. By selling out ahead they would have preserved their capital and been able to invest this year when stocks are bargains.

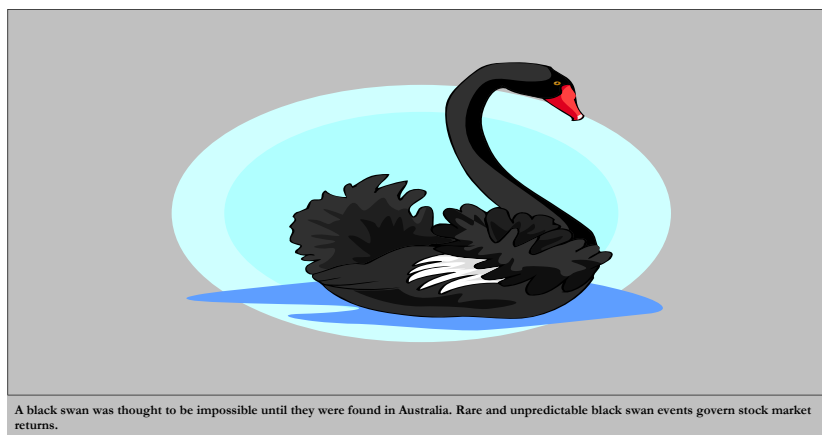
Not so, says Javier Estrada of the IESE Business School in Barcelona, Spain. His recent study shows that a small fraction of days determines most of an investor's gain, and that these abnormal trading days are impossible to predict.

"Much like going to Vegas, market timing may be an entertaining pastime, but not a good way to make money," he concludes.

Many Black Swans

He studied the impact of so-called Black Swans—the unpredictable tiny minority of trading days encompassing abnormally large upward or downward price swings.

The term "Black Swan" comes from the age-old assumption that all



swans were white, hence a black swan was considered an impossible event. That assumption was shattered by the 17th-century discovery of black swans in Australia.

Black Swans, Estrada writes, lay outside the realm of normal expectations because nothing in the past can convincingly point to their occurrence. They carry an extreme impact. After they occur, plausible explanations can be found for them, making it appear as if they were explainable and predictable, even though they were not.

A prime example is the Black Monday stock market crash of Oct. 19, 1987, when the Dow Jones Industrial Average dropped nearly 23 percent. In the Dow's 90-odd year

history prior to Black Monday, it had fallen more than 10 percent in a day only twice, back in the 1929 crash when it fell by 12.8 percent one day and 11.7 percent the next. Nothing had prepared investors for a one-day decline of 23 percent.

Big impact

Estrada studied daily returns in the United States and 14 international markets and found that a handful of days of abnormally high or low swings accounted for a major portion of the return to investors in all markets. For instance, in the United States from 1900 through 2006, an investor turned a \$100 investment

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NO PROFITS FOR THOSE WHO MISS HANDFUL OF DAYS IN THE MARKET

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into \$25,746 (not counting dividend reinvestment).

If an investor missed just 10 days of that 106-year period, he would have cut his gains by an astonishing 65 percent to just \$9,008.

And yet 10 days accounted for just 0.03 percent of the 29,190 trading days from 1900 through 2006.

Even more interesting, an investor who missed the 100 best days during that period ended up making nothing.

Those days made up just 0.34 percent of the total trading days and determined whether an investor made any profit or not.

It would have been exceedingly difficult to find “the 0.34 percent of the time that determines whether or not any wealth is created at all!” Estrada wrote. “The odds against successful market timing are simply staggering.”

Estrada concludes that Black Swans render market timing a “wild goose chase” and that investors should use



Quick market moves surprise investors.

diversified portfolios to mitigate their effects and should stick with their investments through thick and thin rather than trying to time markets.

IT WAS A YEAR OF FINANCIAL CHAOS, BUT WHAT COMES NEXT?

Last year was the second-worst ever for the U.S. stock market.

Only in 1931, when the Standard & Poor's index fell by 43.3 percent, did the market turn in a worse showing than 2008. The loss of trillions of investors' wealth has them running scared as the new year begins.

Adding to the fear is a year-long recession that appears to be deepening with increased unemployment and uncertainty about the timing of a turnaround.

