

Lessons from 2005

Overview: Like most years, 2005 provided us with lessons on the prudent investment strategy. The United States reeled from a disastrous hurricane season, and the market dealt with a grab bag of national and global challenges. The following is a brief recap via six investment lessons. As we look back on 2005, we focus on a number of subjects, including: 1) why it is imprudent to attempt to forecast how the markets will react to events, 2) the speculative nature of investing in individual stocks, 3) avoiding hedge funds, 4) avoiding sub-investment grade corporate bonds, 5) considering long-term care coverage and 6) protecting yourself from escalating information and identity threats, including identity theft.

We begin with a look back at some of the events that helped shape the financial landscape of 2005. Many of the same issues that we highlighted in 2004 remained prevalent this year.

U.S. Involvement in Iraq

Investors still faced the repercussions of the ongoing crisis in Iraq, the federal budget deficit grew and the trade deficit widened. According to an October 2005 Associated Press article, the Congressional Research Service estimated that, since September 2001, Congress has authorized more than \$311 billion for activities in Iraq and Afghanistan.¹

Medicare, Medicaid and Social Security

A new Medicare pharmacy benefit further fueled budget deficits. In addition, Congress failed to find adequate solutions to address potential long-term threats to the solvency of Medicare, Medicaid and Social Security.

The 2005 Hurricane Season

During the most destructive hurricane season in U.S. history, much of the southern coastline from Texas to Mississippi (especially the city of New Orleans) suffered extensive damage.

Interest Rates and Expectations

As of December 13, 2005, the Federal Reserve raised the target federal funds rate 13 times, since it began gradually raising rates in June 2004.² “Don’t fight the Fed” remains one of the catchphrases often heard on Wall Street. In addition, many within the media continued to predict that the housing bubble would burst.

International Events

Terrorist activities abounded around the globe and the media covered the possible threat of a global pandemic (i.e., the Avian flu).

Oil Prices

Although the bond market was relatively unaffected by Hurricane Katrina (and Rita), oil prices rose above \$70 a barrel. Americans paid more at the gas pump and to heat their homes.

The S&P 500 Index

The year began with the price-to-earnings ratio of the S&P 500 Index at about 20, or 43 percent above the historical average of about 14.

Lesson 1: Even with a clear crystal ball, it's hard to predict future events

Even if investors had been privy to a perfectly clear crystal ball that allowed them to foresee all the 2005 economic and political events described, the insights provided might not have been of great benefit to them in terms of subsequent investment decisions. Market history has demonstrated time and again that bad or good news doesn't necessarily translate directly to bad or good investment climates. For example, despite various bad news in 2005, here's what actually happened:

- In general, most markets fared well this year. For example, all U.S. equity asset classes had positive annualized returns. In particular, despite warnings that the housing bubble would burst, REITS had the highest return of the domestic equity asset classes.
- Despite the budget and trade deficits, the dollar rose significantly.
- International equity markets provided strong returns once again, with asset classes providing double-digit gains. Although the dollar rose, international markets provided generally stronger returns than did the U.S. market.
- This year, many voiced their concerns about the U.S. economy in the face of international competition and the damaging impact of the hurricane season. Yet, the United States had another strong year of economic growth and unemployment fell when compared to year-end 2004.
- Despite continued strong economic growth and the Federal Reserve continuing to raise short-term interest rates, 10-year bond rates only rose from 4.21 percent to 4.39 percent.

2005 shared similarities with previous years when the markets overcame bad news on many fronts and delivered strong investment results. (For example, we have described positive markets amidst the following events: the war in Iraq, the SARS virus, corporate scandals and mutual fund scandals.) The evidence remains that, even with a clear crystal ball to predict what events might occur, it has been very difficult to forecast how markets would actually react to those events. Thus, the prudent approach is to ignore the noise of the market and simply adhere to a carefully planned strategy.

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 2005. 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 12/31/04 to 12/31/05
Pier 1 Imports	-54.4%
Krispy Kreme	-54.4%
General Motors	-48.4%
Ford Motor	-45.1%
RadioShack	-35.3%
New York Times	-33.8%
Tenet Health Care	-30.2%
Tribune	-26.8%
Estee Lauder	-26.0%
Eastman Kodak	-25.9%
Avon	-24.8%
Gannett	-24.7%
Verizon	-22.2%
Washington Post	-21.5%

Source: Bloomberg, January 2006.

The alternate approach is to invest in a broadly diversified global portfolio comprised of many equity asset class funds (such as large-cap, small-cap, value or growth equity funds, domestic and international). Because these funds focus on reflecting only those risks that *cannot* be diversified away, investors in them can expect to be compensated in the form of higher returns for taking those risks.

Lesson 3: Continue to avoid hedge funds

We feel these stories speak for themselves and provide excellent evidence on the dangers of investing in hedge funds.

Throughout 2005, new details emerged surrounding the mismanagement of The Ohio Bureau of Workers Compensation Fund. The fund, worth an estimated \$14.5 billion, lost \$300 million in 2004 on investments, including a \$215 million loss by MDL Capital Management, which invested the money in a hedge fund.³ According to the *New York Times*, more than \$13 million was missing from a \$50 million investment in rare coin funds.⁴ In October 2005, *Pensions & Investments* estimated that the entire \$50 million coin investment resulted in a loss. As of this writing, officials continue to investigate as fund trustees consider a recommendation to terminate all fund managers and move to index funds.

