

During the market downturn of late 2007 through early 2009, most of us wished we had less money in the stock market. And in May and June of this year, the market again made many investors worry about how much money they should have there. In fact, when you consider what we've been through in the 21st Century, many investors are asking: "Is it even worth being in the stock market?"

Volatility is the Name of the Game

The stock market has always been risky and prone to bubbles and dramatic drops. A globally diversified, 100% equity investor should expect to experience an assortment of returns like these in any given 10 to 16-year period:

- At least one, maybe two, bad markets (negative returns)
- Several sub-par markets (returns from zero to 7%)
- Several good markets (returns from 8% to 17%)
- And several great markets (from 17% to 30% or more)

Those are annual expectations. Day by day, and month by month, an investor will experience even *more* volatility! And volatility has increased in the last decade. Let's look at some interesting periods in recent years for a globally diversified, 100% equity portfolio.

- In August 1998, this portfolio experienced a decline of more than 15%. This was the time when Long Term Capital Management (a hedge fund) almost took down the whole financial system, leading to a massive bailout by major banks and investment houses supervised by the Federal Reserve. During the following four months, this portfolio earned more than 18% and finished the year with a 6.5% return. Not a great annual return, but okay.
- Following September 11, 2001, the market plummeted. But each of the remaining three months was positive, and for the whole year the portfolio was close to flat with a return of around 1%.
- During 2002, the portfolio had four negative months (between minus 3% and minus 9%) and four flat months (literally right at zero) and finished the year down 10%. In 2003, there were four months with positive returns between 5% and 8% and the gain for that year was in excess of 45%.
- Both January and February of 2009 were more than 11% negative. The rest of the year included many high positive months, and the year finished up by 33%.

Looking at Three Time Periods

Now let's explore three different time periods since 1973 and three different equity allocations for the same globally diversified portfolio. We'll also compare the globally diversified portfolios to the S&P 500 as a benchmark (refer to the three graphs included with this article.) The Traditional portfolio (in blue) has 60% in equities, the Aggressive portfolio (in red) has 80% in equities and the 100% Equity portfolio (in green) is self-explanatory. The S&P 500 is in purple and is also 100% equity. Each market period lasts 16 years and begins with an investment of \$100,000.

For 1973 through 1988, the S&P 500 resulted in an average annualized return of 10.3%. This is just about what we would expect from the S&P for a 30-year period. Notice that each of the diversified portfolios beat the S&P 500 significantly – even the ones with allocations to fixed income. During the early years of this period, the market performed poorly, and all of the portfolios were declining in value. But, by 1977, the three diversified portfolios had approximately the same value. From 1977 forward, the higher the allocation was to equities, the better the performance and the better the ending value. The S&P trailed significantly.

From 1983 through 1998, the S&P 500 had a strong average annualized return of 18.2%. The 100% diversified portfolio did virtually the same as the S&P 500. The diversified 60% and 80% portfolios underperformed the S&P, but only because they had allocations to fixed income. During all of this 16-year period, the stronger the allocation was to equity, the better the return and the better the ending value.

From 1994 through 2009, the S&P 500 had an average annualized return of 7.6% which is certainly below expectations for a 30-year period. Once again, all three diversified portfolios beat the S&P 500!

Risk and Reward Observations

The graph doesn't show it, but each of the diversified portfolios beat long-term and short-term government and corporate bonds for each of the three periods and did so in a meaningful way. So even though there is more risk in owning equities, it paid off in a significant way in each of these three time periods. Yes, historically there have been short term periods when fixed income has generated returns in excess of a diversified portfolio of all equities, but the timing of these periods is unpredictable. If you expect to be in the market more than a short time period, a portfolio that includes diversified equities has a strong likelihood of outperforming any type of fixed income.

Even with an allocation to fixed income, a globally diversified portfolio does not protect an investor from volatility, crashes or from bear markets. Fixed income helps to dampen the downside – it also dampens the upside, of course. With an allocation to fixed income, an investor can temper the risk but still benefit from some of the reward.

The stock market offers investors a way to harness capitalism. Part of the human spirit is a desire to be successful, to progress and to create wealth. Yet, there has always been a dark side of humanity too (e.g., cheating the system, defrauding investors, etc.). Controls and regulations always seem to be a step behind the bad guys. But overall, the market has consistently delivered a reward that is worth the risk for diversified investors with discipline. It is reasonable to expect that these relationships will continue in the future.

