

The Greeks, Debt, and Your Portfolio

Although it has been nearly three years since it began, the European sovereign debt issues continue to create a bit of uncertainty in both global financial markets and in households in our neighborhoods. The crisis is certainly “old news,” yet it has raised questions not only about the sustainability of sovereign debt burdens in Europe, but also about the future of the euro common-currency experiment.

It’s natural for investors to wonder about their portfolio’s exposure to the countries at the center of the crisis, the protections they have in place, and how we would respond if events deteriorated from here. As we have crafted our response to these questions, we do so **within the context of our calm, disciplined, and risk-aware processes.**

In writing this piece, we reaffirm our belief that basing investment decisions on forecasts is counterproductive—something even more true in such a rapidly developing and multifaceted story. As always, new news is quickly reflected in securities prices, and there is little to be gained from speculating about likely outcomes.

There is, however, much to be gained from putting these events in proper context and taking the time to think through how these events can affect our psyche as an investor and how we might be tempted to make behavioral finance mistakes.

The current crisis is a complex and constantly evolving story. But at its heart is concern over sovereign debt burdens in the eurozone—an economic and monetary union that adopted the euro as its common currency in 1999.

The eurozone, originally encompassing ten countries, now consists of seventeen members: Germany, Austria, France, Belgium, Luxembourg, Spain, Portugal, Italy, Greece, Cyprus, Ireland, Malta, the Netherlands, Slovakia, Slovenia, Finland, and Estonia. Another ten members of the wider European Union are not part of the single-currency zone.

Outside the sovereign debt issue, there is also concern about the impact of the crisis on the

eurozone banking system. Refinancing by the European Central Bank in early 2012 provided short-term relief for the banks, but market pricing points to worries over the longer-term solvency of many institutions.



However, this crisis is as much a political affair as an economic one. Austerity programs imposed in several countries as conditions for repeated bailouts from the European Union and the IMF have sparked social and political unrest. Elected governments are torn between their responsibilities to creditors and the anger of some of their taxpayers who do not wish to pay for what they see as the profligacy of bankers and politicians.

On a wider scale, investors globally are expressing concern about the impact of the crisis on economic growth rates and the financial system itself. However, as we have seen, the extent of uncertainty—as expressed in both market prices and volatility—is nowhere near the levels reached during our own domestic crisis of late 2008.

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It is also worth noting that policymakers in the major economies, both inside and outside Europe, have made contingency plans to ensure liquidity is made available in the event of any future strains in credit markets.

For Rockwood’s part, our investment committee and our research resources are closely watching

developments and stand ready to review the status of Greece and other eurozone participant countries should the circumstances merit it.

For clarity, we have zero exposure to Greek government debt, as Greece is not eligible for our fixed income strategies. Our exposure to Greek equities is less than 1/1000th of your equity allocation, and we have suspended further purchases in that country for the time being.

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We understand that investor anxiety is common, particularly as exacerbated by media outlets. Long-term investment success requires one to benefit from uncertainty in the form of participating in recoveries from events that do not have clearly evident solutions.

Like you, we do not know precisely what the future holds. But we do know that markets incorporate all known information and that the widespread anxieties are already reflected in today's prices. Put simply, all the bad news we've collectively heard is already baked into the current market prices. Ill-advised investors who say foolish things like "It's getting bad in Europe, so I am thinking about selling my investments" are really saying "I am unaware that today's prices already include the collective market sentiment and that future price changes only reflect those events that haven't yet happened, not some extrapolation of recent events well publicized by the financial media."

Finally, you can be confident in our disciplined investment processes, the flexibility of our approach, and the resiliency of our investment philosophy. You are positioned extremely well to continue to harness the long-term benefit of a globally diverse, risk-controlled, low-cost portfolio and a steady hand to help guide your way.

New Faces at Rockwood

In pursuit of our commitment to maintaining the highest levels of client service, Rockwood has added two new full-time employees to its staff in the New Hope office.

Ian T. Harvey: Ian is a financial planning associate at Rockwood Wealth Management. He joined us after graduating from Virginia Tech, where he earned a bachelor's degree in finance after completing the board-registered CFP® Certification Education program as well as the Chartered Financial Analyst (CFA®) preparatory program. Ian is passionate about his advocacy for fee-only financial planning and has demonstrated a commitment to learn, grow, and refine the financial planning process.

Ian co-founded the Financial Planning Association Student Chapter at Virginia Tech, which has grown to be one of the largest in the country. Widely recognized as one of the top universities for financial planning education, Virginia Tech has engaged Ian to continue working with student chapters post-graduation in order to improve their effectiveness.

Currently, Ian lives in New Jersey and enjoys playing volleyball on the beach, exercising, and spending time with family and friends.

Alana J. Wagner: Alana brings significant experience in client service and project management to Rockwood Wealth Management. After working for a large multinational corporation, Alana is looking forward to bringing her commitment to organizational excellence to a community-centric and ethically minded firm.

Alana graduated from Temple University *summa cum laude* with a Bachelor of Arts degree in English literature. She currently resides in New Hope, Pennsylvania. In her spare time, she enjoys reading, hiking, cooking, and spending time with her family and friends.

When History Repeats Itself

A recent article appearing in the *Financial Times* caught our eye—or perhaps we should say ear. At first glance it was unremarkable—just one among dozens of recent thought pieces suggesting that investors were losing interest in stocks as markets around the world continued to stagnate.

