Spring 2009

Investment Thoughts

This Issue

LESSONS FROM THE LOST DECADE IN STOCKS

By Christopher Davis

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I'm an avid beach-goer. I love to swim and play in Lake Michigan, pollution warnings or not. But how am I able to wade through a body of water whose average depth is 279 feet? (I'm tall but not *that* tall.) The answer, of course, is that the lake's depth varies widely, from mere inches at its most shallow to more than 900 feet at its deepest.

The stock market isn't much different. Over very long stretches, stocks, on average, have returned around 7% annually. (You used to hear investors cite average long-term returns of about 10% for the broad market, but the recent bear market has depressed that figure.) But in any given year--or even over several years--the stock market can diverge markedly from its long-term average. Throughout the prosperous 1990s, for instance, the S&P 500 Index rose 13% per year. No wonder S&P 500 Index funds were widely touted as can't-miss investments.

The past decade hasn't been so kind, however. Through March 2009, the S&P 500's annualized 10-year return was negative 3%. It's been a wild ride along the way, too. After soaring in the late 1990s, the index slumped more than 40% in the March 2000 to October 2002 bear market and then rallied steadily before faltering from late 2007 through early March 2009.

You certainly could've made more money investing in bonds. Barclays Capital Aggregate Bond Index (formerly Lehman Brothers Aggregate Index), the most widely followed bond market index, returned 5.7% over the past 10 years.

In a sense, it's been a lost decade for stock investors. But hidden in the relatively poor returns are some rich lessons for the future. Below are some of the most important.

Lesson One: The long haul may be longer than you think.

We always espouse the importance of thinking long term if you're a stock market investor. But if "long term" means five or even 10 years to you, it might not be long enough. Stocks may have earned around 7%-10% a year, but that's usually when measured over 20- or 30-year increments. Obviously, if you're younger and saving for your retirement, your time horizon is probably long enough to have most of your portfolio in stocks. (Given longer life expectancies, even the not-quite-as-young should have plenty of stock exposure, too.) But if your financial goals are short- or intermediate-term in nature, it's not a sure thing that you'll be better off in stocks than bonds.

Lesson Two: Diversification is your friend.

There's a saying that even in a bear market, there's always a bull market going on somewhere. Put another way, rarely is every stock going down at once (or at least at the same pace). As the large-cap-dominated S&P 500 was tanking in the early 2000s, for instance, small-value stocks rallied sharply—and kept going even after larger-cap

stocks recovered. And while most types of equities, commodities, and some bonds were way down during the recent bear market, government bonds came on strong. If your portfolio includes appropriate diversification across stocks and bonds, and within those asset classes you hold securities of varying investment styles, you don't have to figure out who the winners of the next bull market will be. You'll already own them.

Lesson Three: Dollar-cost averaging is your other friend.

It's true that you would've been better off putting money under your mattress than into the S&P 500 over the past decade. But most people usually don't put all the cash they'll ever have to work at once (or at least they shouldn't!). If you're investing through your employer's 401(k) plan, for example, you're probably putting money in the market every time you get a paycheck. In financial-planning parlance, the practice of making regular investments is known as dollar-cost averaging. Doing so helps protect you from overinvesting in boom markets (since stock prices are up, your regular investment amount will buy you fewer shares) and makes sure that you're buying more in downturns (when stock prices fall, your regular investment buys you more shares). If you've been dollar-cost averaging over the past decade, it's true that the money you invested in 1998 or 1999 may not have generated great returns. But if you were disciplined and kept investing throughout the 2000 to 2002 bear market, you bought in at cheaper prices and likely have enjoyed a much better return on those investments.

Lesson Four: Save more.

U.S. consumers have been saving less and less, instead letting the stock market (or their house) do all their heavy lifting. But clearly you can't always count on stocks or your house do the hard work. If your investments aren't growing, there's only one way that you can fill the gap, and that's to sock more money away yourself. Fortunately, you can make your money work harder by using tax-advantaged vehicles like a 401(k) or Roth IRA. Both allow you to compound your savings tax-free. In the case of a 401(k), your employer may match the contributions that you make, at least in part. Be sure to put at least enough to capture the full match. Otherwise, you're leaving free money on the table and missing an opportunity to build your savings with no effort on your part.

Lesson Five: Minimize expenses and taxes.

In the go-go late 1990s, many investors didn't care that much about costs. With the stock market rallying 20% or more every year, high expenses didn't matter as much. Take a fund with a 1% annual expense ratio, for example. If the stock market gains 20%, expenses eat up 5% of the stock market's total gain. But in a world of 4% gains--if you're lucky--expenses eat up 25%. While you can't control or predict what sort of returns the stock market will give you, you can control what portion of the stock market's returns will be left over after paying expenses.

As one of life's two unfortunate inevitabilities, taxes are tough to avoid altogether. But they eat into your returns just like expenses, so you want to keep them to a minimum.

Lesson Six: The past isn't always prologue.

