

Greece and Your Portfolio, Again ...

The Greeks are at it again – grabbing international headlines for the ongoing fiscal challenges they must collectively meet as a nation. The good news is that their plight is unlikely to affect your portfolio for any meaningful time period. We need only look back to 2010 to see that an even scarier Greek crisis was only short-lived.

Since Greece's debt crisis began in 2010, most international banks and foreign investors have sold their Greek bonds and other holdings, so they are less vulnerable to what happens in Greece. (Some private speculators who subsequently plowed back into Greek bonds, betting on a comeback, regret that decision.)

And in the meantime, the other crisis countries in the eurozone, like Portugal, Ireland, and Spain, have taken steps to overhaul their economies and are much less vulnerable to market contagion than they were a few years ago. What's more, the European Central Bank has erected powerful firewalls by buying huge amounts of eurozone government bonds and by promising to purchase more if needed, making governments less subject to market whims.



Still, Greece may be linked to the world financial system in ways that may not be evident unless the unlikely scenario plays out where it actually defaults on its debts or its banks collapse. So there is still potential for unpredictable consequences.

Given that there will always be uncertainty, here's what you need to know.

To reinforce what we've communicated in the past, 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 since 2011. 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.

The popular press or those who are transaction-based market makers might be tempting you to react to current events by buying and selling, or otherwise shifting around in reaction to the winds of change. They may be well-versed in market economics, with impressive scholarly credentials and seemingly conclusive reasons for why it's time to act now. However, it's not good or bad news that sets future market pricing; it's whether the news is *better* or *worse* than the market has been expecting.

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 Greece, so I am thinking about selling my investments" are really saying "I am unaware that today's prices are already inclusive of the collective market sentiment and that future price changes only reflect those events that haven't yet happened, not some extrapolation of recent events."

What Long-term Returns to Expect

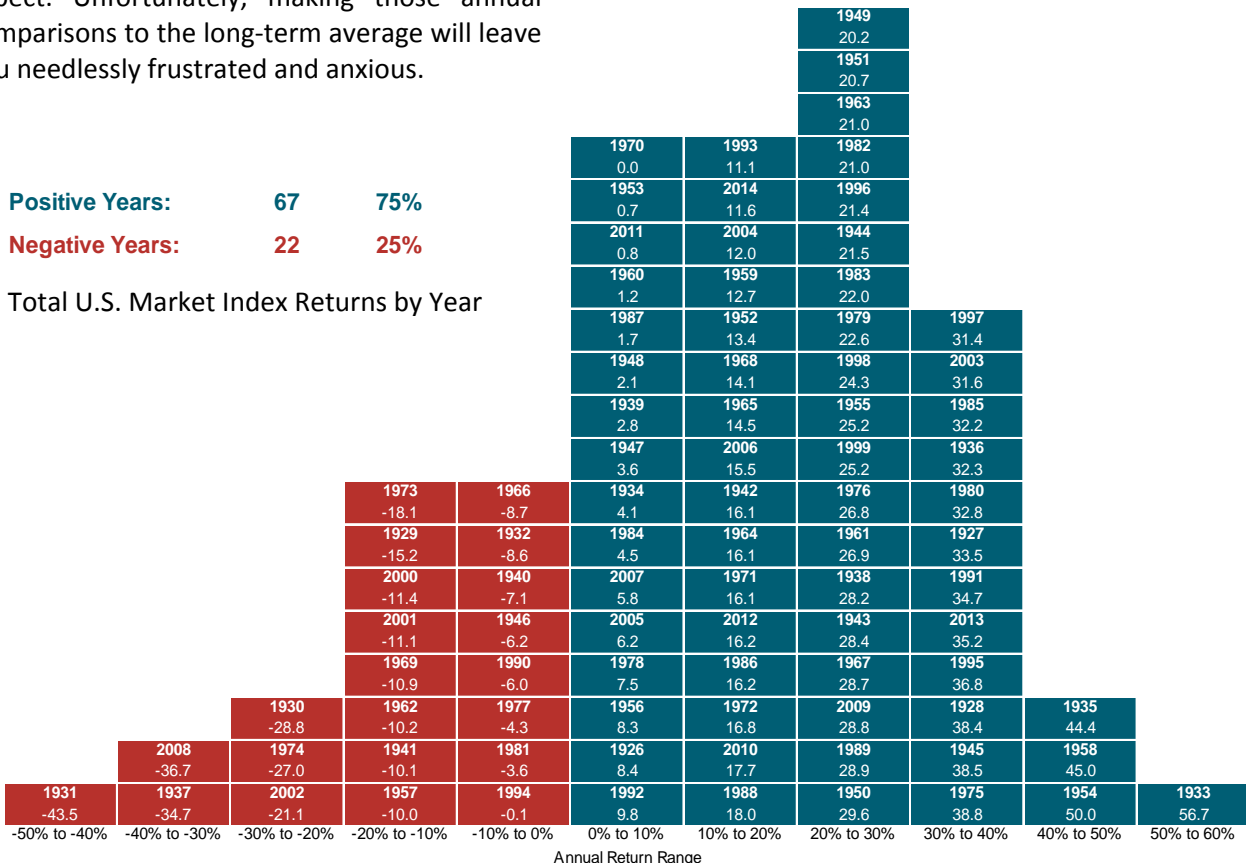
If you ask most financial professionals, retail investors, or PhD-toting economists (or anyone else for that matter) what the long-term returns from the stock portion of their portfolio might be, you're bound to get an answer of something like 8% to 10%.

