QUICK MARKET UPDATE

A Perspective on the Lost Decade

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It has been more than three years since we reached the depths of the most recent financial crisis. At this point, the causes are well known, and in retrospect, there should have been many red flags regarding leverage, the trajectory of housing prices, and inadequate (or, arguably broken) risk models on Wall Street. In the aftermath, trillions of dollars in market value were lost, and many articles started to focus on what has become known as “The Lost Decade.”1,2

This phrase generally is used in reference to the S&P 500 Index, and in fact, over the course of a decade, from December 31, 1999 through December 31, 2009, the index did indeed decline in value. Presumably, investors had nothing to show for the decade of investment. Articles focused on this price decline, and suddenly, the paradigms underlying most investment strategies, that equities are a good long-term investment, that a diversified portfolio of equities can protect the downside and reduce risk, were not only being questioned, they were being characterized as blatantly false.

“A lie gets halfway around the world before the truth has a chance to get its pants on.” – Sir Winston Churchill

Is the Lost Decade truly lost or did we misplace our perspective?

Looking at the issue from the perspective of the level of the S&P 500 index after the market decline at the end of 2008 versus the level of the index 10 years prior, it is true that the S&P 500 and many other equity indices lost value over that 10-year period. So there is some truth in referring to the last decade as The Lost Decade. The story has changed since March of 2009. We have three years of market recovery behind us now and the S&P 500 currently is at approximately 1300.3 It’s time to update the numbers and recalculate. If we look at the last decade…it has not been lost. We simply need to change the perspective by adding some context to the evaluation:

1. Index value comparisons ignore a significant contributor to equity returns – dividends. Over time, dividends have represented a significant portion of total returns. However, comparing index values ignores the returns provided to investors in the form of dividends. Including dividends in the return calculation can change the perceived success of an investment – potentially changing a negative return to a positive return.

2. A point-to-point investment calculation ignores the timeline of investments placed prior to and subsequent to the market highs of 2000. The Lost Decade is largely a function of a behavioral flaw known as “anchoring,” which occurs when an investor measures the success of a strategy relative to the most recent highest market value instead of the value of the investment at the time they made it.

3. A 100% equity portfolio that is not rebalanced, often represented by a single index such as the S&P 500 index, generally is not representative of the diversified portfolios of stocks, bonds, real estate and commodities owned by most investors.
Let’s focus on the LAST decade instead of the LOST!

The graph below shows the S&P 500 from May 1, 2002 through April 30, 2012. The arrow illustrates that an investment in the S&P 500 made at the beginning of the period would have increased in value if held through the end of April (the arrow slopes up). In fact, on a market value basis, the area in the box illustrates the only times in the last decade where the S&P 500 could have been purchased at a level above the April-end value. An investment made at any other time during the last 10 years would have yielded a positive return. Investors may be surprised by these positive results.

![S&P 500, May 1, 2002 through April 30, 2012](Bloomberg)

The graph above and the discussion of returns are only based on the value of the S&P 500. Once again, this ignores a very important component of returns – the dividend yield. As shown below, the dividend yield can compound and accumulate to make up a substantial portion of total return. Dividends cannot be ignored. Without dividends, investors see an incomplete story.

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Price Only*</th>
<th>Price and Dividends*</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 Year Return</td>
<td>17%</td>
<td>19.46%</td>
</tr>
<tr>
<td>5 Year Return</td>
<td>-1.17%</td>
<td>1.01%</td>
</tr>
<tr>
<td>10 Year Return</td>
<td>2.64%</td>
<td>4.71%</td>
</tr>
<tr>
<td>15 Year Return</td>
<td>3.78%</td>
<td>5.65%</td>
</tr>
<tr>
<td>Inception (1/30/1970)</td>
<td>5.36%</td>
<td>10.23%</td>
</tr>
</tbody>
</table>

* S&P 500 Annualized Returns for Period Ending 4/30/2012, Morningstar Direct

Consider the significance of dividends during each time period. Over five years, the dividend yield added enough return to swing the annualized return from negative to positive. Over 10 years, 15 years, and since the inception of the total return index, the dividend yield boosted total return by 78%, 49% and 91%,
respectively. Stories you see on television and read in the media about The Lost Decade generally focus on price return only. If they added the effect of dividends to total returns, it would certainly reduce the editorial shock value by increasing those total returns (thereby losing the attention of the investing public).