After enjoying double-digit gains throughout much of the 1990s, investors came to expect fat returns as their birthright. As the last decade has demonstrated, though, you shouldn't necessarily extrapolate the past into the future. But just as it was a mistake to assume that the good times would keep on going in the 1990s, it's equally foolhardy to expect lackluster stock market returns to continue forever. In fact, the stock market has often gone on to post outsized gains after long periods of drought. The long boom of the 1980s and 1990s, for example, followed another lost decade between 1972 and 1982. The moral of the past 10 years isn't that you should give up on stocks. To the contrary, it's probably a better time to invest in stocks than anytime in years.

Chris and Greg's Take

Dear Clients,

If a number of Mr. Davis' words of wisdom strike you as familiar, or as something less than "ah-hah!" moments, it's probably because they are. The "lessons" to be learned aren't new, they are just forgotten by many investors when times are good and double-digit gains are easy to come by.

Leading a healthy financial life isn't all that different from maintaining one's physical health: there is a basic, straightforward plan that is proven to work. Want to lose weight? Monitor what you eat and get plenty of exercise. Want a pleasant visit to the dentist? Brush twice a day and floss regularly. Want to reach your financial goals? Start early, save and invest in a diversified portfolio. So why is it that so many people dread going to the dentist…?

The answer, of course, is the challenge in following through with the plan. When dieting, it's easier (and tastier) to give in to that ice cream craving, or to hit the snooze button instead of getting up to run. When budgeting, it's easier to enjoy today's desires and put off tomorrow's needs. And when investing, it is easier to give in to our fear or greed (whichever emotion is ruling the day). The problem is, in all three cases, the easy choice won't get you to your destination; only the hard one will.

If you look below, you'll find two different examples of investor's tendencies to forget the adage "buy low, sell high" and in fact do just the opposite. The chart "Flows to Equity Funds" illustrates that cash flows into stock investments tend to peak along with the market, and bottom (large outflows) as the market nears its lows. From November '08 until March '09 the equity markets saw record outflows; given this pattern, is it any surprise that since the lows on March 9th the markets have rallied as much as 40%? The second example is Morningstar's "Investor Return" statistic for a few mutual funds. This figure compares the actual annual performance of the fund over the past ten years to the return the typical investor has realized. As the numbers show, the market timing efforts of the fund's investors have hurt their ability to meet their goals, not helped.

It is our job to help you avoid these pitfalls. If Capital World Growth & Income makes 10% over the next ten years, we want you to participate 100% in that growth. If it is March 9th and you're considering pulling out of the market in your 401(k) investments, we want to know about it. We want to see the statements from your employer plan, your Wisconsin Retirement Service statements, and to know how much you'll need and when you will need it. Just as a doctor can only make an accurate diagnosis when he is aware of all of your symptoms and medical history, we can only implement a successful plan when we are aware of all of your resources and obligations. And just as a doctor wants to see you for regular checkups (not just when you're sick), we want to see you regularly. We promise not to harp about your not flossing too badly!

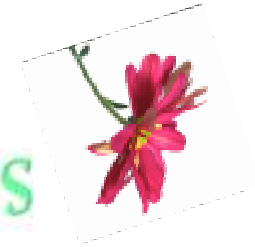
Sources: Investment Company Institute and Morgan Stanley Capital Management

Investor Returns vs. Total Returns

	CWGIX - Capital World G/I		NEWFX - New World		CAIBX - Capital Income Builder	
	Investor Returns	Total Return	Investor Returns	Total Return	Investor Returns	Total Return
Initial Investment	$10,000.00	$10,000.00	$10,000.00	$10,000.00	$10,000.00	$10,000.00
10-yr. Annualized Return	-1.60%	5.32%	-3.81%	5.05%	-1.45%	4.23%
Value after 10 years	**$8,510.42**	**$16,792.24**	**$6,781.09**	**$16,366.68**	**$8,641.05**	**$15,133.08**

Source: Morningstar, Inc.

**Past performance is not necessarily indicative of future results*



Spring Newsletter

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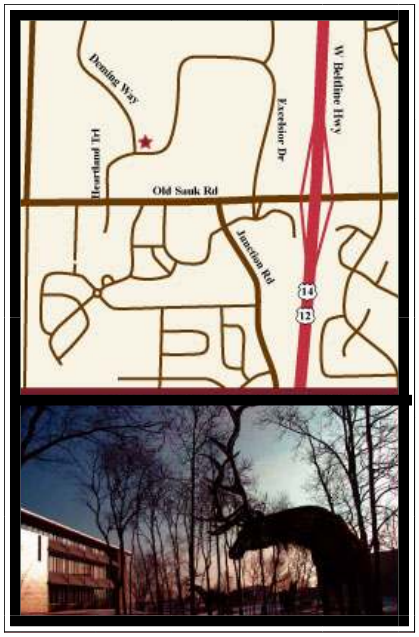

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