A CRASH COURSE IN INVESTING

Six Lessons from the Market Meltdown

The market decline from October 2007 to early March 2009 was the worst since the late 1930's. Stocks dropped 60%, investor uncertainty skyrocketed, and trust and confidence were shattered. The age-old rules for personal investing are now being questioned: *Is Buy-and-Hold dead? Has Asset Allocation outlived its usefulness? Does Diversification still work?* The answers contained in the following lessons serve as a guide for long-term investment success.

LESSON #1
NO ONE HAS TOMORROW'S PAPER

"Prediction is very difficult, especially if it's about the future."
—Niels Bohr, 1922 Nobel Laureate

The truth contained in this whimsical quote reminds us that, in at least one respect, 2008 was not unique: it was just as hard as ever to beat the market by following the advice of Wall Street forecasters.

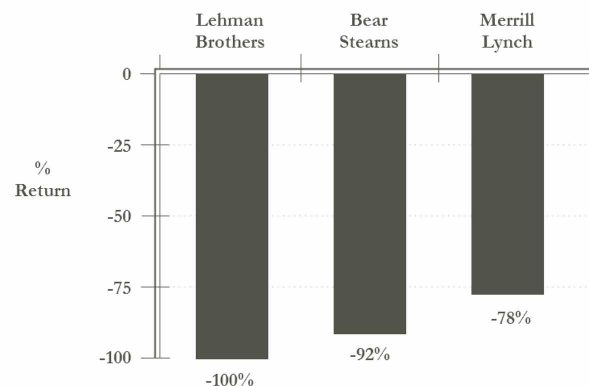
Here's a review of the "where to invest now" advice offered by the country's leading financial magazines at the start of 2008:

To help its readers navigate an uncertain market, *BusinessWeek* sought out guru Elaine Garzarelli, best known for advising her clients to sell just before the 1987 stock market crash. The "extremely bullish" Garzarelli, whose early 2008 models showed the S&P 500 to be "undervalued by 25%," urged investors to load up on Lehman Brothers, Bear Stearns and Merrill Lynch. [1] Oops.

In early January 2008, *Fortune* interviewed successful former hedge fund manager, globetrotting author and commodities bull Jim Rogers for tips on where to invest in 2008. Rogers favored commodities ("the commodities bull market still has years to go") and China ("there are gigantic opportunities in China").[2] In fairness to Mr. Rogers, he was making long-term recommendations, not a 12-month forecast. Investors who overweighted their portfolios with either commodities (down 37% in 2008) or Chinese stocks (down 51%) are still hoping he is right.

For its annual "Where to Invest" issue, *SmartMoney* asked a prominent Wall Street strategist to help recommend stocks of companies "likely to increase profits in a world filled with trouble spots."[3] Unfortunately for followers of the magazine's advice, the average share price decline from recommendation date through year-end 2008 for the dozen stocks listed was 52.4%, more than fifteen percentage points below that of the S&P 500 Index.

"Expert" stock picks?
2008



Longtime *Forbes* columnist, author and money manager Ken Fisher looked into his crystal ball and recommended "a whole new type of stock for

2008," presumably one which could flourish in a year which was more likely to see a "robust market than a bust one."[4] From the January recommendation date through the end of the year, Fisher's five stock selections plummeted 55%, on average, far worse than the U.S. market's 37% slide.

So, the next time you read an "expert" forecast, remember the words of legendary investor Warren Buffett: "A prediction about the stock market tells you nothing about where stocks are headed, but a whole lot about the person doing the predicting."

LESSON #2

EVEN A CRYSTAL BALL MAY NOT BE ENOUGH

Last year was a disaster for many investors, but at least two managers can actually claim they predicted the crash. Both Robert Rodriguez, renowned manager of the FPA Capital fund, and Peter Schiff of Euro Pacific Capital accurately predicted the decline of the past 18 months. Did their prescient forecasts pay off for investors?