Looking only at these three periods covering 37 years does not constitute a complete exercise in market analysis. Some might accuse us of data mining. And it is true that the past is no guarantee of the future. But we find it educational and interesting to observe the facts – without bias – and hope the result creates perspective at a time when emotion can get the best of us and cause us to undermine well-conceived long-term plans.

Market Timing

Why be in the market when it is flat or down? Why not shift to fixed income? Why not take advantage of the market segment that is doing well? These are understandable questions and the best answer can be found by reading our position paper titled, "The Case for Passive Portfolio Management." It was recently updated and is posted on our website under **What's New**. But the short answer is: these cycles cannot be accurately timed; the future is unknown, and even though it may look a lot like the present, we can't discern the important details in advance. Without specifics, we can't make an intelligent transition to a safe or profitable option. Who knew that BP would create the worst oil spill in American history? Who knew that gold would quadruple in value after three decades of not even keeping up with inflation? It is said that the devil is in the details. Speculating about the details can ruin a long-term investment plan. Fortunately, an investor can make good use of the market without being able to predict the future.

We'll continue to work with each of our clients to ensure that their asset allocation is consistent with their long term goals. We remain confident that the market will continue to deliver a fair reward for the long term investor.

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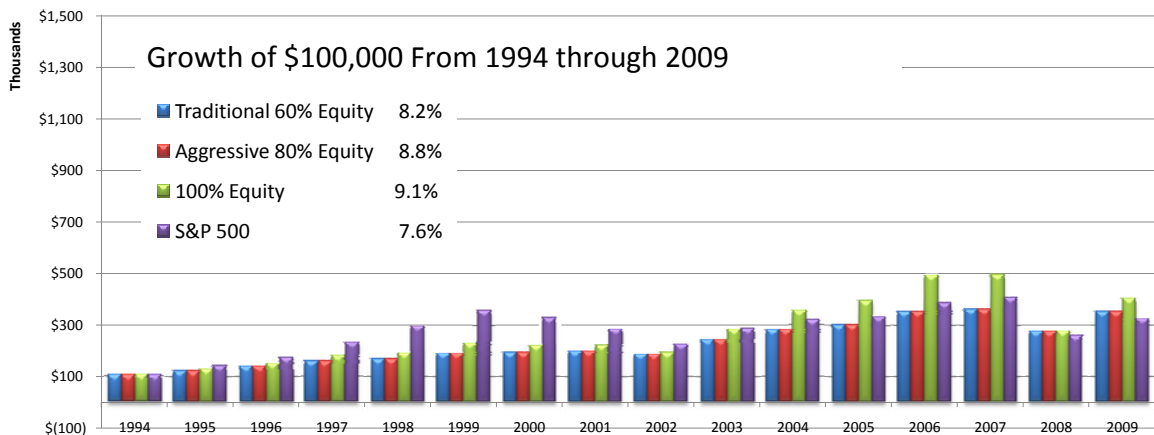
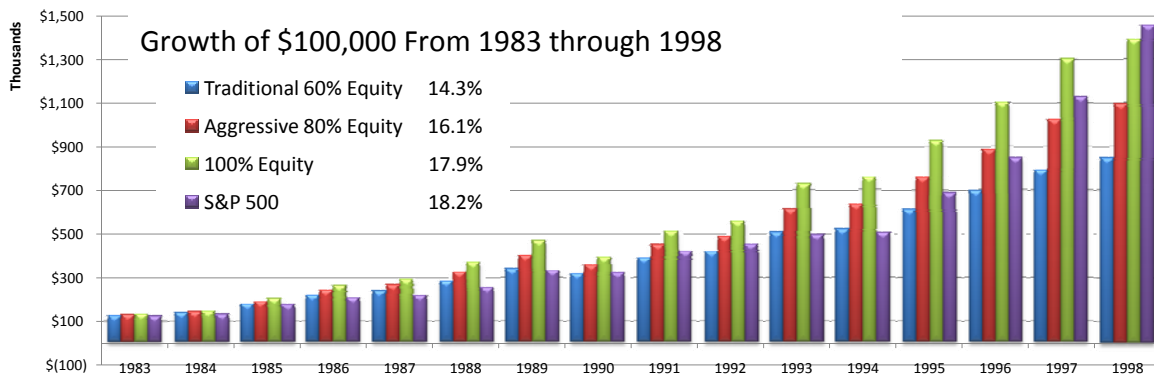
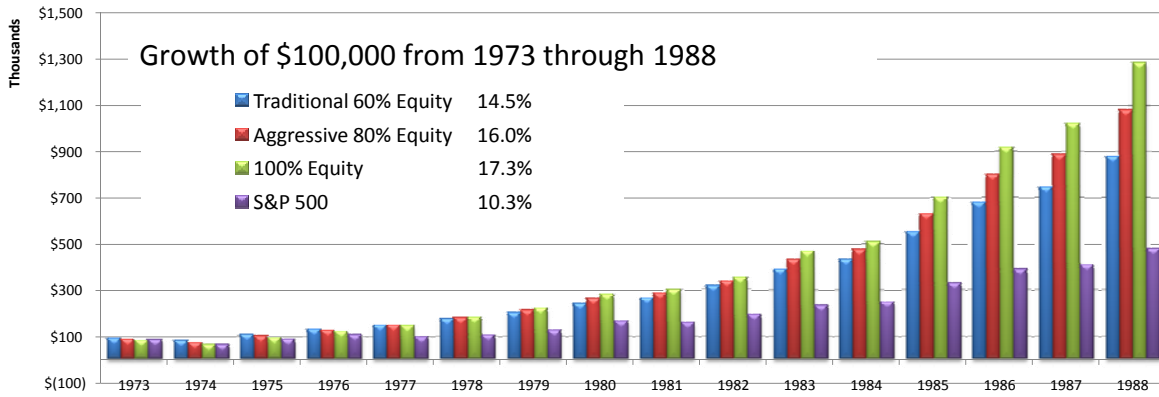
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Comparing Three Portfolios

