FDx Advisor Notes

October 2008

Investment Insights & Observations for Financial Advisors

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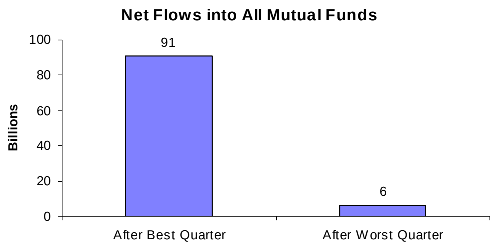
The Current Crisis – Setting Another Trap for Investors to Behave Badly?

The current market environment presents advisors with a unique opportunity to strengthen relationships with clients by helping them make investment decisions that are appropriate for their goals.

The first step is to recognize we are all human and subject to biases in our investment decision making that can cause us to hurt ourselves. The next step is to validate your investment plan and exercise discipline to stay on course in a sea of emotions.

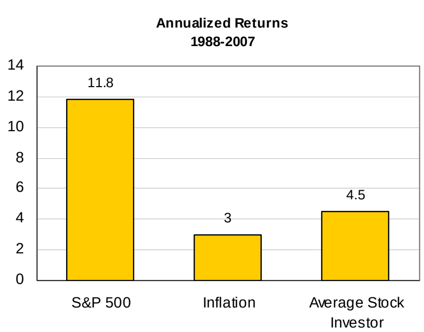
It is well documented that investors often let their emotions and biases get the best of them. This leads all too often to a pattern of "investors behaving badly." Here is what it looks like:



Source: Gavin Quill. November 2001. "Investors Behaving Badly" Journal of Financial Planning. 2001. Data Period: 1990 – 1999. Flows calculated by Morningstar category

It is called performance chasing – running to an investment *after* it has gone up, or from one *after* it has gone down.

Here is the result:



Investor returns lagged ***investment*** returns by a wide margin – more than 7% - over the 20 years ending 2007 according to a recent Dalbar study.

In 2002, Daniel Kahneman, a research psychologist, won the Nobel Prize in economics for "having integrated insights from psychological research into economic science, especially concerning human judgment and decision-making under uncertainty." Kahneman's work in discovering how human judgment may take shortcuts that systematically depart from the basic principles of probability helped lay the foundation for the relatively young field of behavioral finance.

There are lessons we can learn from behavioral finance regarding how certain biases can cause us to make poor investment choices. Here are two to work hard to overcome, particularly in the current environment, as published in a 2003 paper by Jay R. Ritter, Cordell Professor of Finance, University of Florida.

Framing: *The notion that how a concept is presented to individuals matters. For example, restaurants may advertise "early-bird" specials or "after-theatre" discounts, but they never use peak-period "surcharges." They get more business if people feel they are getting a discount at off-peak times rather than paying a surcharge at peak periods, even if the prices are identical. Cognitive psychologists have documented that doctors make different recommendations if they see evidence that is presented as "survival probabilities" rather than "mortality rates," even though survival probabilities plus mortality rates add up to 100%.*

Representativeness: *People underweight long-term averages. People tend to put too much weight on recent experience. This is sometimes known as the "law of small numbers." As an example, when equity returns have been high for many years (such as 1982-2000 in the U.S. and Western Europe), many people begin to believe that high equity returns are "normal."*

Just as many of us put too much weight on the exceptional performance of the equity market in 1990's, we now run the risk of believing the recent market meltdown portends more of the same, as far as the eye can see, and find comfort holding too much cash. It is hard to look past our most recent portfolio statements to consider the long-term track record of equity markets and the unprecedented government actions to address the current problems.

While no one can consistently predict the near term market movements, including us, we can say that equity market valuations and credit spreads are now presenting buying opportunities for the long term investor not seen in many years. Yet, this is precisely the time when our emotions, in the face of negative headlines and severe market volatility, get the better of us.

As Warren Buffett recently penned in a New York Times Op Ed:

"Today people who hold cash equivalents feel comfortable. They shouldn't. They have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value… Equities will almost certainly outperform cash over the next decade, probably by a substantial degree. Those investors who cling now to cash are betting they can efficiently time their move away from it later. In waiting for the comfort of good news, they are ignoring Wayne Gretzky's advice: "I skate to where the puck is going to be, not to where it has been."

