the siena INVESTOR

Winter 2013

Lessons From 2012

Overview: Each year, author Larry Swedroe, director of research for the BAM ALLIANCE, takes a look back at the investing lessons the markets provided in the past year.

Introduction
Over the majority of 2012, our collective attention was focused on several events:

- Our continuing fiscal deficits and our ability to continue to fund them
- What would happen regarding the fiscal cliff
- Who would win the presidential election
- The increased possibility of rapid inflation caused by the fiscal and monetary stimulus
- The European fiscal crisis and the potential for sovereign defaults and the breakup of the Eurozone
- Rapidly slowing growth in China and other developing nations

Together, these events made for a worrisome year. But the dire outcomes predicted throughout the year didn't occur. The following are the big lessons that came from this year's events and, in many cases, non-events.

Lesson 1: Make Sure Your Investment Plan Incorporates the Virtual Certainty That Crises Will Occur and Will Do So With Great Frequency
There are some things we know and some things we don't know. We know that emotions created by crises can cause us to lose perspective — like forgetting that fairly regular crises are actually the norm. We cannot know what form crises will take, when they will occur, how deep they will be or how long they will last. However, we do know they will occur.

Therefore, you must be sure to avoid taking more risk than you have the ability, willingness and need to take. If you do not, you are likely to allow emotions such as fear and panic and the noise of the markets to cause you to abandon your plan. And, once you sell, there is never a green light that will let you know that it is once again safe to invest.

Lesson 2: Practice Stage-Two Thinking
Some investors see a crisis and the risks, but they cannot see beyond that. This type of stage-one thinking leads to sales of assets as investors assume the bad news means prices are surely going lower. They assume the only light at the end of the tunnel is a truck

coming the other way. The result: Sales occur after prices have already fallen, reflecting the bad news. Those sales occur when prices are low and expected returns are high (reflecting the high perception of risk).

On the other hand, stage-two thinking involves seeing beyond the crisis. For example, while there is no certainty, we should expect that a crisis would lead governments and central banks to come up with solutions to try to address the problem. If the crisis worsens, they would be more likely to act with urgency and scale. We saw this in the remaining days of 2012 as Congress dealt with and averted the fiscal cliff.

We also saw this take place in Europe. Over the past two years, Europe has been caught in the eye of a financial storm. In 2011, European equities experienced sharp losses and bond yields on sovereign debts soared as credit ratings were slashed.

In response to the crisis, European governments and the European Central Bank took action —slashing budgets, cutting rates and implementing bond-buying programs. When the first actions were not sufficient, they took further ones and that continued throughout the year. (Note that these actions were a virtual replay of actions taken by the Federal Reserve during our fiscal crisis.) Despite the fact that there is still no clear resolution, European equities fared well in 2012. For example, from January 1, 2012 through December 31, 2012, the MSCI Europe Index had a total return of 19.1 percent.

Stage-two thinking allows one to see that the light at the end of the tunnel might not be a truck coming the other way. Instead, it might be actions to resolve the crisis.

Lesson 3: Last Year's Winners Are Just as Likely To Be This Year's Dogs as to Repeat
The historical evidence demonstrates individual investors are performance chasers — they watch yesterday's winners and then buy (*after* their great performance) and watch yesterday's losers and then sell (*after* the loss has already been incurred). This causes investors to buy high and sell low — not exactly a recipe for investment success. This behavior is consistent with findings that investors actually underperform the very mutual funds they invest in by significant margins.

Using Dimensional Fund Advisors' passive asset class funds, the following table compares the returns of various asset classes in 2011 and 2012. Sometimes, the winners of 2011 repeated, but other times, they became losers. For example, the top two performers among asset classes in 2011 finished 11th and 13th in 2012 of the 14 funds shown.