Put another way, in 85 of the past 88 years, the U.S. total stock market did not produce an annual return between 8% and 10%.

While we believe that range of returns is fundamentally likely for long-term investment horizons (20 years+), the real difficulty exists in the manner in which those annual returns will be delivered. There is a temptation to look at our annual equity returns and check to see whether our stocks returned between 8% and 10% to see if we are "on track" for building wealth as we expect. Unfortunately, making those annual comparisons to the long-term average will leave you needlessly frustrated and anxious.

Positive Years: 67 75%
Negative Years: 22 25%

Total U.S. Market Index Returns by Year



Here's why:

We examined the past 88 years' worth of annual market returns and looked to see how often the market produced a calendar year return within that expected future average range of 8% to 10%. The answer: a paltry three times. Those years were 1926, 1956, and 1992. Put another way, in 85 of the past 88 years, the U.S. total stock market did not produce an annual return between 8% and 10%. The takeaway here is that we should expect significant year-over-year volatility in the stock portions of our portfolios. Annual returns will be bumpy, but long-term returns have been unassailable.

This yearly volatility will test investor discipline and prompt some people to question their commitment to equities. While no one knows the future, looking at the past may help you gain a better view of long-term market performance and put the recent market volatility in perspective.



The chart on the previous page shows the historical distribution of U.S. market returns since 1926. The performance years are stacked in ascending order by return range. This chart illustrates that:

- Over the long term, the market's positive return years have outnumbered the negative return years. Since 1926, the market has experienced a positive return in almost three-quarters of the calendar years.
- Not only are the positive years more numerous, the chart shows a larger concentration of performance in the higher ranges of returns.
- The sequence of calendar returns appears random, suggesting that accurately predicting future performance is a difficult task for any investor or professional manager.

Typically, the market has one down year for every three up years. Over time, the market has rewarded investors who can bear the volatility of stocks and stay committed through various periods of performance.

Australia, Coal Mining, & the Hot Sector

At Rockwood Wealth Management we frequently remind ourselves and our clients to ignore the "hot sector" upon which the media occasionally locks in. Everyone remembers the late 1990s, during which time the hot sector was technology. What you may not remember is what took place in Australia in the mid-2000s – the great mining boom and inevitable subsequent bust.

One can argue that today the hot sector is biotech and health care services. Their combined

trough-to-peak trailing 12-month return is about 40% at the time of writing. We are certain we could fashion a convincing narrative about why these sectors will continue to outperform others. Perhaps we could offer demographics about the aging population, the increasing consumption of health care, the favorable impact of legislation on these sectors, etc. Please know that media outlets writing headlines about fashionable sectors are here to stay. Building investment strategies around them is patently foolish – and our friends in Australia can help us remember why.

There's nothing inherently wrong with this kind of journalistic sector sensationalism, by the way. The boost in productivity brought by digital technology and communication was a real story in the late '90s, as was the impact of China as it integrated into the world economy over the past decade.



Where it goes off the rails for investors is the point at which they extrapolate well-documented economic trends in order to make changes to their portfolios based on what has already happened or speculation about what might happen in the future.

We think the best example of this notion comes to us from the Australian equity market. While it may not have made headlines here in the U.S., mining stocks boomed in the first part of the last decade amid insatiable demand for metallurgical coal and iron ore by Chinese steelmakers (who produce 45% of steel globally). By 2008, the boom was making billionaires of Australian

mining entrepreneurs like Andrew “Twiggy” Forrest and Gina Rinehart. While Texas had its oil tycoons, wrote a *Reuters* reporter, the road to mega-riches in Australia ran through red-dirt iron ore towns.

