ROCKWOOD WEALTH MANAGEMENT

## Some Back of the Cocktail Napkin Perspective

We're sure you've noticed that we are not shy about writing very technical pieces concerning portfolio science, complex taxation issues, investment analysis, etc. However, every now and then it is important to step back and take stock of some of the basic but powerful concepts that merit thoughtful consideration. Sometimes the best medium for analysis is something akin to the back of a paper napkin.

### Napkin Concept #1

The *USA Today* weekend edition that went to print just a few days before Christmas brought a flagrant reminder of the sheer number of forecasts that bombard would-be investors every day. In this particular edition, five Wall Street commentators – Abby Joseph Cohen, Bob Doll, David Bianco, Richard Bernstein and Dan Chung – say it's time for individual investors to shun the perceived safety of bonds. They say that folks should get over their fear of the U.S. stock market – so they can take advantage of what they predict will be a third straight year of solid gains for stocks in 2011.

We think it borders on the ridiculous that articles like this go to print year in and year out. Perhaps *USA Today* forgot about the 2008 edition, when the paper asked the "best minds" in the financial services industry for their thoughts on how the S&P 500 would do in 2008.

In 2008, all nine experts predicted the S&P 500 would increase – meaning none of them managed to predict even the relative direction of the index, much less the exact year-ending value. Two of the "experts" from 2008: Abby Joseph Cohen (Goldman Sachs) and Richard Bernstein (Merrill Lynch) reappeared on the *USA Today* 2010 expert forecasting panel.

Perhaps *USA Today* hopes its readers have short memories – in 2008, Cohen predicted the S&P 500 would close at 1,675 and Bernstein predicted it would close at 1,525. To give you an idea of the magnitude of their "wrongness," the S&P 500 began 2008 at 1,468 and ended at 885. Cohen predicted an increase of 14.2% when in fact the index returned -39.7%.

Why in the world should readers care what these folks think will happen next year? We certainly don't.

### Napkin Concept #2

It's no secret that sometimes investors seek to hold on to investments for emotional reasons. We've seen a widowed spouse walk into our office holding on to a portfolio of heavily concentrated individual stocks that are completely inappropriate for her financial situation but retained just because the deceased spouse had purchased them.

We cannot count on both hands the number of very bright folks to whom we've been introduced who have held on to company stock that is completely inappropriate for their financial situation but held because they work for the company or perhaps their business was bought out by a new company. Whatever the reason, it's emotion driving the decision; it's certainly not logic.

We think that part of this problem stems from investors' lack of clarity regarding why they own certain investments. We find that having meaningful conversations about money and what clients want their money to accomplish for them helps erode any connection between sentimentality and what appears on their monthly statement.

## Napkin Concept #3

Clarity regarding the purpose of your assets in the form of comprehensive planning goes a long way toward helping you tune out the noise of the markets and the media. Financial decisions are always better when they are made in the context of your unique goals in life. The more deeply committed you are to your goals, the less likely you are to listen to the unchecked multitudes of stock forecasts. Some investors who failed to tune out the stock forecasts received a not-so-gentle reminder of single-stock risk, as dozens of companies filed for bankruptcy and/or simply evaporated in 2010.

Here are a few you may recognize:

- A&P (grocery)
- Ambac (bond insurer)
- American Media (tabloids – *Star* and *National Enquirer*)
- Blockbuster (video rental)
- Hummer (gas-guzzling SUV)
- Jennifer Convertibles (furniture)
- *Newsweek* (magazine)
- Uno Restaurant Holdings (Pizzeria Uno)

Company filings for bankruptcy are nothing new. In fact, it happens every year. When your portfolio holds 12,000 stocks in 41 different countries, you have the luxury of simply not caring who went bankrupt, who pulled an "Enron" or who might not survive without a bailout. You have confidence because you know you already own the companies whose share price will rise when they swoop in to pick up the market share of the fallen giants.

Investment pitfalls come in all forms – those that are complex and those that fit on the back of a cocktail napkin. Investment success requires that we all avoid the temptation to depart from a rational investment plan.

## Required Reading – "A Dying Banker's Last Instructions"

"A Dying Banker's Last Instructions" is a reprint from the *New York Times* included in this package for your review. It is an emotional piece encompassing **terminal brain cancer, a reformed Wall Street banker, Dimensional Fund Advisors, fee-only wealth managers and commonsense investing.**

The book this article discusses, *The Investment Answer*, sold out at Amazon.com in the 10 hours following the *NYT* article about Gordon Murray and his fee-only advisor.

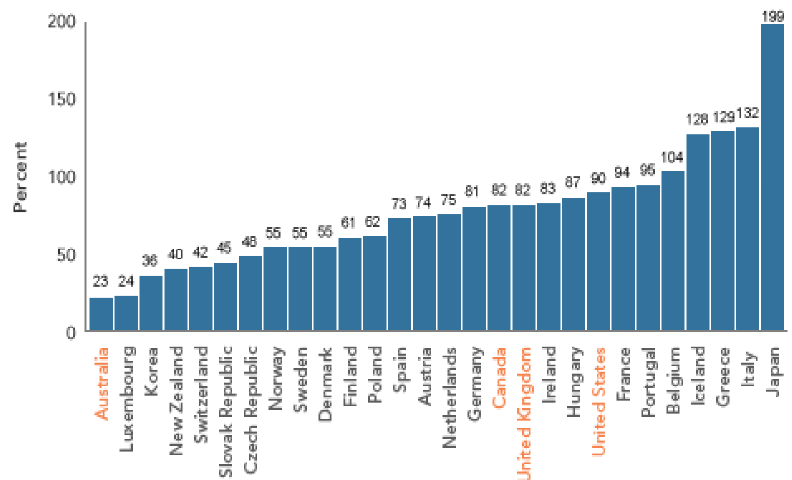
The book may be resonating with people in part because of the way the article framed Murray – as an insider-turned-informant on Wall Street. The article calls Murray one of the highest-ranking Wall Street veterans to take back much of what he and his colleagues worked for during their careers.

