01/05/12: A Turbulent Year in Review

Happy New Year! I hope this email finds you happy and healthy.

If you want to read a very funny take on the Occupy Wall Street movement (and we all need some humor in our lives), look here: http://finance.yahoo.com/news/princeton-brews-trouble-us-1-000000782.html. Financial journalist Michael Lewis, author of "Liar's Poker," "Moneyball" and "The Big Short" (about the 2008 global economic meltdown), has penned a mock memorandum from "The Strategy Committee" representing the large Wall Street firms, with advice on how to offset the protesters, particularly those at elite northeastern college campuses once regarded as prime recruiting grounds. Quite humorous for us financial types, and I'll bet for you too. (I particularly like his first suggested "tactic" for visiting college campuses: Send only women.)

Back to the subject at hand, the investment markets. One of the most interesting things about investing (especially over the short term, but often over the long term, too) is the disconnect between world events and the behavior of investment (especially stock) markets. Every day, we hear that the stock markets went up or down as a result of this or that dramatic event or piece of economic data in the news. But if Rip Van Investor had fallen asleep at the start of the 20th century, and woke up with a yawn 100 years later at midnight, December, 1999, he would have been startled to see that his investment in the S&P 500 had gained more than 10% a year, on average, during his 100-year nap. He might fairly have concluded that he'd slept through ten decades of happiness, sunny economic climate and smooth sailing, when in fact the century included two horrible world wars, the Great Depression, the Cold War, the disastrous war in Vietnam, stagflation, a presidential assassination, impeachment hearings, the rise of global terrorism and truly disturbing social trends like reality TV.

2011 proved to be another example of this odd-but-important investing lesson. If you had gone to sleep on January 1, woke up on December 31 and immediately checked your U.S. stock portfolio, you would have seen the most boring possible outcome: stocks basically unchanged for the year. The Standard & Poor's 500 index finished the year exactly 0.04 points below its level prior to the opening bell on January 1, 2011. That translates to almost exactly a 0% total return. Add in dividends, and the total return came to 2.11%.

The broad-based Wilshire 5000 index rose 0.98% for the year, while the Russell 3000 was up 1.03%. Larger stocks generally fared better than smaller ones. The Wilshire U.S. large cap index went up 1.59%, and the Russell 1000 gained 1.50%. Wilshire's U.S. midcap index fell 1.52% during 2011; the Russell midcap index was down 1.55%. The Wilshire U.S. smallcap index dropped 3.40%, while the comparable Russell 2000 was down 4.18%. Performance in the technology and commodities markets were also

mundane; the Nasdaq composite index fell 1.8% during calendar 2011, and the Standard & Poor's GSCI commodities index was down 1.18%. The larger-cap based DJIA produced a total return of 5.5%.

That means it was a boring, uneventful year for investors--right? Wrong. In fact, this less-than-inspiring stock market performance was achieved in the most exciting possible way. (Okay, I realize it's a stretch to call it exciting.) Remember the heart-wrenching volatility? Remember all the political bickering over raising the U.S. debt ceiling, when we worried that the United States government was teetering on the brink of default? Or how those brilliant (cough) S&P credit analysts stripped the nation of its AAA rating? Yet somehow, despite the best efforts of our politicians, a broad index of U.S. government bonds gained 9.6% for the year. Quite unexpected indeed.

All year long, we heard one gloomy report after another on housing and real estate, yet the Wilshire REIT index gained 9.24% for the year.

In 2011, we watched the European Union teeter on the edge of collapse, the sovereign debt contagion spreading from Greece to Spain and (gulp!) Italy. Yet the international EAFE index of developed foreign markets closed the year with a quarterly gain of 2.86%, cutting an international investor's losses down to 14.82% in dollar terms. (MSCI's emerging markets index, the trendy investment choice for many pundits at the start of the year, which represents fast growing countries such as China and Brazil, was down 20.41% for 2011. Ouch.)

Amid the Arab Spring uprisings and regime changes in Egypt, Tunisia and Libya, constant tensions over the nuclear program in Iran, the terrible tsunami tragedy leading to a nuclear catastrophe in Japan, and the recent unpredictable regime change in nuclear-armed North Korea (really scary), it seemed like every other week there was a reason for investors to believe that the markets would finish 2011 well below their pre-crisis levels.

It's true that portfolios that held foreign stocks would have shown overall losses for the year. But the bigger picture, here in the U.S., is: Why is there such a broken connection between tragedy, political turmoil and scary headlines, on the one side, and market returns on the other? The answer may be that the underlying forces driving our economic growth are more stable than the headlines suggest. Quietly, despite the best (or worst) efforts of Congress, the U.S. unemployment rate has steadily declined from over 10% at the peak down to 8.6% last month, its lowest level in three years. Factory output is rising, consumer spending has been surprisingly strong, and for the first time in decades, the U.S. is a net energy exporter.

Profits, economic growth and jobs are ultimately created by the ingenuity and hard work of millions (or, globally, billions) of people who come to work every day, put their heads down and accomplish the

things set before them. Rip Van Investor would have told you that this drive and initiative was the really big story of the 20th century, more important than the incidental wars, recessions and political bickering. All he had to do is see that his horse and buggy had been replaced by a Lexus, the telegraph he wanted to send could be handled via e-mail and the Internet, walk with wonder through skyscraper cities and see the planes overhead outrun the birds in the sky.

The same hidden underlying forces that power the markets have taken the human species from cave dwellings to a modern electronic age that is still, admittedly, far from perfect. World events have gotten more complicated, more interesting, sometimes more disturbing, so much so that it takes a bit of perspective to see the long-term trend behind the scary headlines, behind the dips and swirls of the markets.

The major U.S. market indices avoided a downturn in 2011 after two strong recovery years. Those who bailed out after the market took any of its many tumbles would have risked missing the year's many improbable, unpredictable recoveries. Rip Van Investor came out all right--and suffered a lot less anxiety than the rest of us.

Stay tuned for what is expected to be another unpredictable year, but our crystal ball says to not take any of the "experts" forecasts too literally. NOBODY can predict the future!

Debt crisis timeline: http://online.wsj.com/public/resources/documents/info-EZdebt0210.html

Year in review: http://www.reuters.com/article/2011/12/22/us-markets-investing-yearinreview-idUSTRE7BL1GH20111222

Job market shifts: http://finance.yahoo.com/news/us-job-market-ends-better-215423241.html

Wilshire index data: http://www.wilshire.com/Indexes/calculator/

Russell index data: http://www.russell.com/indexes/data/daily_total_returns_us.asp

S&P index data: http://www.standardandpoors.com/indices/sp-500/en/us/?indexId=spusa-500-usduf--p-us-l--

Nasdaq index data: http://quicktake.morningstar.com/Index/IndexCharts.aspx?Symbol=COMP

International indices: http://www.mscibarra.com/products/indices/international_equity_indices/performance.html

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Commodities index data: http://www.standardandpoors.com/indices/sp-gsci/en/us/?indexId=spgscirg--usd----sp------

Treasury market rates: http://www.bloomberg.com/markets/rates-bonds/government-bonds/us/

Margie