# LGC&D Wealth Management, LLC
## Educated Investor Feature Articles: 2007, Vol. 2

## Lessons from 2006

**Overview:** Alvin Toffler, a former columnist at *Fortune*, said, “The illiterate of the 21st century will not be those who cannot read or write, but those who cannot learn, unlearn and relearn.” The past year gave us plenty to learn, unlearn and relearn. As we look back on 2006, we focus on: 1) the futility of trying to forecast how the market will react to events, 2) the risks of undiversified investing in individual stocks, 3) the evidence that past performance is not an indicator of future gains, 4) the dangers of hedge funds and 5) the volatility of equities.

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In at least one way, 2006 was no different than any other year — it provided us with lessons on the importance of adhering to a prudent investment strategy. Let’s review some of the issues the financial markets faced in 2006.

Note: With each lesson we’ve included a lighthearted mock headline, one that attempts to capture how media coverage may have sensationalized such events.

**U.S. Involvement in Iraq**
The situation in Iraq deteriorated and contributed to massive government budget deficits.

**International Events**
North Korea continued its renegade nuclear program. The Israeli-Palestinian conflict hit a boiling point in Gaza in June following the kidnapping of an Israeli army corporal.

**The Falling Dollar**
The already massive, record trade deficit deteriorated, leading to a sharp drop in the value of the U.S. dollar.

**Oil Prices**
Oil prices surged, peaking at almost $80 a barrel. They remained above $60 a barrel for most of the year.

**Social Security, Medicare and Medicaid**
Congress failed to address the long-term structural deficits exacerbated by Social Security, Medicare and Medicaid.

**Interest Rates**
The Federal Reserve continued raising interest rates through the middle of the year. The Fed raised rates four times, with the federal funds rate peaking in June at 5.25 percent.

**Housing and Automobiles**
The real estate bubble burst, with housing permits and sales dropping sharply. Prices began to fall. By the end of the year, the housing and automobile sectors, two of the economy’s largest sectors, would be reeling.

**The S&P 500 Index**
And, to top it all off, 2006 began with the price-to-earnings ratio of the S&P 500 Index at close to 18, or about 29 percent higher than its historical average of 14. All this bad news and stocks remain priced well above their long-term average.

## Stocks Survive Another Tough Year!

**Lesson 1: Even with a clear crystal ball, it's hard to predict future events**
Let's imagine you had a perfectly clear crystal ball that allowed you to foresee the economic and political events of 2006. Surely the insights provided would be of great benefit in terms of investment decisions — or would they?

Despite all the bad news, the U.S. economy produced another year of solid growth with low inflation, falling unemployment, and rising wages and profits. Most equity markets produced above average returns. In particular, despite all the attention the housing bubble received, U.S. REITs had the highest return of any major equity asset class.

2006 was similar to previous years when the markets overcame bad news on many fronts and delivered strong investment results. While it may seem hard to believe, the evidence shows it is difficult to forecast how markets react to positive or negative news. Thus, the prudent strategy is to ignore the noise of the market and simply adhere to a well-developed plan, rebalancing as necessary.

## No "Safe" Stocks Left?

**Lesson 2: Investing in individual stocks has more to do with speculating than investing**
There are two types of financial risk: those that can be diversified away and those that cannot. Among the risks that *can* be diversified away are those that come from attempts to pick winning stocks. Investors are not compensated for taking these individual-stock risks that can be diversified away. In other words, although the expected returns from a stock-picking approach are no greater than broadly investing in equities, the risk is significantly greater when one's holdings are concentrated in fewer securities. And that's before one considers the expenses of implementing the approach.

To briefly illustrate, consider the following table, which presents a few examples of relatively well-known stocks that significantly underperformed the market in 2006. In fact, they showed dramatic losses in a year when stocks in general provided strong positive returns. Of course, there were other stocks that significantly outperformed. The point isn't to illustrate poorly performing stocks to avoid. Rather, it is to indicate that there is an alternate approach that enables the investor to more reliably seek to capture the premium that can be expected from investing in the stock market.

| Company | Change from 12/31/05 to 12/31/06 |
|---|---|
| Revlon | –57% |
| Vonage | –53% |
| Whole Foods | –39% |
| Fleetwood Enterprises | –36% |
| Beazer Homes | –36% |
| Yahoo | –35% |
| Cheesecake Factory | –34% |
| Six Flags | –32% |
| eBay | –30% |
| Boston Scientific | –30% |
| Red Robin | –30% |
| Williams Sonoma | –27% |

| Arch Coal | –25% |
| --- | --- |
| Bausch & Lomb | –23% |
| Intel* | –19% |

*Worst performing stock in the Dow Jones Industrial Average
Source: *The Wall Street Journal*, December 30–31, 2006.