As far back as 2005, Robert Rodriguez bemoaned the "investment foolishness" in the market, noted the "financial strains" at Fannie Mae, Freddie Mac and identified problems in the real estate market.[5] In June of 2007, Rodriguez delivered a speech to a group of financial analysts in which he outlined how the stock, bond, private-equity and hedge-fund markets were all caught up in "a speculative bubble". In December 2007, Rodriguez was so worried the credit crunch would cause a severe recession, he temporarily halted all stock purchases in his fund. By March 2008, cash had swelled to more than 40% of the stock fund's total assets.[6]

For these spot-on predictions, *Money Magazine* declared Rodriguez to be "the best fund manager of our time."[7] How were FPA Capital Fund shareholders rewarded for Rodriquez' prophetic calls? Unfortunately, not so well. The fund lost 35% in 2008. Perhaps not the result investors had hoped for from someone who predicted the future.

The financial media's praise of Rodriguez may take second fiddle, however, to the buzz surrounding Peter Schiff, president of brokerage firm Euro Pacific Capital. He gained attention on major television networks in 2006 and 2007 with his bold forecast of over-leveraged American consumers leading the U.S. economy into recession.

In 2007 Schiff authored a book, *Crash Proof: How to Profit from the Coming Economic Collapse*, in which he recommended investors pile into gold, commodities and high-dividend paying foreign stocks. As conditions in the U.S. economy and the markets deteriorated, his predictions brought him fame as an economic guru who could help shelter investors from the storm. Nervous investors poured money into accounts with Schiff's firm.

Sadly, for investors hoping to profit from Schiff's advice, 2008 made mincemeat of their portfolios.[8] Many Euro Pacific customers attested to losing 50% or more, much worse than the 37% drop in the U.S. market. This was due, in part, to Schiff's expectation that the weakening U.S. economy would cause the U.S. dollar to depreciate rapidly, providing an extra boost to shares of international investments. Instead, the dollar advanced, magnifying the already steep losses in the international markets into which Schiff so aggressively steered his clients.

These examples highlight the difficulty of a market-timing strategy even for the smartest (or luckiest) of investors and provide a lesson for the rest of us: When it comes to trying to beat the market, even correctly predicting the future may not be enough.

LESSON #3

IF IT LOOKS TOO GOOD TO BE TRUE, KEEP IT OUT OF YOUR PORTFOLIO

On December 11, 2008, Bernard Madoff was arrested by federal agents for running what Madoff himself called a "giant Ponzi scheme." Investor losses are estimated between $10 Billion and $50 Billion.

For decades, investors were drawn to the consistent, high returns provided by Madoff's funds. By some accounts, Madoff's investors

experienced losses in only a handful of months over a fifteen year period. For the privileged folks granted "access" to Madoff, there was another benefit: Madoff performed these market-beating results for virtually peanuts. While other prominent hedge fund managers were charging 2% of assets and 20% of profits, Madoff was content to work for the commissions generated by client trades.

While many of the world's largest banks, hedge funds and regulatory watchdogs like the Securities and Exchange Commission missed the warning signs, the signs themselves were clear. Had Madoff's victims insisted on any of the following, their losses could have been avoided:

Understandable Investment Strategy
Asked in 2001 by a reporter from *Barron's* magazine how his "split-strike conversion" strategy managed to avoid ever having a down year in over a decade, Madoff said: "It's a proprietary strategy. I can't go into it in great detail."[9]

Investors weren't able to elaborate much further. "Even knowledgeable people can't tell you what he's really doing," one formerly satisfied investor said. "People who have all the trade [confirmations] and statements still can't define it very well."[10]

If your advisor cannot, or will not, clearly and concisely explain the strategy guiding the management of your life savings, don't invest.

Independent Custodian
Madoff took custody of his clients' cash, accounts and securities. Sensible investors demand a separate custodian to ensure appropriate checks and balances are in place to protect their assets from mishandling or fraud.

