# Bear Market Grads: What You Should Learn From the Financial Crisis

**By William Reichenstein and Larry Swedroe**

**By March 2009, most U.S. and international stock indexes had lost at least half of their value in the current financial crisis.**

Since that time, some indexes have managed a small rally, but all remain substantially below their peak levels. In addition, banks are in lousy shape, and governments around the world are running huge deficits and trying, seemingly in vain, to cure the financial ills that beset the world economies.

There has been a litany of articles trying to lay the blame for the crisis. We do not propose to add to this literature. Rather, our primary aim is to discuss the investment lessons from the crisis, and to make positive suggestions for investors today.

As a background, we begin with a brief discussion of a few of the factors that contributed to the financial crisis. Then we progress to the discussion of investment lessons that can be learned and what investors can and should do going forward.

## Contributing Factors

While this article is not intended to "point fingers" of blame, it is helpful to understand some of the factors that contributed to the current financial crisis. This is an impartial list that is included because these factors will be part of the later discussion of lessons learned and advice to investors.

### Lowered Lending Standards

First, a major factor in the crisis was the government-sponsored push to vastly broaden the availability of mortgages. In this, we concur with Nobel-laureate economist Harry Markowitz who, in a major article in the Financial Analysts Journal (January/February, 2009), stated: "[A] basic cause of the current financial crisis was the mandate by the U.S. Congress for the Federal National Mortgage Association (Fannie Mae) to vastly increase its support of low-income housing. This mandate required a lowering of lending standards."

### Overly Complex Investments

Second, the lowering of lending standards resulted in an enormous number of questionable loans that were packaged into complex pools of mortgages (collateralized mortgage obligations, or CMOs). These pools were then sliced up into various combinations of principal and interest repayments, with various maturities, and then sold; the result, in many cases, was that bits and pieces of each original mortgage were spread around various mortgage pools.

In some cases, CMOs were sliced up and wrapped up into other complex and exotic pools, such as collateralized debt obligations (CDOs). For example, one slice of CDO B may contain CMO C. A major problem today is that it is virtually impossible to look inside these opaque investments to determine their value.

### Excessive Leverage

Third, many investments and investment banks used

excessive leverage, and thus incurred excessive risk. Due to this leverage, a small decrease in assets' value could and did wipe out the equity at many financial firms, including the government-sponsored enterprises of Fannie Mae and Freddie Mac, and the investment banks Lehman Brothers, Bear Stearns, Merrill Lynch, and others.

## Lessons From the Crisis

What should investors learn from the financial crisis? This section presents five major lessons that every investor should heed.

### Lesson 1: A mix of high-grade bonds and stocks moderates portfolio risk.

Does history repeat itself?

After the last financial crisis, one of the authors (Reichenstein) wrote the article "10 Lessons You Should Learn from Recent Market History" (February 2003 *AAII Journal;* available at AAII.com). In the first lesson, he wrote: "High-grade bonds and stocks are fundamentally different assets. Bad years for bonds are sometimes good years for stocks. Bad years for stocks are sometimes good years for bonds."

At the risk of sounding like a broken record, that same lesson is repeated here as the first lesson to be learned from this most recent crisis.

A key qualification is that only *high-grade* bonds are fundamentally different assets than stocks. And the higher the credit quality, the greater the difference.

Consider a highly rated 6% coupon ExxonMobil bond. It promises $60 in interest each year, plus the $1,000 principal at maturity. When crude prices rose to $145 a barrel, the bond holders were not promised more than $60. When crude prices fell to $40 a barrel, bond holders were still promised the same $60. The changes in crude prices affected ExxonMobil's stock price, but not their bond prices because of the lack of default risk.

In contrast, consider low-rated Ford bonds. Due to default risk, Ford's existing junk bonds will rise and fall in value, just like the stock value, as the firm's prospects change.

Junk bonds behave like stocks, while high-grade bonds are fundamentally different assets than stocks, and thus provide good diversification benefits.

In the book "The Only Guide to Alternative Investments You'll Ever Need" (Bloomberg Press, 2008) authors Larry Swedroe and Jared Kizer emphasize that high-yield [junk] bonds, convertible stocks, emerging market bonds, and preferred stocks all have stock-like characteristics that can provide some growth benefits during rising markets. Unfortunately, during bear markets, these assets still behave more like stocks than bonds. Therefore, these assets do not provide investors with protection during bear markets. For diversification purposes, the authors recommend that individuals invest in Treasury securities, government agency debt, or FDIC-insured bank deposits (for amounts within the insurable limits).

Another approach, recommended by Prof. Reichenstein, would be to limit bonds to Treasuries or high-grade bonds.

### Lesson 2: Avoid complex investment products.

Wall Street likes to create complex products that appear desirable, but are designed to separate capital from investors.

David Swensen, the portfolio manager of Yale University's endowment fund and author of the popular investment book "Unconventional Success" (Free Press, 2005), may have expressed it best:

"When a sophisticated provider of financial services stands toe to toe with a naïve consumer, the all-too-predictable conclusion resembles the results of a heavyweight champion and a ninety-eight-pound weakling. The individual investor loses in a first-round knockout."

These complex investments may combine $97 worth of assets, but are sold for $100. Recent examples include Accumulators, Booster-plus Notes, Buffered Notes, Principal Protected Notes, Reverse Convertibles, STRATS, and Super-Track Notes.

Author Larry Swedroe has studied these products for more than a decade. In that time, he concludes that every single product that he reviewed was meant to be sold, but never bought. Investment bankers are not in the business of playing Santa Claus.