An alternate approach is to construct a diversified global portfolio that offers exposure to broad equity markets, with tilts as appropriate to equity risk factors (such as small-cap versus large-cap and value versus growth). With broad diversification, investors can expect to be compensated for the degree of risk they choose to accept.

Addressing the problem of confusing the familiar with the safe, we briefly focus on investors who may have large concentrated positions in companies based in their hometown. For example, St. Louis-based companies, on average, did not fare well in 2006 despite the outstanding returns generated by the market.

According to the *St. Louis Post-Dispatch*, of the 54 companies included in a list of St. Louis major-index stocks, 21 (or 39 percent) generated negative returns.[1] Of those 21 companies, 13 produced double-digit losses. Four produced losses of between 20–30 percent, two had losses of between 30–40 percent, one had a loss of 41 percent and one with a whopping loss of 77 percent.

Gary Belsky and Thomas Gilovich, authors of *Why Smart People Make Big Money Mistakes*, warned investors that they should not confuse familiarity with knowledge. "For every example of a person who made money on an investment because she used a company's product or understood its strategy, we can give you five instances where such knowledge was insufficient to justify the investment."[2]

### *Miller's Streak Ends at 15!*

### Lesson 3: Past performance of active managers is not a reliable predictor of future performance

Bill Miller is the legendary manager of the Legg Mason Value Trust, which outperformed the S&P 500 Index for 15 consecutive years. Surely a streak of 15 years could not have been a result of luck. However, in 2006, the fund returned 5.8 percent, trailing the S&P 500 Index by 10 percentage points. In fact, the fund's performance was so poor that its cumulative three-year returns trailed the S&P 500 Index by 2.7 percent per annum.

In regard to the performance of the Legg Mason Value Trust, investors should also note that the fund is called a *value* fund, where the manager decides which stocks qualify as value stocks. The alternative approach is to allow the market to make that determination. Since value stocks have historically outperformed growth stocks, the growth-oriented S&P 500 Index is really too low a benchmark for a value fund. We can use the Russell 1000 Value Index.

For the three-year period ending in 2006, the stock selection efforts of Legg Mason Value Trust resulted in a return of 7.7 percent per annum. The Russell 1000 Value Index returned 15.1 percent per annum. Investors who believed Bill Miller was a superior judge of value underperformed by 7.4 percent per annum.

In fact, since 2000, the Legg Mason Value Trust has outperformed the Russell 1000 Value Index in only one year, 2003, when it outperformed by 13.5 percentage points. However, from 2000–2002 and from 2004–2006 it underperformed by 14.2 percent, 3.7 percent, 3.4 percent, 4.5 percent, 1.7 percent and 16.4 percent, respectively.

It is also worth noting that the fund with the second longest streak (eight straight years) of outperforming the S&P 500 Index was the Quaker Strategic Growth Fund. In 2006, that fund returned just 5.1 percent, underperforming the S&P 500 Index by almost 11 percent.

**Other Noteworthy Examples**

Another good example of long track records proving to be unreliable is the Muhlenkamp Fund. The fund, run by Ron Muhlenkamp, is a value fund with an outstanding track record. However, while the Russell 1000 Value Index returned 22.2 percent in 2006, the Muhlenkamp Fund returned just 4.1 percent. And three-year returns were 15.1 percent per annum for the Russell 1000 Value Index and just 11.8 percent per annum for the Muhlenkamp Fund.

Finally, consider the results of Morningstar's efforts. Each month, Morningstar's monthly magazine *FundInvestor* reports on the results of its three recommended portfolios of actively managed funds and compares those results to benchmark portfolios composed of index funds. Despite hurdles that are arguably too low (Morningstar includes small and value funds in its actively managed portfolios but uses broad market indexes for its benchmarks), all three portfolios have underperformed their respective benchmarks.