Independent Auditor
Audits verify a money manager's financial statements, as well as confirm that reported investments are held and trades actually made. Madoff sidestepped this by hiring a largely unknown accounting firm, reportedly controlled by his brother-in-law, to conduct annual audits.
This familial relationship should have disqualified the firm from acting as an independent auditor, but for 15 years it told its own oversight body—the American Institute of Certified Public Accountants—that it did not conduct audits.

Madoff is a crook, plain and simple. He ruined the lives of countless people who entrusted him with their life's savings. These same investors, however, carry the burden of knowing greed blinded them to signs that what Madoff offered was too good to be true. Had their appetite for returns not overwhelmed their better judgment, a great many would not be part of what will surely go down as the largest investor fraud ever.

LESSON #4
DON'T TAKE RISK WITH THE SAFE PART OF YOUR PORTFOLIO

There is a sense of betrayal among investors who thought their well-diversified and asset-allocated portfolios would protect them from a year like 2008. The focus of their ire? Asset allocation, the long-term strategy used to distribute one's nest egg among different types of stocks and bonds.

Asset allocation has been a cornerstone of investment management and financial planning since the early 1950's. It is based on the idea that different asset classes offer returns that are not perfectly correlated—they do not move up or down at exactly the same time. By allocating among these non-perfectly correlated assets, an investor can reduce portfolio volatility, or risk.

This thoughtful portfolio construction technique now appears under siege, as a number of prominent media outlets and other "experts" have proclaimed asset allocation to be dead.

Reports of its demise have been fueled, in part, by the poor results of the asset-allocated portfolios held by large university endowments, often viewed as the most sophisticated among us. In recent years these endowments were lauded as pioneers in asset allocation, as they took the traditional concept—complementing risky assets with safe bonds—to a whole new level.

Beginning with the dot-com bust of the early 2000's, large endowments began successfully reducing their exposure to traditional stocks and

bonds in favor of "alternative" asset classes such as hedge funds, private equity, venture capital, direct real estate and commodities. While stocks languished, these alternative asset classes soared, adding credence to the growing belief that holding safe bonds to reduce portfolio risk was a thing of the past. Alternative asset classes increasingly began to occupy the traditional spot in portfolios reserved for high quality bonds.

Early success of this "endowment model" inspired countless others to adopt a similar approach. Investors around the world began loading up on investments ordinarily considered risky and volatile, falling prey to the belief that as long as the historical data showed the asset classes didn't move in sync, they could generate higher returns without higher risk.

Then came 2008.

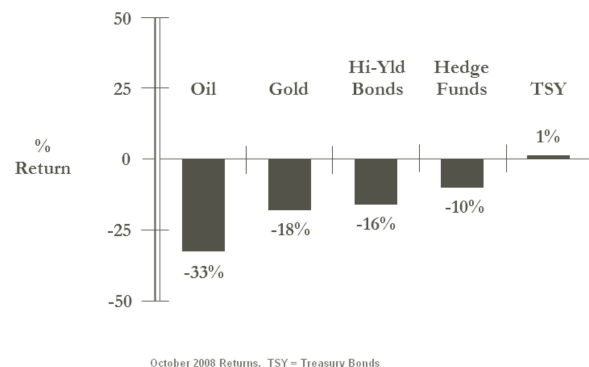
"All these different kinds of investments got clobbered," one prominent university's Chief Investment Officer recently recalled overhearing his peers say. "Maybe we don't need such a complex portfolio."[11]

Many of these endowments—and their followers—are now going back to the drawing board, claiming asset allocation no longer works. The problem, they say, is asset allocation failed when it was needed most. As evidence, they point to October 2008 when nearly all asset classes plummeted in unison. Hedge funds fell 10%. Gold lost 18%. Crude oil plunged 33%. International stocks dropped 20% or more. High yield bonds lost 16%.

The problem, however, is not that asset allocation no longer works. The problem, rather, was in its application.

Too many investors seem to have forgotten that spikes in correlation—periods during which ordinarily low-correlated asset classes become highly correlated and move in lock-step—are nothing new. These spikes tend to crop up during times of extreme market stress, like October 2008. It is during these periods of panic when it seems there are only two asset classes—U.S. Treasury bonds and "everything else."