In 2003, Jonathan Bailey and Stephen Coates founded the Bailey Coates Cromwell Fund in London, accumulating \$1.3 billion in capital. The fund invested in U.S. stocks and lost more than 20 percent in just the first five months of 2005.⁵ These losses led to large withdrawals by investors. In June 2005, less than two years after its inception, the firm announced its liquidation.⁶ Note that in 2004, this hedge fund earned about 5 percent while the S&P 500 Index rose about 11 percent.

These stories recount just two of the many hedge fund horror stories that occurred in 2005, and we expect 2006 will have its share of similar accounts.

Lesson 4: Don't buy sub-investment grade corporate bonds

In November 2005, General Motors (GM) CEO Rick Wagoner announced that GM would cut 30,000 jobs (revising an announcement made earlier in the year and increasing the number of job cuts by 5,000).⁷ In December 2005, GM corporate bonds were downgraded from BB– to B.

It is imprudent to seek increased expected returns by purchasing sub-investment grade corporate bonds because the role of fixed income is not to maximize returns; rather, it is to reduce portfolio risk and/or provide income. In fact, corporate bonds have had significantly higher credit risk when compared to similarly rated municipal bonds. For example, a 2001 Standard & Poor's study found that, a single-A rated municipal bond was one-tenth as likely to default (0.16 percent default rate) as was a similarly rated corporate bond (1.8 percent default rate).⁸

Further, the risk of default increases as the investment grade of a corporate bond decreases.⁹ By using lower risk vehicles in the fixed income portion of a portfolio, it is possible to take more risk on the equity side, which is a more appropriate place to take additional risk.

Lesson 5: Consider long-term care coverage (as a part of overall retirement planning)

According to a September 2005 MetLife report on nursing home and home health costs, the average rate for a private room in a nursing home was more than \$200 a day, or about \$74,000 a year. Estimates indicate that there is nearly a 50 percent chance an individual will eventually require 24-hour skilled nursing care in a long-term care facility. How should individuals prepare for potential long-term care costs?

When individuals begin developing a carefully planned strategy for their retirement, they should determine the following: 1) how much they would need to spend to live the lifestyle they desire and 2) all of the costs that they might incur. For example, one of the first decisions when designing a long-term care plan is to determine how much care will be provided through home health care.

Individuals must make several decisions when building a customized care plan, including choosing a daily benefit amount; selecting the most appropriate method by which to receive benefits; and verifying the quality of the long-term care coverage provider. Thus, it is prudent to consult a financial advisor who can help assess what actions may or may not be appropriate given individual circumstances. Further, an advisor should be sensitive to family concerns, respect a family's wishes regarding care options and design an appropriate plan to meet specific needs.

Lesson 6: Protect yourself from identity (and personal information) theft

Some in the media reported that 2005 was potentially the worst year for data security. Information breaches (and, in many cases, identity theft) occurred at numerous institutions and those responsible did not discriminate by size or affiliation. In February 2005, the Federal Trade Commission (FTC) reported that identity theft affects approximately 10 million Americans each year.

In January 2006, the FTC released its annual consumer fraud report.¹⁰ For 2005, complaints regarding identity theft accounted for 37 percent of approximately 687,000 reports filed. While Internet-related complaints made up 46 percent of overall 2005 fraud complaints, credit card fraud ranked as the most common form of identity theft.

For the five-year period 2001–2005, the FTC has reported significant annual increases in the approximate number of identity theft complaints: 86,000 in 2001; 163,000 in 2002; 215,000 in 2003;

246,570 in 2004; and 255,000 in 2005. The FTC encourages investors to take precautions when sharing personal information with institutions and individuals, and advises them to refrain from sharing information (such as account passwords and Social Security numbers) with strangers.

This topic is far-reaching and it is not possible to cover it completely in this document. For example, properly storing (and destroying) confidential papers is an essential component of reducing the possibility of being a victim of identity theft or an information breach.

Whenever possible, it is prudent to use caution when sharing and storing personal information. For more information, see the FTC Web site entitled, “Your National Resource about Identity Theft” at <http://www.consumer.gov/idtheft/>.

Conclusion

Like most years, 2005 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. If investors ignore the noise of the market (which may come in the form of events that receive national or global coverage), they will be well prepared to face the coming years.

¹ **Senate OKs \$50 Billion More for Wars.** MSNBC.com, October 7, 2005. Available at <http://www.msnbc.msn.com>. Accessed December 19, 2005.

² **Open Market Operations.** Federal Reserve Board, December 13, 2005. Available at <http://www.federalreserve.gov/fomc/fundsrate.htm>. Accessed December 20, 2005.

³ Vince Calio, **Active Managers Make Their Case to Stay with Troubled Ohio Fund.** *Pensions & Investments*, October 3, 2005.

⁴ James Dao, **Coins Go Missing, and G.O.P. Insider Becomes Outcast.** *New York Times*, May 28, 2005.

⁵ David Reilly, **How to Make \$600 Million? Get \$1.3 Billion.** *Wall Street Journal*, May 23, 2005.

⁶ David Reilly, **Bailey Coates Will Close Fund After Racking Up Big Losses.** *Wall Street Journal*, June 21, 2005.

⁷ Sharon Silke Carty and James R. Healey, **Chief of GM Says He Won’t ‘Run and Hide.’** *USA Today*, November 22, 2005.

⁸ **Municipal Rating Transitions and Defaults.** Standard & Poor’s, June 13, 2001.

⁹ **Municipal Default Risk.** A.G. Edwards, October 6, 2003.

¹⁰ **FTC Releases Top 10 Consumer Fraud Complaint Categories.** Federal Trade Commission, January 25, 2006.

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