Along with flying off of the Amazon cybershelves, the book also sold out at Overstock.com and Buy.com. Wal-Mart had the most remaining inventory. The article zoomed to the top of the most e-mailed list at the *New York Times* and remained there for a week. We think you'll be glad if you invest the 10 minutes or so required to read it.

## Deficits, Debt and Markets

Noise that would distract a savvy investor from a prudent portfolio doesn't always show up in such cheesy publications as *Kiplinger's, Money* magazine, etc. Sometimes noise arrives in the form of daunting macroeconomic trends that give investors pause. As government spending hits record levels around the globe, some worry that rising indebtedness may drag down economies and financial markets. Rest assured, despite what one may think, a government's fiscal policy is not closely linked to the country's economic growth and market returns.

The graph below shows the projected state of indebtedness around the world. Over half the Organization of Economic Co-operation and Development (OECD) member countries expect to have debt-to-GDP levels above 70% – and the U.S., Canada and the U.K. project debt levels exceeding 80% of their economic output.




Government efforts to stimulate these economies out of recession may partly explain this level of borrowing, which is high compared to historical levels. But longer-term trends such as aging populations, expanding public pensions and rising health care obligations are compounding the fiscal challenges of these countries.

So how does public debt affect economic growth and market returns? The evidence might surprise you. Although rising levels of government debt create headwinds for economic growth, a country's deficit and debt levels do not seem to adversely impact capital market returns.

Let's explore these issues by addressing a looming question regarding macroeconomics:

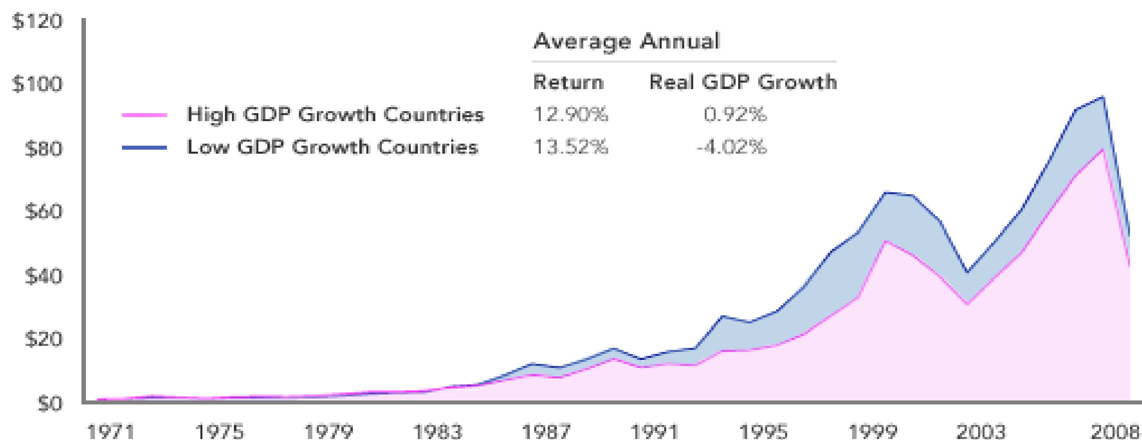
**Does low economic growth result in diminished equity returns?**

In a word – no. This relationship can be tested by comparing a country's GDP growth to its equity market performance in subsequent years. We conducted this analysis using the developed countries, divided each year into high-growth and low-growth "portfolios" based on growth in real GDP. There was no statistical difference between the annual returns of equity markets in high-growth versus low-growth countries. In fact, low-growth countries had slightly higher average returns than did high-growth countries.

24.62% for the low-growth portfolio (-4.94% GDP growth). Other research has confirmed a weak relationship between a country's economic growth and its stock market returns. Several factors may contribute to this decoupling effect. For one, with globalization, a multinational company's stock price in its home market may not reflect economic conditions in other countries. Also, the fruits of economic growth do not accrue exclusively to public companies, but also to income earners, nonpublic businesses and private investments.

**Economic Growth Does Not Predict Equity Returns**

Growth of $1 in the Stock Markets of Developed Countries




Source: MSCI

The graph above illustrates this relationship in terms of a dollar invested in high- versus low-GDP growth portfolios from 1971 to 2008. The low-GDP growth portfolio's higher annual return would have generated slightly more wealth for the period. The chart on the following page details the average annual return and real GDP growth for both groups.

Applying the same methodology to the MSCI emerging market countries shows an even greater return difference, although the data period is much shorter (2001 to 2008). The return of the high-growth country portfolio averaged 19.77% (with 2.5% GDP growth), versus

Finally, consider that risk, not economic growth, determines a stock's expected return. Research indicates that this principle also applies to a country's stock market. Similar to value and growth stocks, markets with a low aggregate price (relative to aggregate earnings or book value) have high expected returns, and markets with a higher relative price have lower expected returns.

Consequently, while holding a "growth market" may seem like a rational investment approach, investors should not expect to earn higher returns by tilting their portfolios toward countries with high expected GDP growth.

**Conclusions**

Some economists claim that developed market countries are moving into an era of higher government deficits and lower market returns. While higher deficits and debt may impact a nation's interest rates and economic growth to some extent, the investment implications are not easily discerned. History does not offer strong evidence that current deficits predict future bond or equity returns in a country's financial markets.

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