"Safe" asset classes?
October 2008



While everything else plunged in October, U.S. Treasury bonds did what they were supposed to do—maintain their value. Short-term Treasuries gained 1.3% while intermediate-term issues rose slightly less than 1%. For the full year, short- and intermediate-term Treasuries rose 9% and 11%, respectively.

Treasury bonds certainly can't be expected to provide investors long-term returns that compete with most other asset classes. They do, however, have one very attractive feature not shared by fashionable alternatives: they hold up when you need them most.

LESSON #5
DON'T BE FOOLED BY THE "SMART" MONEY

Over the years, many studies have examined the investment results of individual investor's decisions. These studies consistently conclude that individuals trade too frequently and chase returns, resulting in much worse performance than would have been earned by simply investing in a market-tracking index fund.

Less attention, however, has been paid to how portfolio moves by large institutional plan sponsors—pension funds, endowments and foundations—have impacted those funds' performance. Plan sponsors collectively control billions of dollars, are managed by professional

fiduciaries devoting considerable time and resources to selecting managers, and have access to consultants who are paid specifically to help their portfolios outperform. In other words, plan sponsors should know what they're doing. For this, they are labeled the "smart money."

Just before the stock market began its swift decent in October 2007, a team of researchers headed by Boston University professor of finance Scott Stewart researched whether the smart money makes better decisions than the individual investor. Specifically, they wanted to determine if plan sponsors make or lose money when they hire and fire money managers.

The conclusions of Stewart's research may surprise you. The study found plan sponsors actually destroy value when shifting assets among managers. Fired managers outperformed those hired by 3% in the year following the hiring/firing decision. Over the subsequent five years, "fired" managers beat "hired" managers by 1% per year.

In dollar terms, these figures are staggering. The opportunity cost of plan sponsors' decisions, on average, amounts to $20 billion in the twelve months immediately following a decision to change managers. Over one five-year period, as much as $77 billion was lost due to firing managers who subsequently outperformed and hiring managers who proceeded to underperform.

Professor Stewart concludes, "The effort that plan sponsors are putting towards hiring and firing managers is not just a waste of time. It is actually hurting them."[12] It seems the "smart money" may not be so smart, after all.

LESSON #6
BUY AND HOLD IS STILL THE BEST STRATEGY

For almost sixty years, the nearly universally-accepted advice for managing one's nest egg was to select a diversified mix of stocks and bonds based on personal circumstances, diligently add to it over time, and rebalance when any single component of that mix gets too far out of whack. Buy, hold, and rebalance—a successful recipe for over half a century.

The worst year for stocks since 1931, however, has thrown the age-old advice into question.

"*Buy and Hold*?" the headlines taunt. "*This is a stock-picker's market*," the talking head on TV claims. "*You can't be diversified in this market*," your neighbor chirps. Followers of the traditional advice feel under attack. What's a sensible buy-and-hold investor to do?

The fashionable answer, of course, is that investors today need to be more "tactical" in their moves—moving in and out of investments more quickly.

Before turning buy-and-hold out on its ear, however, the thoughtful investor might ask for evidence to support the contention that an alternative approach to buy-and-hold is in order: Specifically, do professional fund managers—those who tactically choose asset classes, picking stocks and timing the market—really outperform a buy-and-hold approach?

This is an easy question to answer with the help of the mutual fund database Morningstar. Morningstar tracks the performance of thousands of mutual funds, of which hundreds aim to add value primarily through tactical asset allocation, more commonly known as market-timing. Morningstar classifies these funds as "asset allocation" funds, which are further broken down into three groups based on risk preference: Conservative, Moderate and Aggressive.