From its inception in November 2001 through November 2006, Morningstar's Aggressive Wealth Maker portfolio has underperformed its benchmark by 0.73 percent per annum. From its inception in November 2001 through November 2006, Morningstar's Wealth Maker portfolio has underperformed its benchmark by 1.05 percent per annum. From its inception in May 2002 through November 2006, Morningstar's Wealth Keeper portfolio has underperformed its benchmark by 0.31 percent per annum. In all three cases, Morningstar has failed to deliver added value, even with all its resources and risk factor advantage compared to its benchmarks.

With about as many mutual funds as there are stocks (about 8,000), we should expect some funds to *randomly* outperform for long periods. Thus, outperformance by a manager or fund for even periods as long as 10 or 15 years is not a reliable predictor of future performance.

## Amaranth's Spectacular Collapse!

**Lesson 4: Continue to avoid hedge funds**

Amaranth was perhaps the biggest hedge fund story of 2006. Fund founder Nick Maounis allowed his star energy trader Brian Hunter to invest heavily in natural-gas markets, and the move backfired. The $9 billion hedge fund lost approximately $6.5 billion in September alone. Quickly, the fund was forced to close. *The New York Times* singled out the failure during its 2006 year-in-review of the business world, saying, "It takes skill to lose that much money that fast."[3]

Several other hedge funds suffered notable declines or closings:

- Archeus Capital, which held more than $3 billion in assets in 2005, announced its intentions to close last year after heavy investor withdrawals reduced the fund to $700 million.[4]
- Goldman Sachs' flagship hedge fund, Global Alpha, lost about 10 percent in 2006.[5]
- Vega Asset Management was managing more than $12 billion by 2004. By October 2006, Vega managed $5 billion and its largest fund, the Vega Select Opportunities Fund, had lost about 17 percent with most of the losses coming in August and September.[6]

Hedge funds are risky investments that not only experience losses, but offer greater risk of extreme losses. Evidence and horror stories such as the ones mentioned above indicate investors cannot set investment goals and seek to achieve them in any sort of disciplined manner via hedge funds.

## The Market Is for Investors, Not Speculators

### Lesson 5: Equities are risky

Investing in equities involves risk. For the 81-year period beginning in 1926, there were 23 years (about 30 percent of the period) when stocks, as measured by the S&P 500 Index, produced negative returns. In 10 of those years, losses were in double digits. There were two more years when losses exceeded 9 percent and another five years when losses exceeded 8 percent. Thus, there were a total of 17 years (or about one year in five) when losses exceeded 8 percent.

Some investors may have forgotten the bear market of 2000–2002, becoming comfortable with the returns that equities have provided since 2003 (not including the brief and relatively small dip in the market in the spring of 2006). The bull market of the past four years provided investors with higher-than-expected returns. Investors should treat these returns like they would an inheritance. Inheritances reduce the need to take risk. Those investors who have benefited from great returns since 2003 should take the time to revisit their Investment Policy Statement (IPS) and determine whether their need to take risk has fallen sufficiently to allow them to lower their equity allocation (and sleep better).

It's important to remember that successful investing requires a well-developed plan as well as the discipline to stick with that plan in the face of adversity. Many plans fail because investors take an inappropriate amount of risk. Then, when the risks show up (perhaps unexpectedly), the plan may be abandoned, either out of necessity or because panic sets in. Thus, an investor's written IPS should accurately reflect his or her true ability and willingness to take risk.

### Conclusion

Like most years, 2006 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 IPS, 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.

[1] **Stock Indexes Show Best Annual Gain Since 2003**. *St. Louis Post-Dispatch*, December 30, 2006.

[2] Gary Belsky and Thomas Gilovich, **Why Smart People Make Big Money Mistakes — And How to Correct Them**. Simon & Schuster, 1999.

[3] Gretchen Morgenson, **A Year to Suspend Disbelief**. *The New York Times*, December 31, 2006.

[4] Landon Thomas Jr., **A $700 Million Hedge Fund, Down From $3 Billion, Says It Will Close**. *The New York Times*, October 31, 2006.

[5] Edward Chancellor and John Christy, **Insights on Investing: Exile for a Failed Hedgie?** *The Wall Street Journal*, January 8, 2007.

[6] Gregory Zuckerman and Alistair MacDonald, **Top Global Trader Is Suddenly Losing Investors**. *The Wall Street Journal*, October 17, 2006.

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