Now, however, investors face a new year: what are the possibilities for their portfolios?

Good follows bad

Many investors may say they expect the market to continue to decline. In fact, that happened after 1931: in the next year, stocks fell an additional 8.2 percent.

However, that is not the norm. Many of the best years in the stock market have come after miserable years.

Two of the best came after the worst years. In 1933, the best year ever, stocks rose by 54 percent. Two years later, they gained another 48 percent.

It is also notable that the second

best year came at the height of a recession when stocks rose by nearly 53 percent in 1954. The same happened in the recession year of 1958, when stocks went up by 43 percent.

Roger Ibbotson, professor of finance at Yale, notes that the odds are always good for a positive year in stocks. The market has gone up during 59 of the 83 years since 1926, or 71 percent of the time. Moving the time horizon out over five and ten years increases the odds of positive returns.

Although there is no way of knowing when the market will begin to rise again, Ibbotson urges investors not to wait to invest until things are clear. “Unless you have more knowledge than the market, the long run starts now,” he wrote in *Wealth Manager* magazine in December.

The last big bear

It is also instructive to look at the last severe recession and bear market to hit the United States. Back in 1973-1974 the market fell by 43 percent over 21 months. This was also the last time that the U.S. economy posted three consecutive quarters of negative growth in Gross Domestic Product, a measure of the growth or decline in all goods and services.

The first decline in GDP occurred in the third quarter of 1974, well after the stock market had experienced most of its decline. The economy went on to contract for another two calendar quarters. However, an investment made in the S&P 500 Index during that first quarter of economic decline in 1974 would have returned almost 31 percent over the next year, notes U.S. Trust, a subsidiary of Bank of America.

“The point is that markets bottomed well before the economy,” U.S. Trust says. “It goes without saying 2008 is quite different from 1974, but the concept of markets looking forward will apply at some point during this bear market.”

Policy response

Many experts also note that the federal government has taken, and promises to take, significant action to shore up the economy and financial markets.

During the last quarter of 2008 significant easing in interest rates, increase in money supply, and financial institutions took place. The incoming Administration has pledged to spend significant sums to spur the economy.

ACTIVE MUTUAL FUNDS DO NOT PROTECT AGAINST A BEAR MARKET

Investors like to believe that active mutual fund managers—those who are allowed to buy and sell according to their predictions of the markets—can outperform during bear markets.

Index funds, the reasoning goes, are stuck with the downward trend, since they must remain fully invested at all times and will follow the general trend.

A new study by The Vanguard Group, one of the largest mutual fund companies, has turned that common wisdom on its head.

It found that even though as much as 60 percent of active funds beat the indexes in a particular bear market, that did not predict how well they would do in the next bear market. Instead, a different group of funds outperformed during the next down cycle.

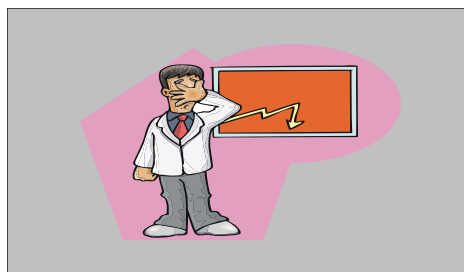
Missing the bull

Even worse, the majority of active funds—including those who had done

well during the bear market—lagged behind when a subsequent bull market asserted itself.

“The combination of cost, security selection, and market-timing proves a difficult hurdle to overcome in any market environment,” wrote author Christopher B. Philips. The study looked at six market declines of more than 10 percent in the United States and five in Europe, all since 1973.

The study found that a majority of active funds beat the indexes during three of six U.S. bear markets and two of five



Active fund managers claim they can beat bear markets, but a new study disputes that.

European bear markets.

Timing is hard

That inconsistency of success looks worse from the finding that a majority of market-beating funds did not repeat their performance in the next bear market, making it difficult for an investor to identify bear market winners in advance.

This probably occurs because the actively-managed funds have taken a defensive position relative to the market.

Obviously it is very hard to time the market's shifts accurately, and these funds do not reallocate to stocks quickly enough to participate in the inevitable market upturn.

The study confirms the value of an indexed investing approach. “We conclude that an indexed investor is not at a disadvantage when investing in bear or bull markets,” Philips wrote.