Traditional 60%, Aggressive 80% and 100% Equity Allocations



See disclosure on composition of globally diversified portfolios

Comparing Three Portfolios

As of December 31, 2009	Traditional Portfolio	Aggressive Portfolio	All Equity Portfolio	S&P 500
EQUITY	60%	80%	100%	100%
US Stocks	42%	56%	70%	100%
Large Cap (S&P 500 Index)	12.0%	16.0%	20.0%	100.0%
Large Cap Value (Fama/French US Large Cap Value Index)	12.0%	16.0%	20.0%	0.0%
Small Cap (Fama/French US Small Cap Index)	6.0%	8.0%	10.0%	0.0%
Small Cap Value (Fama/French US Small Cap Value Index)	6.0%	8.0%	10.0%	0.0%
Real Estate Strategy (Dow Jones US Select REIT Index)	6.0%	8.0%	10.0%	0.0%
Non US Stocks	18%	24%	30%	0%
Value (Fama/French International Value Index)	6.0%	8.0%	10.0%	0.0%
Small Cap (International Small Cap Index)	3.0%	4.0%	5.0%	0.0%
Small Cap Value (International Small Cap Value Index)	3.0%	4.0%	5.0%	0.0%
Emerging Markets (MSCI Emerging Markets Index)	1.8%	2.4%	3.0%	0.0%
Emerging Markets Value (Fama/French Emerging Markets Value Index)	1.8%	2.4%	3.0%	0.0%
Emerging Markets Small Cap (Fama/French Emerging Markets Small Cap Index)	2.4%	3.2%	4.0%	0.0%
FIXED INCOME	40%	20%	0%	0%
One-Year (Merrill Lynch On-Year US Treasury Note Index)	10.0%	5.0%	0.0%	0.0%
Two-Year Global (CitiGroup World Government Bond Index 1-3 Years (Hedged))	10.0%	5.0%	0.0%	0.0%
Five-Year Government (Barclays Capital Treasury Bond Index 1-5 Years)	10.0%	5.0%	0.0%	0.0%
Five-Year Global (CitiGroup World Government Bond Index 1-5 Years (Hedged))	10.0%	5.0%	0.0%	0.0%

Real Estate Stocks weighting allocated evenly between US Small Cap and US Small Cap Value prior to January 1978 data inception.

International Value weighting allocated evenly between International Small Cap and MSCI EAFE Index (net dividends) prior to January 1975 data inception.

International Small Cap Value weighting allocated to International Small Cap prior to July 1981 data inception.

Emerging Markets weighting allocated evenly between International Small Cap and International Value prior to January 1988 data inception.

Two Year Global weighting allocated to One-Year prior to January 1990 data inception.

Five-Year Government weighting allocated to Barclays Capital US Government Bond Index Intermediate prior to January 1976 data inception.

Five-Year Global weighting allocated to Five-Year Government prior to January 1990 data inception.

For illustrative purposes only. The balanced strategies are not recommendations for an actual allocation. Indices are not available for direct investment; their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results.