ROCKWOOD WEALTH MANAGEMENT

Rising Well Above the Noise

It is our practice to take careful notes throughout the year of all the seemingly cataclysmic news events for the purpose of revisiting their relevance to market returns and, more importantly, to investor psyche.

If you had the misfortune of choosing to focus on short-term events during the year 2010, this is a sample of what you endured:

- **Jan:** The financial media points to technical stock indicators that suggest poor stock performance in 2010.
- **Feb:** New home sales fall to lowest level since 1963.
- **Mar:** Controversially, a sweeping health care reform bill is enacted into law.
- **Mar:** California unemployment reaches 12.5%, the highest since tracking started in 1976.
- **Apr:** Greece and Portugal sovereign debt is downgraded.
- **May:** Bewildering "flash crash" sees Dow drop nearly 1,000 points in a few minutes.
- **May:** Scope of BP Gulf oil spill exceeds Exxon Valdez disaster.
- **Jun:** Stocks fall on disappointing job growth.
- **Aug:** The financial media sends an alarm that the "Hindenburg Omen" technical indicator forewarns of losses ahead.
- **Sep:** Five-year Treasury yields fall to a record low of 1.26%.
- **Nov:** Ireland accepts a bailout from the EU.

An emotional investor who lacks an understanding of the nature of global equity markets would have been hard pressed not to pull his or her hair out while absorbing the constant stream of mini-apocalypses in 2010.

Conversely, what happened to investors in 2010 who patiently ignored all that noise? Well, they were rather pleased that the broad US Stock Market returned 16.93% and the S&P 500 recouped all its losses since the Lehman Brothers implosion in 2008.

Forget the month-to-month oscillations; admittedly, even examining one year's worth of returns is still very narrow, short-term thinking. Let's broaden our view a bit more and focus on investment horizons consistent with yours. We need to debunk this persistent myth called the "new normal."

What Is New About the "New Normal"?

The 2008 global market crisis and the struggling economy have left many investors fatigued. Not uncommonly, despite two years of strong equity returns, some investors have been slow to regain market confidence. Many are accepting the talk about a "new normal" in which stocks offer lower returns in the future.

Perhaps ironically, the concept of a new normal is anything but new. In fact, throughout modern history, periods of economic upheaval and market volatility have led people to assume that life had somehow changed and that new economic rules or an expanding government would limit growth. What they failed to see was how markets naturally adapt to major social and economic shifts, leading to new wealth creation.

We prefer to view these concepts scientifically and quantitatively. Let's look at a few other periods in history when investors thought they had compelling reasons to abandon stocks. We'll leave it up to you to consider the parallels to today's environment.

1932: The US stock market had just experienced four consecutive years of negative returns. A 1929 dollar invested in stocks was worth only 31 cents by the end of 1932. Hopes were sinking during the Great Depression, and many people felt as though the economy had permanently changed. Many investors left the market, and some would not return for a generation. Amid what is considered the roughest economic time in US history, the markets looked ahead to recovery.

US Stock Market Performance after 1932			
	5 Years	10 Years	20 Years
Annualized Return	**15.35%**	**10.07%**	**13.19%**
Growth of $1mil	**$2.04mil**	**$2.61mil**	**$11.92mil**

1941: World War II was raging, and the US had just entered the conflict. The US stock market had experienced two consecutive years of negative performance, and the economy had shown signs of sliding back into depression. Although conversion to a wartime economy would revive industrial production and boost employment, investors struggled to see beyond the conflict. Reasonably, many expected rationing, price controls, directed production, and other government measures to limit private-sector performance.

US Stock Market Performance after 1941			
	5 Years	10 Years	20 Years
Annualized Return	**18.63%**	**16.67%**	**16.29%**
Growth of $1mil	**$2.35mil**	**$4.67mil**	**$20.47mil**

1974: Investors had just experienced the worst two-year market decline since the early 1930s, and the economy was entering its second year of recession. The Middle East war had triggered the Arab oil embargo in late 1973, which drove crude oil prices to record levels and resulted in price controls and gas lines.

Consumers feared that other shortages would develop. President Nixon had resigned from

office in August over the Watergate scandal. Annual inflation in 1974 averaged 11%, and with mortgage rates at 10%, the housing market was experiencing its worst slump in decades. With prices and unemployment rising, consumer confidence was weak, and many economists were predicting another depression.

US Stock Market Performance after 1974			
	5 Years	10 Years	20 Years
Annualized Return	**17.29%**	**15.92%**	**14.89%**
Growth of $1mil	**$2.22mil**	**$4.38mil**	**$16.07mil**

1981: The stock market had delivered strong positive returns in five of the last seven calendar years, and the two negative years (1977 and 1981) were only moderately negative. Despite these results, investors were weary from stagflation, which was characterized by high annual inflation, anemic GDP growth, and unemployment, and from fears of another economic downturn.

Memories of the 1973–74 bear market lingered. A 1979 *BusinessWeek* cover story titled "The Death of Equities" claimed that inflation was destroying the stock market and that stocks were no longer a good long-term investment.

US Stock Market Performance after 1981			
	5 Years	10 Years	20 Years
Annualized Return	**18.82%**	**16.58%**	**14.54%**
Growth of $1mil	**$2.37mil**	**$4.64mil**	**$15.11mil**

1987: On "Black Monday" (October 19, 1987), the Dow Jones Industrial Average plummeted 508 points, losing over 22% of its value during the worst single day in market history. The plunge marked the end of a five-year bull market. But in the wake of the crash, the market began a relatively steady climb and recovered within two years. The effects of the crash were mostly limited to the financial sector, but the event shook investor confidence and raised concerns that destabilized markets would increase the odds of recession.

US Stock Market Performance after 1987			
	5 Years	10 Years	20 Years
Annualized Return	**16.16%**	**17.75%**	**11.89%**
Growth of $1mil	**$2.11mil**	**$5.12mil**	**$9.46mil**

2002: By the end of 2002, investors had experienced the stress of the dot-com crash in March 2000, the shock of the September 11 attacks, and the early stages of wars in Afghanistan and Iraq. Although October 9, 2002, would ultimately mark the market's low point, investors had endured three years of negative performance and an estimated $5 trillion in lost market value. A younger generation of investors had experienced its first taste of old-world risk in the "new economy."

US Stock Market Performance after 2002			
	5 Years	10 Years	20 Years
Annualized Return	**13.84%**	**?**	**?**
Growth of $1mil	**$1.91mil**	**?**	**?**

2008–Today: The market slide that began in 2008 reversed in February 2009—gaining 83.3% from March 2009 through 2010. Despite two years of strong stock market returns, memories of the 2008 bear market and uneducated references to the "lost decade" have led many investors to question stocks as a long-term investment. But earlier generations of investors faced similar worries—and today's headlines echo the past with stories about government spending, surging inflation, deflationary threats, rising oil prices, economic stagnation, high unemployment, and market volatility.

Of course, no one knows what the future holds, which brings the concept of "normal" into question. What exactly is the status quo in the markets? We know, and you know, that normal is short-term fluctuation en route to a long-term upward trajectory.

Since 1926, there have been only four periods when the stock market had two or more consecutive years of negative returns. In addition, annual returns are rarely in line with the market's 9.67% long-term average (annualized). Perhaps the most obvious normal may be that, over time, stock prices reflect the uncertainty that investors must bear to earn the returns to which they are entitled.

What is so new about that?

Sources: Center for Research in Securities Prices, Morningstar

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