The Lost Decade and Our Brains – It’s All in Our Heads!

As emotional creatures, our brains often get the best of us. In fact, there is a whole field of study called behavioral finance that explains how our emotions affect our decision making when it comes to investments. When you talk to investors about The Lost Decade, it’s common that they will exhibit a behavioral finance flaw known as anchoring.

Investors who suffer from anchoring bias change the reference point used to evaluate investment results. For example, assume an investor bought a stock for $25, and the stock currently trades at $75. Most would assume the investor is happy with the gain in value. However, let’s further assume the stock traded at $100 within the last year. The investor is likely to change their perception of a gain to a loss by changing their reference point, or anchor, from the $25 purchase price to $100, the most recent high value. While we know the investor has a positive return when viewed relative to the purchase price, the investor starts to view the investment as a loser because of anchoring bias.

Within the context of the S&P 500, there are two significant anchoring points in the last 15 years – the high levels reached in 2000, and the subsequent high levels reached in 2007. The graph below shows the anchoring points at the two market peaks of the last 15 years.

![S&P 500, May 19, 1995 through April 30, 2012](image-url)

Bloomberg.
The yellow (solid) lines show the perceived negative returns for investments made at the anchoring points. However, it is important to remember that most investors likely did not make investments only at these high points of the S&P 500 (the anchoring points.) The reality is that most investors don’t make huge lump sum investments but instead make regular periodic investments over time through 401(k) contributions and other savings plans. Most investors have made investments throughout the decade, not just at the anchoring points.

The green (dashed) lines show that these “other” investments which were not made at the anchoring points have actually had positive returns. However, investors have likely changed their perception of these returns by changing their anchoring points. For example, investments C and D on the chart clearly have gained in value over their holding periods, but investors likely changed their perceptions by moving their anchor point to Anchor A, and now view those investments as having lost value.

**It’s not just about the S&P 500.**

Finally, all the discussion up to this point has focused on the S&P 500. However, it is important to remember that outside of speculators and very aggressive investors, we recommend that most investors own a diversified portfolio of stocks, bonds, real estate, and commodities. In addition, we recommend that investors rebalance their portfolios when markets allow assets to drift too far away from the prescribed allocation. Therefore, it is appropriate to also evaluate the return of a diversified, rebalanced portfolio to evaluate the past decade of returns.

To evaluate, we back tested a balanced portfolio comprised of 60% diversified stock mutual funds (including domestic large and small companies, international companies, and real assets) and 40% bond mutual funds. We assessed a 1.5% management fee, and rebalanced the portfolio annually.

In our back tested balanced portfolio, a hypothetical investment of $100,000 made on April 30, 2002, would have been worth $171,429 at the end of the period. Few would argue that represents a lost decade.4

“You can always count on Americans to do the right thing – after they’ve tried everything else.” – Sir Winston Churchill

Churchill may have uttered the phrase in a very different context, but it seems applicable to investors today. Investors are barraged with “new” investment strategies by an industry eager to develop new products. We can look at investor flows and see that, to a large extent, many of these strategies are capturing assets, that is, Americans are trying everything else. They are doing this because they have been told that stocks have been and continue to be in a lost decade.

We hope that the addition of some different perspectives of the last decade shows that the last decade has not necessarily been a Lost Decade. Not all investments have performed poorly over the last decade. Whether or not you truly believe that depends on the anchoring point you use in evaluating returns, consideration of all returns including dividends, and a comparison of returns that is based on the reality of how today’s investors likely approach markets.

We continue to believe that most investors are best served through a diversified portfolio of stocks, bonds, and real assets, which is systematically rebalanced to control risk. If you have any questions regarding an appropriate strategy to follow, we suggest contacting your H.D. Vest Advisor.
Disclosures:

Standard & Poor’s is a corporation that rates stocks and corporate and municipal bonds according to risk profiles. The S&P 500 is an index of 500 major, large-cap U.S. corporations. You cannot invest directly in an index. Investments are subject to market risks including the potential loss of principal invested.

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Asset allocation and diversification do not assure or guarantee better performance and cannot eliminate the risk of investment losses.

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Dividends are not guaranteed and are subject to change or elimination.

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1 “Will Stocks’ ‘Lost Decade’ Usher in Another Bull Market,” USA Today, January 4, 2010
3 S&P 500 Index, Bloomberg, 5/17/2012
4 Hypothetical portfolio returns generated in Morningstar Advisor Workstation