Monthly Focus - October, 2011

Historical Perspective

There have been many challenges for the U.S. since the 1940s. World War II lasted six years and more than 55 million people died worldwide. The Korean war started in 1950 and lasted for three years. In 1962, the Cuban Missile Crisis threatened WW III. The Vietnam war began in 1965 and ended in 1973. Then, in 1989 the Berlin Wall came down and the fall of communism kicked in and a democratic capitalist revolution broke out the world over. Then there was the first Persian Gulf War, 9/11, Afghanistan War, Iraq War, hurricanes and mortgage crises galore. And, as you can see from the chart below, there have been 13 bear markets since World War II.

Bear Markets Since World War II

#	Market Peak	Market Low	Loss	Duration In Years	Market Peak	Market Low
1	May 1946	June 1949	-30%	3.0	19.3	13.6
2	Aug 1956	Oct 1957	-22%	.7	49.7	39.0
3	Dec 1961	June 1962	-28%	.5	72.6	52.3
4	Feb 1966	Oct 1966	-22%	.7	94.1	73.2
5	Nov 1968	May 1970	-36%	1.5	108.4	69.3
6	Jan 1973	Oct 1974	-48%	1.7	120.2	62.3
7	Sep 1976	Mar 1978	-19%	1.5	107.8	86.9
8	Nov 1980	Aug 1982	-27%	1.7	140.5	102.4
9	Aug 1987	Dec 1987	-34%	.3	336.8	223.9
10	Jul 1990	Oct 1990	-20%	.3	369.0	295.5
11	Jul 1998	Aug 1998	-19%	.1	1,186.8	957.3
12	Mar 2000	Oct 2002	-49%	2.5	1,527.5	776.7
13	Oct 2007	Mar 2009	-45%	1.4	1,565.1	676.0

Some observations:

- In spite of the many challenges we have faced as a nation, the overwhelming historical trend for the Market[1] has been upward. From the market low in 1949 to the market low in 2009, there was an annualized growth rate of 6.7%. If you include dividends (which is the common sense thing to do), the return[2] for same time period is 10.7%. And, this is a very conservative growth rate since it is for the market low in 2007; the growth rate would be significantly higher if you used the market close today.
- Since 1946, bear markets have occurred, on average, every five years. Bear markets are oftentimes called "corrections" for good reason; they are a necessary and healthy part of free-market capitalism. When a given part of the market gets overpriced, there must be a correction.
- The two most common mistakes investors make are: selling low and buying high. These mistakes are usually emotional reactions to what is going on with the Market which is typically overblown in the 24-hour news cycle. When the market is going down and bottoming out, the natural tendency is to "get out." And, when the Market is going up and the news is upbeat, the natural tendency is to buy. However, from a long-term investment standpoint, this is just the opposite of what a typical investor should be doing.

- Much of the time when investment returns are discussed in the media, there is an assumption that 100% of an investor's portfolio is invested in stock. In practice, not many investors have 100% stock in their portfolios (at this writing, I don't have any client portfolios with 100% stock). A common portfolio asset allocation is 60% stock and 40% bonds. Assuming that the 60% stock is the S&P 500 total return[3] and the 40% bonds is a mix of investment grade U.S. bonds[4], the annualized return for the 10 years ending 9/30/2011 was 4.3%. Not great, but certainly not a "lost decade" as you hear in the media. For this hypothetical portfolio, the worst rolling three-year annualized return since 1976 was -7.23%, while the best rolling three-year annualized return was 26.5%.

For most investors with investment timeframes of over 20 years (which is almost everyone under the age of 65), riding out fluctuations in the market is the common sense thing to do. Research shows that investors who try to "time" the market usually end up with returns that are less than market returns over the long haul. Of course, each investor's situation is unique. That's why the best strategy is to to develop and regularly update a comprehensive financial plan that fits your particular situation.

[1] The "Market" is based on the S&P 500 PR (price) Index, which is a collection of the stock of 500 of the largest companies in the U.S. [2] S&P 500 TR (IA Extended) Index. [3] S&P 500 TR Index. [4] BarCap US Agg Bond TR (total return) USD Index. Data is from "Behavioral Investment Counseling" by Nick Murray and Morningstar. Data believed to be from reliable sources but accuracy cannot be guaranteed. Indexes cannot be invested in directly and do not reflect deductions for expenses. Past performance is no guarantee of future returns.