Now, it would be nice to have the stomach, wisdom and resources of Warren Buffett, as well as the ability to buy on his terms from the likes of Goldman Sachs. Alas, only Warren is Warren. He is currently ranked #1 on the Forbes billionaires list. If massive wealth created through long-term investing suggests a modicum of credibility, we may be wise to heed his message – take a longer-term view and don't get derailed by the emotion of the moment.

So, let's begin to address the investment challenge by using our knowledge of behavioral bias to our advantage.

First, by ***framing*** today's decision to invest, or stay invested, in the context of client goals, we refocus on what the client can control – spending, saving and investment decisions – and not on what they can't control – the daily mood swings of the market.

Making the asset allocation decision appropriate to client goals is essential to success over time. Stress testing the investment and savings plan will help build confidence and gird the client's tolerance for taking risk in the current market environment.

Second, framing today's market environment and recent returns as ***not representative*** of reasonable long-term expectations, clients can begin to see the current valuations as an opportunity going forward rather than just a loss looking backward.

The time tested principles of successful investing – planning, asset allocation, diversification, professional management, and systematic rebalancing – still apply.

Since Mr. Buffett has already pointed out that "cash is a terrible long-term asset," we won't dwell on this point. Rather we will take a look at stocks and corporate bonds – two assets that have taken a beating.

How bad a beating? On our measures, stocks valuations relative to government bonds are as cheap as they have been since about the early 1980's. The dividend yield is now almost 3.5% versus less than 2% a year ago.

As of October 27th, the loss on the S&P 500 Index from its peak was 42.6%. Since 1945, there have been only six months where a loss of more than 40% from peak has occurred and in the subsequent 12 months, the index returned over 33% on average.

S&P 500 Returns Following Significant Losses

		Next 12 Months Returns		
% Loss	Occurrences	Average	Max	Min
-10%	176	14.6%	61.0%	-26.5%
-20%	69	13.4%	41.9%	-24.8%
-30%	22	21.0%	38.5%	-20.5%
-40%	6	33.2%	38.5%	24.4%
Entire Period	753	12.6%	61.0%	-38.9%

Time Period: Jan 1945-Sept 2007 Source: Ibbotson, MPI Stylus, FDx Advisors
% Loss and occurrences calculated from prior peak
Past performance does not guarantee future results

Taking a three year view, the subsequent returns after a loss are even better:

S&P 500 Returns Following Significant Losses

		Next 36 Months Returns		
% Loss	Occurrences	Average	Max	Min
-10%	173	12.1%	29.6%	-5.5%
-20%	69	11.2%	24.5%	0.6%
-30%	22	13.4%	20.0%	4.0%
-40%	6	17.0%	20.0%	14.4%
Entire Period	729	12.0%	33.4%	-16.1%

Time Period: Jan1945-Sept 2005 Source: Ibbotson, MPI Stylus, FDx Advisors
% Loss and occurrences calculated from prior peak
Past performance does not guarantee future results

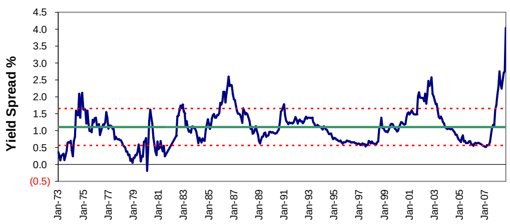
Corporate credits have also taken a beating. Aggregate fixed income markets fell by 0.5% for the 3rd quarter but the modest decline of 0.5% masks the bifurcation within the bond market. U.S. Treasury bonds posted a robust return of 2.3%, driven by a flight to quality, while the Lehman Credit Index posted a decline.

Intermediate Credit Spreads almost doubled in the 3rd quarter from 2.5% to over 4.0%. Long Credit Spreads moved significantly higher from 2.2% to

3.2%. As a result of this spread expansion, the Lehman Credit Index returned a minus 6.4%---its worst return since early 1980.

Below is a visual of the credit spreads over time. In previous crises, most recently the period following the dotcom crash of the early 2000's, the spread peaked with the investment grade corporate bond market yielding about 2.5% more than equivalent duration Treasuries. Today, at more than 4%, the spread is in unprecedented territory.

