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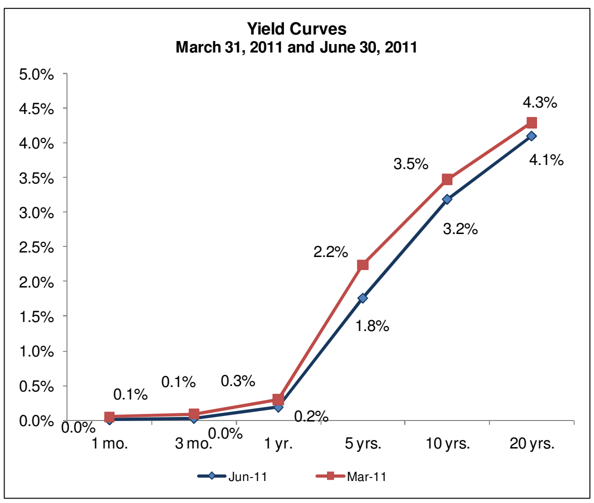
Capital Market Perspectives

JULY 2011

Capital Market Activity

Bond Markets

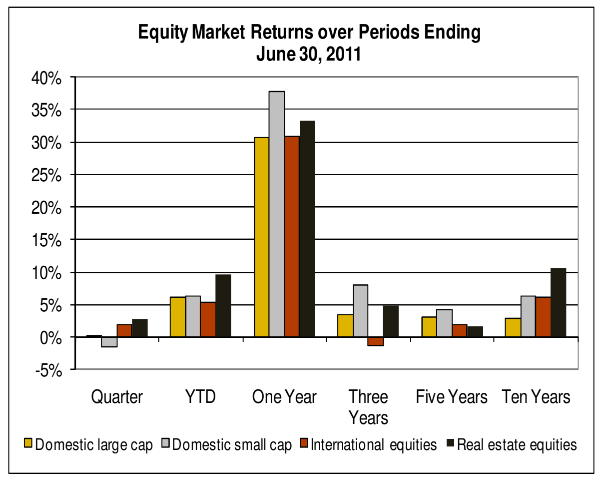
Even in the face of the wrangling over the debt ceiling and deficits as far as the eye can see, yields on U.S. Treasury securities fell slightly over the past quarter as shown in the Yield Curve graph below. As yields fall, bond prices and returns are higher; this helps to explain the positive bond returns over the most recent quarter.



The Federal Reserve System (FED) continues to be a major factor in bond markets with its quantitative easing program (QE2) under which it is buying significant amounts of bonds in an effort to keep interest rates low and to help spur on the domestic economy. The FED has recently discontinued this program and seems to indicate that it will not be renewed in the near future. We'll see what the impact is of this well-publicized change on yields over the next few months.

Equity Markets

Equity market returns over the June quarter were mixed with the domestic large cap markets (S&P 500) flat, international equities and real estate markets (MSCI EAFE and Dow Jones Real Estate Index) up slightly and domestic small cap (Russell 2000) down. Trailing 12-month returns are significantly above historical averages. Yet, even with these results, returns over other periods are generally below their long-term averages. These results are presented in the chart below:



A common stock represents ownership in productive activities and its price reflects the present value of these future activities. The expected return to its shareholders is the firm's cost of capital. This expected return is always positive (no one would buy a stock expecting to lose money) and reflects the compensation for the risks of the firm's activities. If there were no surprises as the future unfolds, the shareholders would earn the expected return. However, there are always surprises. These surprises occur due to what's going on in the particular company as well as what's happening in the overall global economy. When you bring a lot of stocks together in a broadly diversified portfolio, the impact of company-specific surprises tends to go away and we are left with uncertainty about the overall economic factors that explain short-term results.

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Dealing with Uncertainty by Engaging Active Managers to Predict Surprises — the Record

Surprises in the economy create much of the volatility in the market to which we have become accustomed. By hiring an active investment manager, the goal is to profit from this volatility in order to “beat” the market. The following study, published by Standard & Poor’s titled “The S&P Persistence Scorecard: Does Past Performance Really Matter”, examines the ability of managers to use their “skill” to outperform the market on a consistent basis.

The latest study, published in June 2011, breaks down the domestic stock market into asset classes and tracks top performing mutual funds over various time periods. An excerpt is presented below.

Note in the following table that very few funds consistently remained in the top 50% over the five year period from April 2006 to the end of March 2011. For example, look at the mid-cap category; of the 176 outperforming funds at the period ending March 2007, there are just 68 that remained in the top 50% at the end of March 2009, and only 4 that were still in that category by the end March 2011. This overall trend is consistent over other time periods. Clearly, the odds of picking these 4 funds out of the 176 funds in the top 50% are long indeed. One criticism of this study is that it tracks funds and not the managers. There is a possibility that the same managers consistently outperform, but move to different firms. If this were the case (highly unlikely) it would pose a difficult scenario for an investor wanting to follow their favorite managers. When investors move, they may be subjected to increased costs through associated sales charges and various tax implications.

