Learning From History

Bulls, Bears and Fish?

If you caught a whopper the first time you ever went fishing, you'd probably think it was luck. If you reeled them in year after year, you'd assume your pond was the right place to be. Similarly, investors who bought their first stocks between 1982 and 1999 — one of the most extraordinary bull markets in history — became conditioned to expect that stocks would yield strong returns year after year. After the twin bear markets of the 2000s, however, it's clear that investors, like fishermen, must monitor and adapt to changing conditions.

Key points

1. **Looking back.** History clearly illustrates that markets move in cycles. The timing of such cycles is uncertain, but you can be sure that good times will eventually follow bad times — and vice versa.

2. **The boomer experience.** The baby boomer generation experienced high returns with low volatility during the '80s and '90s bull market — and came to believe this type of market was the norm. They were surprised by the volatility of the 2000s and questioned their views of diversification.

3. **Rethinking diversification.** Different asset classes have historically outperformed during different market environments, so diversifying a portfolio by risk sources — rather than return sources — is important when building a financial plan.

4. **Diversifying by risk sources.** Bonds have historically led the way in deflationary environments. Commodities have outperformed during inflation, and stocks have been the clear leaders in low-inflationary growth periods.

5. **Talk to your financial advisor.** Discuss constructing a portfolio that helps mitigate against unacceptable risks while pursuing returns.

While diversification can help mitigate volatility, it does not guarantee a profit or eliminate the risk of loss.
Looking back

Over the past century, markets have cycled through good times and bad. From 1900 to 1982, recessions were frequent and stock market volatility was often dramatic, as illustrated by the Dow Jones Industrial Average (the Dow).

For decades, recessions were common and stock market volatility was dramatic.

### 1900 to 1929 – Years of Volatility, Then a Surge in Stock Prices

Throughout these years, recessions were frequent, and some of the Dow’s losses approached 50%. While the period was exceptionally volatile, stocks essentially went nowhere for 22 years. It wasn’t until the credit bubble of the late 1920s that stocks rose significantly.

### 1929 to 1982 – Frequent Recessions and Dramatic Volatility

Recessions were still prevalent during these years. The biggest, of course, was the Great Depression, and it took 25 years for the market to return to its 1929 level. Stocks experienced a 16-year bull market between 1950 and 1966, and a 16-year bear market from 1966 to 1982, as seen in the Dow’s performance below.

The boomer experience

While history clearly shows that markets move in cycles, many of today’s investors view bull markets as the norm, and tend to chase returns at the expense of risk management. Why? Because before the 2000s, they had never personally experienced significant losses.

Consider the baby boomers. This generation lived through the 16-year bear market from 1966 to 1982, but in general, they didn’t have much money invested at that time. The oldest boomers, born in 1946, were in their 20s and early 30s during those years – and most of their income was used to start families and buy homes. The youngest boomers, born in 1964, were kids during that bear market.

In general, the boomers began investing seriously during the 1982 to 1999 bull market, and they experienced consistently high returns with low volatility. For many boomers, this experience significantly shaped their perceptions of investment risk. Their biggest fear wasn’t losing money, it was missing out on gains. The two bear markets of the 2000s came as a shock to those who thought bull markets were the norm.

Many baby boomer investors consider bull markets to be the norm because their early experiences were so positive.

1982 to 2012 – A Long March Upward, Then Volatility Returns

In 1982, the landscape changed dramatically as the US entered an extended noninflationary growth environment. During this period, recessions were few and far between. Stocks marched steadily upward until 1999, when the tech bubble popped. The market started coming back in 2003, as seen by the Dow’s performance below. Then in 2007 the US entered a recession, and extreme market volatility led virtually all assets to plunge simultaneously.

<table>
<thead>
<tr>
<th>Price Level</th>
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<tbody>
<tr>
<td>16,000</td>
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<tr>
<td>12,000</td>
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<tr>
<td>8,000</td>
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<td>4,000</td>
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*This period did not represent a true deflationary period because consumer prices did not fall. However, there were dislocations in credit to the upside and downside during the decade. The reductions in credit supply that occurred in the earlier and later part of the decade led to economic contractions similar to what would be experienced in a deflationary environment.*

Rethinking diversification

Many boomers were also shocked to see that their diversification strategies didn't hold up during the most recent recession. But when you compare the boomer experience with longer-term performance trends, it becomes clear why this was the case.