IF THE EXPERTS CANNOT PREDICT THE MARKETS, YOU CAN'T EITHER

Were you able to predict the global bear market that sucked trillions of dollars out of investors' pockets in late 2008?

In retrospect, it looks like it should have been easy to predict—after all, the subprime mortgage crisis had gone on for a year before stocks started crashing in October 2008. It seems obvious that the economy was collapsing and that stocks were going to head down sharply.

Hindsight bias

Unfortunately, that is our hindsight bias talking. The past always looks inevitable and predictable, because we now know what happened. But even the experts have a tough time predicting the markets. In fact, they usually make more wrong predictions than right, and these are the people who have more information at their fingertips and more experience than most investors.

Consider what the experts said at the beginning of 2008, when the storm clouds were already gathering.

Global strategists for Citigroup in late December 2007 issued a report that said the bull market was not dead.

While “undoubtedly mature and subject to increasing volatility, the current bull market is not yet over.”

Market analyst Jeffrey Kleintop of LPL Financial in Boston told his clients the market would have a ‘fourth quarter breakout to the upside as the uncertainty fades and the U.S. economy avoids a recession.’

Bullish on Europe

The Wall Street Journal told readers on Jan. 2, 2008 that “European shares are likely to rise this year for one reason: They are cheap.”

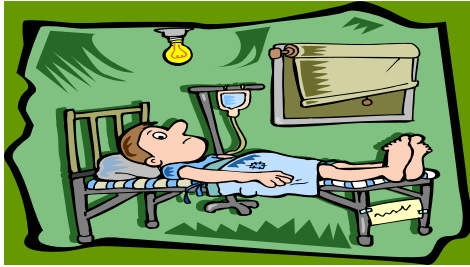
Even at the end of the third quarter, just before the crash came, the forecasts were muddy. *The Hulbert Financial Digest*, which rates the performance of investment newsletters, found that the 10 best performing newsletters were far more bullish than the 10 worst newsletters. Although the 10 best newsletters had demonstrated the most skill in allocating assets over the previous 15 years, that wasn't enough for them to foresee the bear market.

Apply this forecasting lesson to your own view of the markets going forward. It might be helpful to write your predictions down and look at them in a year.



Although everything seems easy in hindsight, forecasting markets is impossible.

YOUNGER AND SICK, NEED LONG TERM CARE INSURANCE



Long term care insurance is typically purchased in anticipation of needing nursing care at home or in a facility after retirement. However, new statistics from Unum, a large long term care insurer, shows that almost half of its policy claims were made by people under age 65.

The average age for younger clients making claims was 53, and the average claim lasted for 31 months, Unum said.

Brain and nervous system injuries were the leading causes for claims.

Indexes win again

Over the last five years Standard & Poor's stock indexes have beaten the majority of actively managed funds, the company said.

The S&P 500 beat almost 69 percent of large-cap stock funds, its SmallCap 600 index beat 78 percent of small-cap funds, and its bond indexes beat 75 percent of bond funds. The DFA funds that we use for the majority of your investments are based on the index philosophy without some of the disadvantages or negatives of the standard index funds.

Retirement income

Retirement savers are usually focused on building up their portfolios before retirement by taking investment risk.

However, a new study by Russell Investments found that 60 percent of retirement income is generated by a portfolio *after* retirement.

That means the investment strategy in retirement is even more important than the one used prior to retiring.

Opportunity of a Lifetime?

Many advisors and economists whose information we follow state that equities are currently "on sale". This could make it a very good buying opportunity and give you a very positive long-term investment experience.

We don't know if the market has hit bottom at this time, (as it is very difficult to time the market), but even if it hasn't, buying now may allow you to purchase more shares for your dollar.

Therefore, we encourage you to fund your IRA's to the fullest extent possible and to consider investing extra cash that you may have available. Please contact us with questions.

Our Basic Tenets

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

- ◆ Fee-only investment management
- ◆ A disciplined investment strategy
- ◆ Access to institutional no-load passive asset class funds
- ◆ An academic Nobel Prize-winning investment approach

- ◆ 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
- ◆ No front-end loads, no back-end loads, no surrender fees, not locked in
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