Fund	2011 (Rank)	2012 (Rank)
DFA Real Estate	**9.0 (1)**	**17.5 (11)**
DFA U.S. Large (S&P 500)	**2.1 (2)**	**15.8 (13)**
DFA U.S. Large Value	–3.1 (3)	22.2 (4)
DFA U.S. Small	–3.1 (4)	18.4 (9)
DFA U.S. Small Value	–7.5 (5)	21.7 (5)
DFA International Real Estate	–7.8 (6)	33.4 (1)
DFA Commodity Strategy	–12.1 (7)	1.3 (14)
DFA International Large	–12.3 (8)	17.7 (10)
DFA International Small	–15.3 (9)	18.9 (8)
DFA International Value	–16.7 (10)	16.8 (12)
DFA Emerging Markets	–17.4 (11)	19.2 (7)

DFA International Small Value	–17.5 (12)	22.3 (3)
DFA Emerging Markets Small	–22.6 (13)	24.4 (2)
DFA Emerging Markets Value	–25.6 (14)	19.4 (6)

While there are streaks in asset class returns, they occur randomly relative to expectations. The streaks have no more meaning than streaks at the craps table — a good (poor) return in one year does not predict a good (poor) return the next year.

In fact, great returns lower future expected returns and below-average returns raise future expected returns. Thus, the prudent strategy for investors is to act like a postage stamp. The postage stamp does only one thing, but it does it exceedingly well — it adheres to its letter until it reaches its destination. Similarly, investors should adhere to their investment plan (asset allocation).

Adhering to one's plan does not mean just buying and holding. It means buying, holding and rebalancing — the process of restoring your portfolio's asset allocation to the plan's targeted levels.

Lesson 4: Hedge Funds Are Compensation Schemes, Not Investment Vehicles
Yet again, 2012 was another year that demonstrated that hedge funds have more in common with compensation schemes than prudent investment vehicles. For the year, the HRFX Global Hedge Fund Index returned 3.5 percent. It underperformed all the major domestic equity and international asset classes by at least 11 percent, though, by small margins, it did outperform short-term (3.3 percent), intermediate-term (2.9 percent) and long-term U.S. Treasuries (0.2 percent).

Hedge funds often tout the freedom to move across asset classes as their big advantage, so one would expect that "advantage" to show up. The problem is that the efficiency of the market, as well as the costs of the efforts, changes that supposed advantage into a handicap.

Lesson 5: The Economy and the Stock Market Are Very Different
It was a very nervous year for most investors. The Eurozone crisis was threatening in headlines the entire year. The U.S. unemployment rate stayed high. The fiscal cliff went right down to the wire. But the market responded positively, in part because these outcomes were better than expected. This is separate from the economic reality of these events. For example, although the unemployment figure was lower than expected, millions of people remain unemployed.

For another example, we turn again to Europe. The outlook for Europe was that it would be in a severe recession and the Greek default would lead to other defaults.

While Europe is in a recession, it's not a severe recession, except for Greece and, to a lesser extent, Spain. Growth of Europe's economy has slowed, but it was nowhere near as bad an outcome as expected because the governments got together to address the problem and provided lending support to Greece. They forced Greece to raise taxes and cut spending. And, central banks have been taking steps to solve the banking crisis. They're providing liquidity support just like the Fed did. That's stage-two thinking in action. And the markets responded positively.

Greece didn't leave the Euro. It didn't spill over: Spain and Portugal and Italy were not forced to leave the Eurozone. There weren't big defaults besides Greece. That was a big deal. And the markets responded positively with interest rates on European government debt falling sharply because the news was better than expected.

So, even with all this bad news, this was a remarkably good year for stocks. But many investors ended up missing out. We know this because again in 2012 money flowed out of U.S. equity mutual funds, continuing a trend of outflows from domestic stocks in the hundreds of billions since 2008.

Conclusion

Perhaps the most notable lesson this year would be that it's wise to ignore economic and market forecasters, the noise of the market and the emotions that noise can cause. With the time you'll get back, you'll have more time to spend on the truly important things in your life.

siena™
WEALTH • ADVISORS
seeking your success

Siena Wealth Advisors
209 South Bridge Street
Grand Ledge, MI 48837
517-627-1412 Tel
517-627-5575 Fax
sienainvestor.com
A fee-only independent advisor