2010: A Truth Odyssey

By Ron Surz *Wed, Jan 12, 2011*

Each January, Ron Surz, president of PPCA Inc. and Target Date Solutions of San Clemente, California, unveils his proprietary interpretation of the prior year's market performance. We've publish a summary, with a link to the complete, chart-rich document.

As I rang in 2011, I found myself in awe of how quickly time had passed and how much things have changed. The 1968 movie "2001: A Space Odyssey" caught our fantasy as a journey into the distant future, yet here we are a decade beyond 2001 (and more than 40 years after the movie came out).

And who ever thought Dick Tracy's two-way audio-visual watch could exist outside a comic strip, or that 3-D color TV's would hang on walls like paintings? Transporters and holodecks can't be far behind.

The investment profession has also been on an odyssey: a quest for truth, spurred by the recent financial crisis. The truth was easier to grasp before investing became so complicated and challenging, with quantitative easing, bank failures, the mortgage crisis, etc. The recent lessons we've learned about excesses and fraud, especially those of 2008, have not yet been entirely digested, yet they should certainly not be forgotten.

So in this end-of-year commentary I review some of those lessons with an eye to the truth so we can benefit from them in the future. But before I bring us back to that painful 2008 and what has happened since, let's review the year 2010. I then discuss 2008's lessons, and conclude with my traditional review of the longer-term history of U.S. markets over the past 85 years, the longer odyssey.

U.S. stock market performance in 2010

We dodged a bullet in 2010. At mid-year it was looking like 2010 was going to be a big fat letdown, but the last half of the year brought a nice recovery. In the meantime, gold, a current hot topic, continued its upward progression throughout the year. Gold was less volatile than U.S. stocks.

Smaller companies returned in excess of 25%, with small-cap growth leading the way with a 33% return, while larger companies lagged with returns in the low teens. Large-cap value in particular returned 14%. It was primarily this concentration in large-value companies that caused the S&P (15%) to lag the total market (18%) in 2010.

- The total market (5000 stocks) returned 18%.
- The S&P500 lagged with a 15% return.
- Smaller companies were in favor, returning more than 20%, while large companies returned "only"13%.
- Materials and Consumer Discretionary companies performed best, earning 35% and 30% respectively.
- Health Care and Consumer Staples lagged with 6% and 9% returns.

Foreign stock market performance in 2010

Now let's turn our attention outside the US, where the total foreign market earned 17.5%, in line with the total US market's 18%, but the Europe Australia and Far East (EAFE) index substantially lagged the total foreign market, earning only 8%.

Small-to-mid ("Smid") cap value was in favor outside the US. However, unlike the S&P, stock selection within styles was poor. This is due to the country allocations of the EAFE. In other words, the EAFE suffered a double whammy: both style and country allocations were out of favor in 2010. The EAFE's large value orientation was out of favor, as was its overweight in Europe-ex-UK, and its absence from Latin America.

- The total market (20,000 stocks) earned 17.5%, more than doubling the EAFE (900 stocks) index's 8.2% return.
- Small-to-mid (Smid) value was in favor, earning 30%, while large companies returned 12%.
- Latin America and Emerging Markets led with 40% and 28% returns, respectively.
- Europe-ex-UK lagged with a 5% return.

Unlearned Lessons from 2008

2008 brought us two painful lessons: the Madoff crime (see Madoff Prescription) exposed our vulnerabilities to trusted bandits, and we suffered the free-fall in value of almost every asset type as the mortgage crisis snowballed into deleveraging around the world. Madoff should have led us to heightened due diligence, but it has not. The market crash has investors concerned about "Black Swans" and searching for new portfolio constructs.

- The Madoff Mess showed us that most due diligence is a big fat fake-out, including due diligence on traditional long-only managers.
- Portfolio structure could be improved upon. In particular, core-satellite investing would be much better with a centric core, that is neither value nor growth, rather than a blend core that combines value and growth.
- The average 2010 Target Date Fund (TDF) lost 25% in 2008, demonstrating that fiduciaries should take back control by setting investment objectives. So far, fiduciaries have abdicated this responsibility to fund companies, with the predictable outcome that TDFs are built for profit rather than the best interests of the participants.

The history of the US stock and bond markets, 1925-2010

- T-bills paid far less than inflation in 2010, earning 0.12% in a 1.21% inflationary environment. We paid the government to use their mattress.
- Bonds were more "efficient", delivering more returns per unit of risk, than stocks in the first 42 years, but they have been about as efficient in the most recent 43 years. The Sharpe ratio for bonds is .60 versus .38 for stocks in the first 42 years, but the Sharpe ratio for both is about the same in the more recent 43 years.
- The past decade has been the worst for stocks across the past eight consecutive 10-year periods.

- Average inflation in the past 43 years has been about three times that of the previous 42 years.
- Long-term high grade bonds fared very well in 2010.
- Of the last 85 years, on an inflation-adjusted basis, the market delivered positive returns in 58 calendar years and negative returns in 27, with an average annually compounded real return of 6.8%.