Active managers have not exhibited a successful track record in being able to consistently beat the market and there is no reason to believe this trend will reverse itself. Therefore, the best way to deal with market uncertainty is to forego the added costs of active management, as well as the long odds of identifying top managers in advance, and instead, hold a well-diversified, low-cost portfolio with a regular rebalancing strategy.♦

Performance Persistence over Five Consecutive 12-Month Periods *

Mutual Fund Category	Funds in Top 50% from Prior Year	Funds Remaining in Top 50% in Performance			
	Mar-07	Mar-08	Mar-09	Mar-10	Mar-11
All Domestic Funds	1025	735	416	106	32
Large-Cap Funds	313	180	102	26	6
Mid-Cap Funds	176	122	68	10	4
Small-Cap Funds	232	228	148	48	12
Multi-Cap Funds	304	204	98	22	10

* Source: Standard & Poor's Persistance Scorecard June 2011

Dealing with Uncertainty – Studies of the Efficacy of Individual's Decisions

This article looks at data on the performance of individuals to anticipate surprises. A recent Dow Jones investor study found that 41% of investors are managing their own investments through online or discount brokerage firms. Included in this 41% are investors that have some of their assets managed by a professional, yet maintaining a portion of their assets themselves.

An investment research firm, Dalbar Inc., recently published their 2011 Quantitative Analysis of Investor Behavior (QAIB). This report measures the effects on investment returns caused by individual investment decisions. It looks at average returns from equity, fixed income, and asset allocation mutual funds over several periods and compares the results to the S&P 500, an index that represents the prices of 500 U.S. large-cap common stocks, and the Barclays Aggregate Bond Index that represents investment grade bonds traded in domestic markets. These benchmarks are a proxy for a simple "buy and hold" strategy.

The results of the Dalbar study are presented in the table below. Note that for the 1-year period the average equity investor underperformed its benchmark by 1.5%.

You can also see that over the 20-year period, the average equity investor fell short by 5.3% when compared to the S&P 500. While individual investors generally underperform the benchmarks over all periods reported, the results can be distorted by the timing of when individual investors enter the market. One reason for the distortion is that the Dalbar study measures "dollar-weighted" returns while the benchmark reflects "time-weighted" returns. A dollar-weighted return is impacted by the timing of the investment. You will notice that the 10-year results for the average equity investor stand out. Over this period, in contrast with other periods, Dalbar reports that the average equity investor earned slightly more than the S&P 500 benchmark. This result is explained to some extent by the low market returns at the beginning of the period when the average investor did not have as many dollars invested versus the end of the ten years when the average investor had more dollars to earn greater returns.

While the results of the Dalbar study may not be completely attributable to individual investors' timing decisions, it does show generally consistent underperformance. With the ongoing media coverage of short-term economic activity, it is not surprising that individual investors that lack long-term discipline generally end up buying and selling at just the wrong time and fail to match the results of market benchmarks. ♦

Annualized Investor Returns by Fund Type vs. Benchmark

	20-year	10-year	5-year	3-year	1-year
Equity	3.83%	1.55%	1.61%	-4.21%	13.60%
Fixed Income	1.01%	0.77%	0.86%	0.33%	2.99%
Asset Allocation	2.56%	1.31%	0.96%	-2.27%	9.34%
S&P 500	9.14%	1.41%	2.29%	-2.86%	15.06%
Barclays Agg. Bond Index	6.89%	5.84%	5.80%	5.90%	6.54%
Inflation	2.57%	2.48%	2.46%	1.86%	1.48%

All data thru year end 12/31/10

Source: DALBAR, Inc. 2011 QAIB

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Surprises can be either good or bad and how they unfold explains the short-term volatility of prices and returns in equity markets. I think it is uncertainty about some of the following that explains today's volatility in equity markets:

- the pace of growth of our domestic economy
- the debt crisis in several European countries
- our government's resolution of its tax and spending policies
- the long-term impact of budget deficits on economic activity

I am sure you can think of others. Surprises, by definition, cannot be predicted. Understanding that dissimilar markets react differently to surprises, we are convinced that the best way to deal with this uncertainty is to hold a well-diversified portfolio and endure the short-term ups and downs as they happen. In the other two articles of this newsletter we discuss some of the data that results from other approaches.♦

Market Returns

We show returns over several periods ending June 30, 2011 from indices typically used as proxies for individual markets as well as from diversified portfolios with differing risk profiles. The results are generally as expected. Also, note that inflation has been fairly subdued over all periods.

Chart I - Returns from Individual Markets

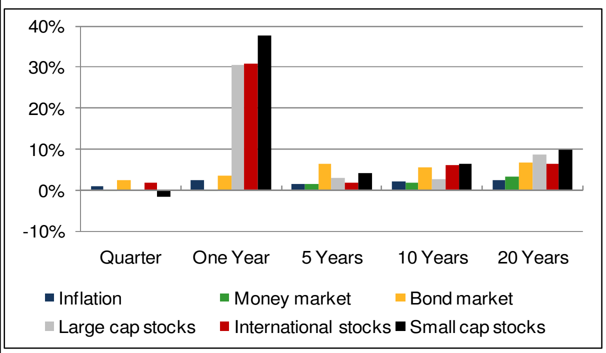
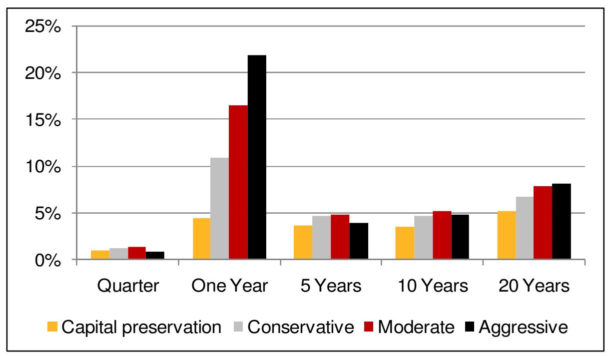


Chart II - Returns from Diversified Portfolios



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