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Investment Update

THE MUNCY BANK & TRUST COMPANY

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Points of interest:

- The U.S. stock market dropped by 37 percent last year. International stocks fell even harder.
- Stodgy long-term government bonds beat stocks over the last 10 and 20 years.
- A diversified stock and bond portfolio, however, beat the market as well, gaining 6.5 percent annually over 10 years.

Did the 2008 Bear Market Put an End to Diversified Portfolios?

The bear market of 2008 has raised some serious questions: Do stocks really outperform bonds in the long-term? Is asset allocation dead?

The Standard & Poor's 500 Index fell 37 percent in 2008, and other groups of stocks, especially foreign stocks, fell even more.

The 2008 bear market came just five years after the end of another bear market early in the decade. The two events pushed stock market returns well below average. The S&P 500 Stocks index, for instance, lost an average of 0.2 percent per year over the past 10 years.

Meanwhile, long-term government bonds gained 8.0 percent per year in the same period, well over their historic average of 5.5 percent per year going back to 1926.

Bonds even beat stocks over the last 20 years, gaining 8.8 percent per year, while stocks gained 8.0 percent per year.

A portfolio solely consisting of high grade bonds did better than the stock market over the last 10 years.

Diversification dead?

Meanwhile, some investment experts say asset allocation is dead, because it didn't protect diversified portfolio owners from loss in 2008, when nearly every asset class except for cash and short-term Treasury securities fell in value.

Does this mean the long-accepted wisdom that you should have a portfolio diversified among different asset classes— including bonds, stocks, and cash—no longer works?

Don't give up yet, because even last year a well diversified portfolio went down less than the stock market did. Yes, it declined, but this was no surprise: asset allocation advocates have always said that it is possible for pretty much everything to move in lockstep for a short time during a panic or a mania.

However, the diversified portfolio did offer some protection. Consider a balanced portfolio of 60 percent stocks, spread among large and small stocks both foreign and domestic, and 40 percent among various short term bonds. It lost only 24 percent in 2008 compared to the market's 37 percent loss, according to Dimensional Fund Advisors, an institutional mutual fund company.

Long term results

In the longer term, however, the diversified portfolio did well. The sample DFA portfolio has returned 6.5 percent annually in the ten years through September, compared to a loss of 0.2 percent on the S&P 500.

That return beat the re-

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DON'T EXPECT MORE THAN THE CURRENT YIELD FROM BONDS

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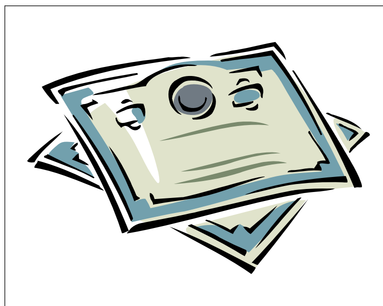
turns of cash and medium-term government bonds, and was over twice the rate of consumer inflation. Long-term government bonds still beat the diversified portfolio by about 1 percentage point per year.

Yield is all you get

Those who tout the higher long-term returns of bonds over the last 20 years may not see those returns repeat over the next 20.

The old saying in the bond market is that you "earn your yield," in other words, the yield on a new bond is about all you can expect to earn during its lifetime. Twenty years ago yields were much higher. Since then, interest rates have fallen, creating capital gains for older bonds and contributing to their good returns.



Bond owners may get modest returns.

Today the yield on a 30-year Treasury bond is a little over 4 percent, not 8 percent as it was 20 years ago.

Since no one can predict the next year or 10 years, it still seems wise to maintain a mix of stocks and bonds so that you can benefit from either asset when they rise.

STOCK MARKET TIPS FROM 1926 STILL STAND

The lessons of Wall Street rarely change. What does change are the memories of investors, which are notoriously short-term and seem to easily discard sound advice when a market mania takes hold.

Investors trying to make their way through the stock market's thickets today could find much of what they need to know from "How to Make Money in Wall Street" by George Frederick, a 50-page pamphlet published by Little Blue Books in 1926.

It's not easy

Despite the convenience of online trading, instant stock quotes, and cheap commissions, investors today need to remember that individual stock investing isn't easy.

Buying and selling individual stocks requires personal qualities that include "courage, coolness, caution, judgment." It is not a business designed for "people of very small means or lack of analytical powers," Frederick wrote in 1926.

Investors won't get ahead by heeding easily-available tips, whether from brokers in 1926 or talking heads on MSNBC in 2009:

"Tips and advice are worthless in exact proportion to their wide scattering," he wrote. In addition, "Tips, if valuable, are usually stale when they reach the ordinary trader or the public."

Wall Street investors in 1926 got good advice on stock trading that is just as valuable for investors who buy stocks in 2009.

This advice predates the academic research which demonstrates that the market is information-efficient, meaning that any publicly available information is probably already processed into current prices.

Brokers, Frederick reminded his readers, are not market geniuses: "If he was so extremely able a trader he would not be a broker." In other words, he would be off making his own millions through investing.

