

"THE MARKET IS MOST DANGEROUS WHEN IT LOOKS BEST; IT IS MOST INVITING WHEN IT LOOKS WORST."

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Recent headlines have trumpeted alarm about where the stock market is heading. Here in the U.S. and around the world, consumer sentiment is plunging. According to a February 26, 2008 Reuters article, consumer confidence is at a five-year low and expectations fell to a 17-year low, "fueling fears the economy was already in recession." Bloomberg News recently reported that consumer confidence in France is the lowest it's been since 1987 when the survey began. What's more, a recent survey by the American Association of Individual Investors revealed that at the beginning of 2008, only 19 percent of investors were bullish, the survey's lowest score since June 1993. To put that into perspective, investors were more bullish for the future of stocks in the aftermath of 9/11 and throughout the bear market of 2000-2003 than at the start of this year.

Everyone, it seems, has the stock market blues.

What's fascinating is that for the most part, people have perceived the last five years in the market as generally positive. Analyzing the past decade's returns in real terms tells an entirely different story, however. Unless the rest of 2008 and all of 2009 see huge returns to large stocks in the United States, we are on track to experience the *second worst returns for a decade since 1900!*

Here are the decade-by-decade real returns for large US stocks¹ since 1900, listed from best to worst:

Index	Real Compound Average Annual Return Large Stocks ¹
1950-1959	+16.78%
1990-1999	+14.84%
1920-1929	+14.37%
1980-1989	+11.85%
1900-1909	+9.32%
1960-1969	+5.15%
1940-1949	+3.57%
1930-1939	+2.04%
1970-1979	-1.41%
2000-2008 ²	-1.93%
	2nd worst real return in 108 years
1910-1919	-2.46%

Unless we see a massive turnaround through the end of this decade, U.S. stocks are headed for returns *worse* than those earned by investors during the Great Depression of the 1930s; the stagflation of the 1970s and the world wide market carnage inflicted by World War II during the 1940s.

What's the Bad News?

And those returns are for the average large-cap stock in the U.S., typical of those found in the S&P 500. If we look at where most investors *actually* had the lion's share of their equity assets at the start of the decade—mutual funds and separately managed accounts invested in large-cap growth stocks—the news gets *far worse*. Here's what the returns look like for the average large-cap growth stock³ from 1930 on:

Index	Real Compound Average Annual Return Large Growth Stocks ³
1990-1999	+16.89%
1950-1959	+15.05%
1980-1989	+9.79%
1960-1969	+5.28%
1930-1939	+3.67%
1940-1949	+1.82%
1970-1979	-3.67%
2000-2008 ²	-6.72%

To understand how bad things have been for the average large-cap growth portfolio, when you look at *all* 98-month holding periods (I use 98 months because that is the exact number of months so far this decade). The upshot? The 98-month period ending February 29, 2008 was the *worst* since the formation of the Russell indices in 1979. What's more, since 1927 there were only four other 98-month periods where large-cap growth stocks did worse!

These are historically dreadful results. In the year 2000, a typical investor had the majority of his or her assets in large-cap growth stocks. Let's assume that an investor had a portfolio worth \$100,000 on January 1, 2000. Had it all been invested in large-cap growth stocks with returns equal those of the Russell 1000 Growth index, at the end of February 2008 the portfolio would be worth just \$56,676 after inflation. For this hapless investor to just break even, the portfolio would have to go up more than 70 percent! In real terms, millions of people saw their portfolios slump by nearly 50 percent, putting on hold retirement, a better college choice for the kids and that much hoped for dream vacation.

The Importance of Asset Allocation

In my book *Predicting the Markets of Tomorrow*, I looked at three equity asset allocation portfolios: the first typical of many investors' 401(k) plans; the second my recommended conservative allocation and the third my recommended optimal asset allocation.

Let's start by looking at a typical generic 401(k) allocation:

- 50 percent large-cap core stocks (S&P 500 used as proxy)
- 40 percent large-cap growth stocks (Russell 1000[®] Growth used as proxy)
- 10 percent small-cap stocks (Ibbotson small stocks used as proxy)

Starting with \$100,000 in January of 2000, and rebalancing the portfolio annually, an investor in the typical 401(k) allocation would have seen his portfolio lose 2.90 percent per year and his original investment shrink to \$78,614 after inflation. Not great, but a heck of a lot better than someone who held all of their equity assets in large-cap growth stocks.

What about the other two allocations I recommended in my book? Here was my recommendation for a conservative allocation:

- 60 percent large-cap value stocks (Russell 1000[®] Value used as proxy)
- 25 percent small-cap stocks (Ibbotson small stocks used as proxy)
- 15 percent large-cap growth stocks (Russell 1000[®] Growth used as proxy)

Once again starting with \$100,000 in January, 2000 and rebalancing annually, an investor implementing the conservative allocation would have seen his portfolio *gain* 2.32 percent per year and his original \$100,000 grow to \$120,600 after inflation..