As markets marched upward in the 1990s, investors were especially attracted to the flashy growth potential of technology and telecommunications stocks. Then the tech bubble popped, and investors who had all their eggs in this one basket paid the price.

As the market resumed its gains between 2003 and 2007, investors remembered their tech bubble experience and didn't pile into just one hot sector – they included allocations to international and emerging market stocks and private equity. But when recession hit in 2007, virtually all asset classes plunged together.

What happened? In their pursuit of returns, investors avoided assets such as long-term government bonds and cash, which offer lower growth potential than equities, but have historically held up during recessions. In essence, they diversified their sources of return, but didn't diversify according to risk.

Diversification is key to risk management. Investors should be prepared for any economic environment.
4 Diversifying by risk sources

The table below shows the annualized performance of various asset classes starting in 1929, the earliest year when data was available for these asset classes. The years are divided into six time periods representing five distinct economic environments that each posed unique risks to investors. (Within the inflationary period of 1966 to 1981, we have highlighted the years 1973 to 1981, because the commodities index was not established until 1973.) It’s clear to see that during different environments, different asset classes have historically risen to the top.

- In times of low-inflationary growth, equities and equity-like investments have historically performed well. These investments pursue growth, which potentially may help protect against the risk of shortfalls in retirement.
- In deflationary environments, bonds have outperformed, which may help defend against the risks of steep market losses.
- During the inflationary period ending in 1981, commodities were the only asset class to provide meaningful returns above inflation, which may help preserve buying power. (Commodities are generally volatile and may not be suitable for all investors.)

Diversifying by risk sources involves including assets in your portfolio that have historically outperformed in different economic environments.

## During Different Economic Environments, Different Asset Classes Have Outperformed

Portfolio diversification is necessary when pursuing financial goals across market cycles.

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<tbody>
<tr>
<td>Market Environment</td>
<td>Deflation</td>
<td>Low-Inflationary Growth</td>
<td>Inflation</td>
<td>Commodity</td>
<td>Low-Inflationary Growth</td>
<td>Deflation-Like*</td>
</tr>
<tr>
<td>Corporate Bonds</td>
<td>6.06%</td>
<td>Stocks</td>
<td>15.70%</td>
<td>Inflation</td>
<td>7.00%</td>
<td>Commodities</td>
</tr>
<tr>
<td>Long-Term Govt. Bonds</td>
<td>4.55%</td>
<td>Inflation</td>
<td>3.06%</td>
<td>T-Bills</td>
<td>6.83%</td>
<td>Inflation</td>
</tr>
<tr>
<td>T-Bills</td>
<td>0.79%</td>
<td>Corporate Bonds</td>
<td>2.45%</td>
<td>Stocks</td>
<td>5.95%</td>
<td>T-Bills</td>
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<tr>
<td>Inflation</td>
<td>-0.79%</td>
<td>Long-Term Govt. Bonds</td>
<td>2.11%</td>
<td>Corporate Bonds</td>
<td>2.89%</td>
<td>Stocks</td>
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<tr>
<td>Stocks</td>
<td>-2.43%</td>
<td>T-Bills</td>
<td>1.70%</td>
<td>Long-Term Govt. Bonds</td>
<td>2.53%</td>
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5 Talk with your financial advisor

As we can see from the example of the Dow, each generation of investors has seen the stock market fall by 50% at least once, and 20% or more numerous times. Therefore, risk management is a key challenge investors need to face.

Talk to your financial advisor about constructing a portfolio that helps mitigate against unacceptable risks while pursuing returns. The ability to weather a variety of economic environments may help investors meet their financial goals over time.

Intentional Investing Challenge

Your challenge as an investor is to create a financial strategy that’s built to meet your needs no matter what the markets are doing. Meeting that challenge requires thoughtful planning, deliberate action and a financial partner who’s dedicated to your success – that’s what Intentional Investing® is all about.