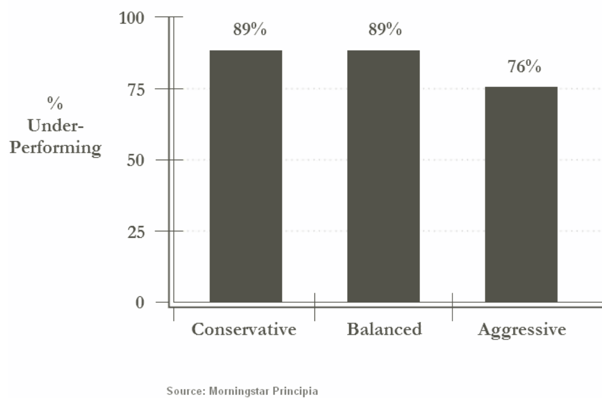
According to Morningstar, managers of asset allocation funds "use a flexible combination of stocks, bonds and cash; some shift assets frequently based on analysis of business-cycle trends."[13] In short, they do exactly what your neighbor, today's papers and most TV prognosticators are now claiming is a superior approach to buy-and-hold: tactically move in and out of the market.

Once again, however, the conventional wisdom that a prescient stock-picker or market-timer can tactically sidestep the hazards of the market falls flat on its face. The vast majority of asset allocation funds actually fail to match the returns of the market.

The average conservative asset allocation fund, for example, lost 16% in 2008. An investor who chose instead an index mix consisting of 35% Total US Stock Market and 65% Barclays Capital Aggregate Bond, lost "only" 10%. Of the 37 conservative allocation funds, only 4 beat the passive index benchmark—the other 89% failed to do so.

Balanced asset allocation funds fared no better than their conservative peers in 2008. The average "moderate allocation" fund fell 27%. Of the 55 moderate allocation funds, 49 failed to keep pace with the index alternative.

Funds outperformed by index
2008



While aggressive allocation funds did perform better relative to their conservative and balanced peers, still fewer than one-quarter of funds managed to beat their benchmark. The average aggressive allocation fund lost 34% in 2008, poking a hole in the oft-heard argument that a fund manager's freedom to "go anywhere" offers refuge from the storm.

All told, nearly 85% of the 141 unique asset allocation funds failed to match an equivalent index mix.[14] While a sensible buy-and-hold approach in 2008 certainly tested the resolve of even the steeliest of investors, it sure beat the alternative.

WHAT CAN WE LEARN FROM 2008?

- Be skeptical of expert forecasts—even the "smart money" gets it wrong
- Don't be tempted to time the market, and don't believe anyone who claims they can
- If you turn your life's savings over to an advisor, ask hard questions, demand sensible answers and insist on an independent custodian
- Put a portion of your nest egg in truly safe assets—tough times can and will happen
- A basic buy-and-hold strategy gives you the best chance for long-term success

WHAT SHOULD I DO NOW?

Keep it simple. There is no better advice on how to live longer than to quit smoking and buckle up when driving. The lesson: advice doesn't have to be complicated to be good.[15] The same is true with investing:

- Spread your nest egg across a mix of different asset classes—stocks, bonds, real estate and cash
- Diversify broadly within each asset class
- Use index funds to keep a lid on costs and taxes
- Rebalance whenever a part of your portfolio gets too far out of whack, even when doing so seems most uncomfortable

And finally, if you have neither the time nor inclination to faithfully execute this on your own, find an independent, fee-only advisor who can.

Vista Capital Partners, Inc. is a fee-only investment advisor based in Portland, Oregon. We specialize in managing globally-diversified portfolios of low-cost, tax-efficient index funds for individual clients with more than $1 million to invest. Call us at 503-772-9500 or visit www.vistacp.com

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[14] Vista Capital Partners calculations from Morningstar Principia data. Performance of 141 funds reporting 2008 performance and with a prospectus objective of "asset allocation." Where multiple share classes, fund with highest 2008 return used. Conservative , Moderate and Aggressive fund performance compared to 35%/65%, 65%/35%, and 80%/20%, respectively, mix of indices (Wilshire 5000 Total Stock Market Index and Barclays Aggregate Bond Index).

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