Finally, my optimal allocation would look like this:

- 50 percent large-cap value stocks (Russell 1000[®] Value used as proxy)
- 35 percent small-cap stocks (Ibbotson small stocks used as proxy)
- 15 percent large-cap growth stocks (Russell 1000[®] Growth used as proxy)

Using the same time frame and rebalancing annually, an investor in this allocation would have seen his portfolio grow to \$124,230, a gain of 2.69 percent per year after inflation.

(Continued on reverse.)

¹ For the period 1900-1929, we use the Dimson-Marsh-Staunton Global Returns Data. For the period 1930-2008, we use the Ibbotson Large Stocks data.

² For the period January 1, 2000-February 29, 2008.

³ For the period 1930-1979, we use the Fama-French Large Stocks Growth Index. For the period 1980-2008, we use the Russell 1000[®] Growth Index. The correlation between the Fama-French Growth Index and the Russell 1000 Growth Index is 0.98.

The Power of Disciplined Asset Allocation

Thus, if an investor diligently followed a simple asset allocation plan over the last eight years, he would have earned a reasonable return during one of the worst markets for equities in 110 years! If he simply took an hour on the first of every year to rebalance his portfolio back to its target allocation, he would manage to sidestep a market meltdown of epic proportions. Sounds simple and sensible, yet many investors have a nearly impossible time following this simple advice. We live in the full-blooded world of the here and now—headlines scream warnings at us; experts deliver endless advice on what is hot *right now* and we feel overwhelmed and either do nothing or take rash action at the worst possible time. Early research in the field of neuroeconomics indicates that even when we logically understand what we should do, our brain processes our choices through its emotional centers, negating the power of factual choice.

According to Jason Zweig's book *Your Money and Your Brain*, when forming predictions about the future we are predisposed to overweight our experiences of the present and recent past. Neuroscientists have isolated neurons in the brain which form incredible moving averages as a means of predicting future outcomes. Unfortunately for investors, the neurons tracking older experiences do not fire as powerfully. This research clarifies why Large Cap Growth stocks (and other investment fads) looked irresistible at the turn of the millennium: investors again relied too much on what the short-term market action and media were telling them. Incredibly, one study showed that the brain activity of an investor whose performance was soaring was nearly indistinguishable from someone high on cocaine or morphine!

Thus, we are fighting the basic chemistry of our brains when we attempt to suppress our emotional reactions to current market conditions. When we allow our emotions to guide our investment decisions, we will be worse off in the long run. Alternatively, if we listen to what ample historical market data tells us, we can improve performance and avoid the stressful highs and lows of short-term market movements.

The Ever-Present "Experts"

Yet even those investors armed with the data provided by behavioral economists and those studying the neurochemical reactions in investors' brains are ineluctably drawn to what the gurus and experts are saying *now*.

But when you look at the long-term results of these intuitive predictions, the results are appalling. According to Barton Biggs' book *Wealth, War and Wisdom*, there is ample evidence that so-called experts making intuitive forecasts are right *less than half the time* and "that they were worse than dart-throwing monkeys in forecasting outcomes when multiple probabilities were involved." And the study he was referring to did not use a small sample—it tracked 284 experts who made 82,361 forecasts over a period of years. Yet because of the way our brains are wired, we can't help but react emotionally, usually to our detriment. We don't judge the advice we are receiving critically, and we make little distinction between advice based upon decades of empirical evidence or simply somebody's current "gut" feelings. Our brains are wired to jumble them all together; rarely do we sort the experts' advice based upon the availability of proof or the absence thereof.

In his book *Expert Political Judgment*, Philip Tetlock says, "Human performance suffers because we are, deep down, deterministic thinkers with an aversion to probabilistic strategies that accept the inevitability of error." In other words, even though the rational thing to do is bet with the base rates and accept that we will not always be right, we are forever rejecting the long-term evidence in the face of the short-term hunch, even though the probability of being correct plummets.

The Good News—The Empirical Solution

We are approaching end of the first decade of the 21st century. As I've made abundantly clear, it has been one of the worst decades for stock returns in history. The question becomes, "Where do we go from here?" First, as we've seen from looking at the historical data, markets like those we've just lived through are historically rare, so there is much to be optimistic about moving forward. Generally, people become very bearish nearer a market bottom than a market top, so much of the bearishness might be signaling a market rebound over the intermediate term. Indeed, when we look at all the *other* 98-month periods where large stocks did this poorly in real terms, we see that they are dominated by years like 1937-38; 1974-75 and 1980-81, at or near major bear market lows.

Second, I passionately believe that investors who manage to short-circuit their underlying emotions by following a simple equity asset allocation plan with consistent discipline will vastly outperform those who are unable to do so, whatever the overall market environment. By letting the data of

108 years inform us—rather than listening to what a talking head is saying right now on the TV or internet—we can see the simple truth that using simple, straightforward and time-tested investment strategies leads to the best overall results in virtually all market environments. Look at the last eight years—historically among the worst in history—yet someone following a simple asset allocation scheme managed to *increase* the real value of their portfolio by 24 percent. That's no small feat. Imagine how well it will work in markets that are actually headed *up*.

Investors should keep in mind that there is no certainty that any investment or strategy will be profitable or successful in achieving investment objectives. Past performance is not an indication of future results.

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