But the tone of the article sounded remarkably similar to the "Death of Equities" article appearing in *BusinessWeek* on August 13, 1979. How similar? Well, we invite you to be the judge:

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| BusinessWeek, 1979: | Financial Times, 2012: |
| “This ‘death of equity’ can no longer be seen as something a stock market rally—however strong—will check. It has persisted for more than ten years through market rallies, business cycles, recession, recoveries, and booms.” | “Stocks have not been so far out of favor for half a century. Many declare the ‘cult of the equity’ dead.” |
| BusinessWeek, 1979: | Financial Times, 2012: |
| “Individuals who are not gobbling up hard assets are flocking to money market funds to nail down high rates, or into municipal bonds to escape heavy taxes on inflated incomes.” | “The pressure to cut equity exposure is being felt across the savings industry. ... In the US, inflows to bond funds have exceeded equity inflows every year since 2007, with outright net redemptions from equity funds in each of the past five years.” |
| BusinessWeek, 1979: | Financial Times, 2012: |
| “Few corporations can find buyers for their stocks, forcing them to add debt to a point where balance sheets seem permanently out of whack.” | “With equity financing expensive, many companies are opting to raise debt instead, or to retire equity.” |
| BusinessWeek, 1979: | Financial Times, 2012: |
| “Today, the old attitude of buying solid stocks as a cornerstone for one’s life savings and retirement has simply disappeared.” | “Few people doubt, however, that the old cult of the equity—which steered long-term savers into loading their portfolios with shares—has died.” |
| BusinessWeek, 1979: | Financial Times, 2012: |
| “We have entered a new financial age. The old rules no longer apply.” —Quotation attributed to Alan B. Coleman, dean of business school, Southern Methodist University | “The rules of the game have changed.” —Quotation attributed to Andreas Utermann, Allianz Insurance |

When the first “Death of Equities” article appeared, the S&P 500 had underperformed one-month Treasury bills on a total return basis for the fourteen-year period ending July 31, 1979 (107.0% vs. 119.6%, respectively). Was buying stocks in August 1979 a smart contrarian strategy? Yes, but only if one had the patience to stick it out for years. Imagine the frustration of an investor who had been counseled to “stay the course” in response to the “Death of Equities” article appearing in August 1979.

Stocks did well for a while, jumping over 27% from August 13, 1979, to March 25, 1981, when the S&P 500 hit an all-time high of 137.11. But by July 31, 1982, stocks had given back all their gains, and the S&P 500 was almost exactly where it had been nearly three years earlier. As of July 31, the S&P 500 had extended its underperformance relative to one-month Treasury bills to seventeen years (total return of 150.5% vs. 213.6%).

Imagine this same investor arriving at her financial advisor’s office on Friday, August 13, 1982, with a three-year-old copy of *BusinessWeek* under her arm.

Stocks had drifted lower in the preceding weeks, and the S&P 500 had closed the previous day at 102.42.

“You told me three years ago to stay the course, and I did,” she might have remarked to her advisor. “It hasn’t worked. Obviously, the world has changed, and it’s time I changed too. Enough is enough.”

We suspect even the most capable advisor would have faced a big challenge in seeking to persuade this investor to maintain a significant equity allocation. For many investors, seventeen years is not the long term, it’s an eternity.

Superstitions aside, stocks rose that day, with the S&P 500 advancing 1.4%. It wasn’t obvious at the time, but August 13, 1982, marked the first day of what would turn out to be one of the longest and strongest bull markets in US history. The S&P 500 was 16% higher by the end of the month and went on to quadruple over the subsequent decade. The table below shows data for the S&P 500 on a price-only basis. With dividends reinvested, the return would be materially enhanced.

The following table shows the magnitude of the resiliency of capital markets (using the S&P 500 as a proxy) following that publishing of the 1979 article:

| "Death of Equities" Anniversary | | |
|---------------------------------|-----------------|---------|
| 1st Anniversary | August 12, 1983 | 58.3% |
| 5th Anniversary | August 12, 1987 | 224.5% |
| 10th Anniversary | August 12, 1992 | 307.9% |
| 20th Anniversary | August 12, 2002 | 782.4% |
| (Almost) 30th Anniversary | June 19, 2012 | 1225.9% |

One of the authors of the recently published *Financial Times* article, John Authers, is familiar with the *BusinessWeek* article and wary of making pronouncements that might look equally foolish ten or twenty years hence. In a follow-up article appearing several days after the first, he appealed for divine assistance in his forecasting effort: "O Lord, save me from becoming a contrarian indicator." Nevertheless, after revisiting his arguments, he remained persuaded that the climate for equities was too hostile to be appealing.

We should not use this discussion to make an argument that stocks are sure to provide investors with appealing returns if they just wait long enough. If stocks are genuinely risky (which certainly seems

to be the case), there is no predetermined time period over which we can be assured of receiving a positive result. Nor should we seize on every pundit's forecast as a reliable contrarian indicator. With dozens of self-appointed experts making predictions, some of them are going to be right. Perhaps even John Authers.

Although short-term market movements are quite meaningless for long-term investors, it is worth noting that the Dow Jones is nearly 500 points higher today as this piece goes to print than it was on May 24 when John Authers' article appeared in the *Financial Times*. We continue to find that the market is often a great source of humility, as it has a habit of surprising us (meaning the investing public) just when we feel it is obvious what the market will do next.

In the end, the notion that risk and return are related is so simple and so widely acknowledged that it hardly seems worth arguing about. But these articles (and others of their ilk) offer compelling evidence that applying this principle year in and year out is a challenge that few investors can meet and explains why so many fail to achieve all the returns that markets have to offer.



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