Buy at the bottoms

The same crowd psychology that worked through the bear market last year was in force back in 1926. Greed and fear are nothing new, and Frederick reminds us that we can use them to our advantage. "The time to beware is when there is a peak of optimism, and the time to open your purse is when everybody is imbued with pessimism."

Indeed, that held true this year: the current market upswing began back in March, even as investors were fleeing the market in droves in the face of dire headlines.

"Tips and advice are worthless in exact proportion to their wide scattering."

Falling prices and low rates do not signal inflation resurgence

One of the two prevailing public fears about the economy's near term centers on inflation.

Commentators on television, the Internet, and in print warn that inflation is due for a big jump due to the massive government spending done to rescue failing financial institutions and to jump start the economy.

Add to that the Federal Reserve's decision to open the money spigot to counteract the tight credit conditions of 2008, and the recipe for an inflationary disaster is here, the inflation hawks say.

Where's the problem?

And yet, nothing seems to indicate inflation is on the way.

In fact, inflation has been falling over the past year at an annualized rate of about 1.3 percent, according to the latest reading on Consumer Price Inflation in September. The inflation rate has fallen in each of the last seven monthly readings.

Also, there are plenty of signs that the economy has a large amount of slack. Much manufacturing capacity is not being used, and unemployment is very high, meaning that wage pressures are non-existent.

Inflation fears abound, but there doesn't seem to be any inflation on the horizon.

The government is borrowing more in order to pump money into the economy, but that borrowing is being offset by lower borrowing on behalf of consumers and corporations. That means the government's borrowing is not creating competition for capital nor is it forcing interest rates up.

Pros aren't worried

There is also evidence that professional investors—those who presumably have the most informed outlook—are not worried about inflation.

The prices of inflation-indexed U.S. Treasuries remain low, and the rates on long-term Treasury bond yields stand at about 3 percent for 10-year bonds and 4 percent for 30-year bonds. Bond investors would not be buying 30-year bonds at a fixed rate of 4 percent if they foresaw rampant inflation.

At some point the Federal Reserve will have to tap on the brakes and start raising interest rates in order to prevent inflation from returning once the economy picks up.

At this point, however, inflation fears may be misplaced and interest rates should be expected to remain at moderate levels.

"In fact, inflation has been falling over the past year at an annualized rate of about 1.3 percent."

Sin stocks, loyal 401k savers, & more

"Sin" stocks that represent tobacco, alcohol, and gaming companies offer market-beating returns, a new study concludes.

Marcin Kacperczyk of New York University and Harrison Hong of Princeton say sin stocks outperformed by 2.5 percentage points annually from 1926 through 2006.

They say it appears that societal norms—which force pension funds and other investors to avoid these stocks—forces the stocks to offer higher returns in order to attract capital.

Sticking with 401k plans

American workers have remained committed to their 401k plans despite the financial upheaval of 2008, the Investment Company Institute says.

The mutual fund trade group says its latest statistics show only a slight increase in savers who ended their contributions during the first half of 2009.

Only 1.8 percent of participants took withdrawals from their plans during the first half of the year, while 7.7 percent changed their investment allocations, the Institute said.

Retirement worries

A majority of working Americans fear they will not have enough money to live comfortably once they retire, found the latest Gallup survey on the economy and personal finance.

Fifty-two percent said they fear they will not have enough saved for a comfortable retirement. In addition, only 30 percent believe they will be able to rely on Social Security.

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THE BEST TIME TO INVEST COMES AFTER BIG ECONOMIC RECESSIONS

The easy money in the stock market comes in the first two to three years after a recession ends.

During the 10 recessions preceding the one that began in December 2007, the U.S. stock market on average was up 33 percent a year after the economy bottomed. Within three years the market was up an average of 59 percent.

Those figures were compiled by Tweedy, Browne Co., manager of three value stock mutual funds, based on data from the National Bureau of Economic Research and Standard & Poor's.

The figures show that investors who try to buy into a market at the low point need impeccable timing: much of the gains after a recession come within the first year after the low point.

Don't cry when the stock market is deeply depressed; instead, open up your wallet and buy.

For instance, after the recession that ended Dec. 31, 1970, the market gained 44 percent in the first 12 months. The market's gain was 60 percent in two years.

The biggest gains historically came after the biggest recessions. After the dismal recession of 1981-82 the market was up by 58 percent 12 months later and 83 percent three years later.

Likewise, a year after the recession of 1973-74, which rivals today's recession and recent bear market, stocks gained 38% and were up 67% in two years.

Many economists speculate that the recent recession has already ended. However, it may be some time until the National Bureau of Economic Research determines the end date.

In the meantime, the S&P 500 Index in late October was up 58 percent from its low point on March 9.

Tweedy, Browne's managers warn that investors can't wait until the end of a recession is officially determined. "There is no starting gun signaling the beginning of the next bull market," they wrote in April. "It has been our experience that the low hanging fruit gets picked early and fast."

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