At the time, Forrest’s listed company, Fortescue Metals Group, was so hot that it launched a 10-for-one stock split to take advantage of strong interest among smaller retail investors. (They knew that amateur investors chase hot stocks.) The shares had quadrupled in value in less than a year. The performance of stocks such as Fortescue mirrored what was going on in the commodity markets they serviced. Coal and iron ore prices had roughly tripled in Australian dollar terms in the six years up to mid-2008, with these bulk commodities by that stage accounting for nearly 30% of the Australian economy’s total exports.

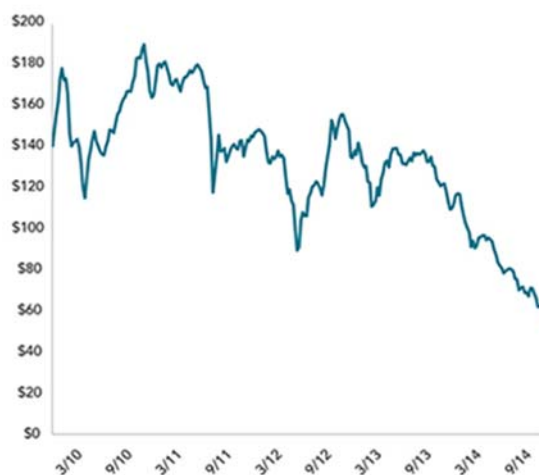
The love affair around mining and commodities continued to intensify over the next couple of years. By March 2010, London’s *Telegraph* newspaper predicted a further doubling in ore prices within months, stating the outlook for the sector was “very sunny indeed.” Desperately seeking cheaper supplies, Chinese companies went on an acquisition spree. In July 2010, the *Wall Street Journal* said acquisitions by companies based in China or Hong Kong had grown a hundredfold in five years.

By 2012, though, iron ore prices were starting to fall from historic highs as China’s economic expansion slowed. Chinese steelmakers, in annual contract negotiations, sought to pay prices that better reflected the fall in the spot market.

Even so, Australian mining companies remained bullish. In an interview with the *Australian*, BHP Billiton’s head of iron ore forecast that the spot price would settle around US\$120 per metric ton, down from the record of about US\$180. Oops, that wasn’t to be the case. Indeed, as the

chart shows, iron ore prices collapsed, falling by two-thirds to below US\$60 by 2015. Chinese demand peaked just as new growth in global supply was coming online, a legacy of the long lead times in mining investment.

Exhibit 1 Iron Ore Prices, \$US per metric ton



Source: Bloomberg. Past performance is no guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

The market prices of mining stocks followed suit. On the Australian market during 2012–2014, many of the worst-performing stocks have been either iron ore miners or companies serving that market, as shown in Exhibit 2.

Exhibit 2 Australian Iron Ore Stocks, 2012–2014

Name	Code	Performance
Atlas Iron	AGO	-93.89%
Sundance Resources	SDL	-93.67%
BC Iron	BCI	-80.00%
Mount Gibson Iron	MGX	-78.13%
Fortescue Metals	FMG	-35.83%
Broad Market (S&P/ASX 300)	AS52	32.00%

Source: Bloomberg. Past performance is no guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

Ouch! This all goes to show the dangers of building investment strategies around sector stories. The iron ore companies were leveraged to China's steelmaking boom. They invested heavily in new capacity to take advantage of high prices. But China's boom started to wind down just as new mining capacity was coming online. The double whammy from weakening demand and surging supply pummeled iron ore prices and drove down the market values of the mining stocks.

This is all another argument for the virtues of diversification. The more sector-specific risk and company-specific risk in a portfolio, the more it is exposed to these idiosyncratic factors beyond the control of the individual investor. But diversification does not just apply to sectors. We can also manage it by diversifying across the dimensions of returns, identified by academic research as the basic organizing principles of the market.

These dimensions point to systematic differences in expected returns based on characteristics of the security. To meet this definition, they must be shown to be sensible, persistent across different periods, pervasive across markets, and capable of being cost-effectively captured.

The four dimensions are the degree to which the portfolio is exposed to stocks vs. bonds, small vs. large companies, low relative price stocks (value stocks) vs. high relative price (growth stocks), and high vs. low profitability firms. High risk-

adjusted returns are derived from these dimensions – not from the hot sector.

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In the small-cap, high relative price (growth stock) end of the Australian market, where many of the underperforming mining companies have crowded, some of the risk may be managed by excluding and underweighting companies with the lowest profitability and those with the highest relative prices.

Of course, this does not mean a portfolio will be completely immunized against security- or sector-specific risk. But it is a way of diluting those influences and finding a balance between seeking to improve expected returns and striving for appropriate low-cost diversification.

At the end of the day, nothing in investment is ever cast in iron. But diversification, discipline, and maintaining a level of balance can help ensure that a single sector doesn't bend your portfolio out of shape.



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