

# CAPITAL IDEAS

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## Lessons from 2004

**Overview:** Like most years, 2004 provided us with many reminders of the principles of the winning investment strategy. It was a good year for equity investors, especially those who believe in the benefits of diversification across multiple asset classes and global diversification. We find it significant that almost no one forecasted a bull market in 2004 — let alone the kind of returns that were experienced. At the same time, the market dealt with a surfeit of problems. The following is a brief recap via four investment lessons.

### 2004 in Review

We begin with a look back at some of the events that helped shape the financial landscape of 2004. Recall that investors were faced not only with the repercussions of the ongoing situation in Iraq and escalating problems in the Middle East, but also with issues related to the federal budget deficit and a record trade deficit. The markets also began to focus on the Social Security and Medicare deficits, which together have been estimated to be as high as \$60 trillion. And the Federal Reserve adjusted interest rates several times throughout the year.

With rates at the lowest levels seen in five decades, there was only one way for them to go, and that was up. The conventional wisdom is that rising rates are bad for the stock market. The Fed raised its discount rate five times, and yet the market rose by slightly more than 10 percent (the market's long-term historic annualized rate). In spite of the Fed raising short-term rates five times, long-term bond rates ended the year about where they started — another surprise to most investors. In addition to all of these events, oil prices rose to over \$50 per barrel, most other commodity prices rose sharply as well (including gold) and the U.S. dollar fell sharply in value relative to the currencies of most of our major trading partners.

Market valuations (at least in the U.S.) began the year at levels that had most financial economists forecasting long-term returns in the neighborhood of 6 to 7 percent, well below the market's long-term historic annualized return. Moreover, this was considered an optimist's forecast because it assumed that P/E ratios, which began the year at very high levels from a historic perspective, would not revert to their historic mean of approximately 15. Some forecasts predicted a severe short-term reversion to the historic mean that would have very negative consequences for the market. In retrospect, the market overcame all of these obstacles. The economy grew at a relatively rapid pace throughout the year and, as is typical during economic rebounds, corporate profits grew rapidly as well.

### **Lesson 1: Investing in Individual Stocks is Speculating Not Investing**

There are two types of financial risk: risks that can be diversified away and those that cannot. Among the risks that can be diversified away are those of investing in the stocks of individual companies and investing in companies in the same industry (sector funds). Research has indicated that investors are not compensated for taking such risks because they can be diversified away. Although the expected returns are no greater than investments in an entire asset class, such investments have greater risks because assets are concentrated in just one or a few securities.

Investors who invested in such companies as Merck and Marsh & McLennan learned this lesson the hard way — buying individual stocks has more to do with speculating than investing. Both stocks finished the year with losses of about 30 percent (excluding dividends). In addition, both were more than 50 percent below their all-time highs reached in 2000. Just think how many employees of formerly great companies have lost the vast majority of their net worth because they believed they knew how safe their own companies were, and that there was no need to diversify. This group includes employees and senior officers laid off just as the stock price (and their net worth) collapsed. Individuals who have their intellectual capital and financial assets in the same basket are playing a game of “double jeopardy.” Again, diversification of risk is the guiding principle for prudent investors.

### **Lesson 2: Diversification Is the Prudent Approach (and International Investing is an Important Part of the Strategy)**

One of the greatest mistakes that investors can make is to confuse the familiar with the safe, which can lead to recency (extrapolating the recent past indefinitely into the future as if it is preordained). The 1990s saw U.S. stocks far outperform international equities; the reverse was true in the previous two decades. The outperformance of domestic stocks (combined with a home country bias) led many investors to question the need for investing internationally. Those investors with the discipline to avoid this common mistake were rewarded, as 2004 was the third consecutive year that the S&P 500 Index significantly underperformed international stocks. See the table below:

<b>Annual Returns for the S&amp;P 500 Index vs. the MSCI EAFE Index* for 2002, 2003, 2004 and the Period 2002-2004</b>				
<b>Fund</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2002-2004</b>
S&P 500 Index	-22.1	28.7	10.9	3.6
MSCI EAFE Index	-15.6	39.2	20.7	12.3

\*MSCI EAFE Index = Morgan Stanley Capital International Europe Australasia Far East Index.

### **Lesson 3: Currency Risk Is a Two-Way Street**

Unfortunately, many investors avoid international equities because they entail currency risk.<sup>1</sup> Many assume incorrectly that currency risk is a one-way street — with foreign currencies falling in value against the U.S. dollar, negatively impacting returns. Instead, it is a two-way street because the dollar can fall in value against foreign currencies with a resulting positive impact on returns.

Owning assets denominated in a foreign currency (if the currency risk is not hedged) also reduces the correlation of returns between foreign and U.S. stocks, providing an important diversification benefit. As noted earlier, the U.S. dollar fell sharply in value in 2004. For example, it fell approximately 7.6 percent against the Euro. This fall in value had a very positive impact on the returns of international equities.

#### **Lesson 4: A High Percentage of Equity Return Often Comes in a Very Short Period**

The S&P 500 Index hit a low for the year on August 12, when it was down more than 4 percent from the beginning of the year. Few people anticipated the powerful year-end rally in stocks that made the full year numbers look so respectable. Author Charles Ellis said: “As in hunting deer or fishing ... investors have learned the importance of 'being there' and using patient persistence — so they are there when opportunity knocks.”<sup>2</sup>

#### **Conclusion**

Like most years, 2004 provided many real-life examples that illustrate why one of the main principles of a winning investment strategy is building and steadfastly maintaining a globally diversified portfolio, which reflects an investor’s unique ability, willingness, and need to take risk. Investors can formalize that plan by creating an Investment Policy Statement, including a schedule for regular rebalancing — and then take the important step of adhering to that plan. If investors ignore the noise of the market (and do not give in to the emotions such noise can inspire), they will be well prepared to face the coming years.

<sup>1</sup> Currency risk refers to the currencies of emerging markets countries, which are often highly volatile, contributing to the high volatility of returns of the asset class in U.S. dollar terms.

<sup>2</sup> Peter Bernstein (editor), *Portable MBA in Investment*, John Wiley & Sons, 1995.

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