Intermediate Credits - Average Yield Above Treasuries
Period Beginning 01/1973 Period Ending 09/2008



Last	4.04	Max	4.04	Std Dev	0.54
Average	1.11	Min	(0.19)	+1 Std Dev	1.65
Median	1.06			-1 Std Dev	0.56

This is another market where recent performance is *not representative* of the long-term averages. Many active bond portfolio managers will tend to overweight credits on a structural basis to capture the excess yield over time and increase the overweight when spreads are near historical highs. Over a complete cycle, the managers will tend to capture the extra return associated with the higher yields available from owning credits.

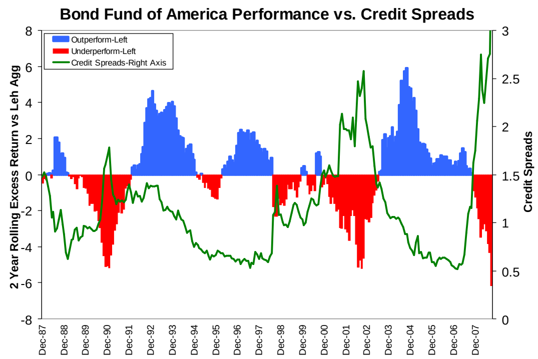
Most of these managers will have been at or near their maximum overweight to credits when the spread was near 2.5%, only to see it increase to more than 4%. So these managers will have underperformed, by a lot. The knee-jerk reaction is to fire them for performing so poorly.

However, doing so is the equivalent of the proverbial closing of the door after the horse has left the barn. If you sell a manager that is overweight credits to buy one that is not, you lose the extra 4% in yield spread and risk losing the appreciation that occurs when spreads return to more normal levels.

So, we have another *framing* challenge, or opportunity, depending on your perspective.

Do you look backward with your client at recent returns, or do you look forward at the opportunity to add value to the portfolio?

Let's take a look at American Funds Bond Fund of America. It has performed poorly looking backward. The chart below shows the rolling two year excess returns versus the Lehman Aggregate Index with the credit spread chart overlaid. While past results do not guarantee future performance, the pattern is almost like clockwork. Spreads widen (narrow) and the fund underperforms (outperforms).



On this basis, now is the time to buy a fund in this position, not sell it. The fund has a relative low expense ratio which is good for clients. Our recent dialogue with the fund company indicates that they are maintaining their overweight, while managing default risk, to capture the benefit of the higher spreads over time.

We recognize that the credit crunch has been fear provoking with a lot of press warning of an economic collapse. While a severe recession through most of 2009 is likely, policy makers are taking the necessary steps to ensure the long-term stability of our financial system. Yet, the markets have not responded and are continuing to price extreme negative outcomes.

Although markets are better valued today, we will likely experience further volatility and episodic declines as market participants react to the news of the day. For an investor with a solid plan, and one that exercises discipline and diversification to manage risk, the current market environment offers interesting opportunities.

A final insight from Warren Buffett:

A simple rule dictates my buying: Be fearful when others are greedy and be greedy when others are fearful. And most certainly, fear is now widespread, gripping even the most seasoned investors… In short, bad news is an investor's best friend. It lets you buy a slice of America's future at a marked-down price.

Important Information and Disclosures

Sources of information for this report include The Wall Street Journal, The Economist, The New York Times, Bloomberg, Econometrics.com, Conference Board, US Department of Labor, Bureau of Economic Analysis, Lehman, MPI Stylus, University of Florida, Dalbar, Ibbotson and FDx Advisors.

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Asset allocation analysis may assist you in determining if you have the right mix of investments for a given set of objectives and risk tolerance. Asset allocation does not ensure a profit or protect against losses in a declining market.

Diversification may help to reduce the effects of investment risks when gains in one investment class help offset losses in another. There is no certainty that any investment or strategy will be profitable or successful in achieving your specific investment objectives.

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Costs associated with an investment are not reflected in the illustrations [e.g., mutual fund sales charges, management fees, administrative fees, taxes, other maintenance fees or mortality fees]. If included, these costs would lower returns. Note that costs differ depending on the investment. Assuming two investments have identical returns, the investment with lower costs would provide a higher overall projected value.