Another example: On a Saturday morning radio show in Dallas, brokers encourage individuals to attend their seminar where they will reveal the wonders of equity-indexed annuities. These assets, which were discussed in our November 2007 *AAII Journal* article ["Investment Products: If It Has to Be Sold, Don't Buy It!"; available at AAII.com], have hidden costs, complex features, surrender penalties, a lack of a secondary market, and more. But they pay huge commissions, and are aggressively sold.

In "An Overview of Equity-Indexed Annuities," a 2006 working paper by the Securities Litigation and Consulting Group, authors Craig McCann and Dengpan Luo conclude that the "net result of equity-indexed annuities' complex formulas and hidden costs is that they survive as the most confiscatory investments sold to retail investors."

If it sounds too good to be true, it probably is.

### Lesson 3: Insist on simple, transparent investments.

Individual investors can create prudent portfolios by combining stocks, bonds, mutual funds and exchange-traded funds. They do not need to resort to non-transparent products like CMOs, CDOs, hedge funds, and funds of hedge funds.

The markets for CMOs and CDOs have frozen because no one knows what is in these opaque investments.

Some hedge fund managers refuse to reveal their strategy because, they claim, they do not want other investors to learn about the market inefficiency that they are allegedly exploiting.

Bernie Madoff had a history of

providing consistent stable returns before his $50 billion Ponzi scheme collapsed. Allen Stanford, head of Stanford Financial Group, and also accused of running a Ponzi-type scheme, also had a strong record allegedly built on secret strategies before the fraud was discovered.

Investors should not trust opaque strategies that seem to offer returns that are too good to be true.

Buying simple investment products provides a degree of safety against fraud that is not available in complex and opaque investments.

### Lesson 4: Avoid leveraged investments.

It should be clear that there is plenty of risk in traditional stocks, bonds, mutual funds and exchange-traded funds. We suspect few, if any, individuals feel the need to leverage up their risk beyond that inherent in stocks and stock funds.

However, many hedge fund managers use substantial leverage. Hedge funds' cost structure, where managers typically charge 2% of assets under management plus 20% of profits, encourages this risk-taking. After all, when leverage increases returns, it magnifies the managers' profit-sharing returns, while when leverage decreases returns, the investor bears all the risk. This is a classic example of "heads" the manager wins and "tails" the investor loses. It makes sense for the manager, but not for the investor.

Table 1 shows the 2003–2008 returns on an HFRX index of hedge funds [HFRX indexes are published by Hedge Fund Research Inc.] and several stock and fixed-income indexes. The HFRX index indicates returns "as reported by hedge fund managers."

These returns may have several upward biases. First, the returns are "reported" but not necessarily audited.

Second, they likely included returns from hedge funds run by Madoff and Stanford that looked good, but were fraudulent.

Third, there may be survivorship bias. Several hedge funds in existence in 2003 did not survive through 2008. When a fund dies, it usually has poor returns, and most indexes delete the historical records of these non-survivors at their death. The survivorship bias reflects the fact that the average return of investors in surviving funds exceeds the average return of investors in all funds, including those that survived and those that failed.

Despite multiple upward biases in this hedge fund index, Table 1 indicates that hedge funds had negative returns for 2003–2008, while domestic stocks, international stocks, and high-grade U.S. bonds had positive returns.

The dramatic failures of Fannie Mae, Freddie Mac, Lehman Brothers, and Bear Stearns would not have been possible without the use of excessive leverage. Fannie Mae, Freddie Mac and Lehman Brothers had leverage ratios of about 30, meaning they borrowed about $30 for each $1 of their money. (Counting off-balance-sheet obligations in the form of guarantees made the real leverage at Fannie Mae and Freddie Mac much higher, perhaps 100 to 1). So, it took less than a 4% drop in the underlying asset's value to wipe out their equity positions.

With this level of leverage, investment bankers could not be right just some of the time. They had to be right all the time.

**Table 1. Annual Index Returns: 2003–2008**

| | 2003–2008 Return (%) |
|---|---|
| **Hedge Fund Index** | |
| HFRX Index* | (0.7) |
| **Domestic Indexes** | |
| S&P 500 | 2.4 |
| Russell 2000 | 5.8 |
| Russell 2000 Value | 6.8 |
| Russell 2000 Growth | 4.7 |
| Wilshire REIT | 5.9 |
| **International Indexes** | |
| MSCI EAFE | 7.5 |
| MSCI International Small | 9.8 |
| MSCI International Value | 8.6 |
| MSCI Emerging Markets | 14.9 |
| **Fixed Income** | |
| 1-Year Treasury Notes | 3.3 |
| 5-Year Treasury Notes | 5.3 |
| 20-Year Treasury Bonds | 8.8 |
| Barclay's Aggregate | 4.6 |

**The HFRX index is an index of hedge fund returns.*

### Lesson 5: There is no "smart money," or investors who are consistently smarter than others.

There is the myth that there exists so-called "smart money" and "smart investors," and if you only had access to that smart advice, you could consistently earn market-beating returns.

If only it were true!

This financial crisis, perhaps more so than any other, should dispel the myth that "smart money" and "smart investors" exist that individual investors can tap into and earn higher-than-most-anybody-else's rates of return.

For 15 straight years from 1991 though 2005, Bill Miller's Legg Mason Value Trust mutual fund beat the S&P 500, and he was considered by many investors to be "smart money." However, his fund has dramatically underperformed since 2005. According to Morningstar, as of year-end 2008 his fund's returns were in the bottom quartile of one-, three-, five-, and 10-year trailing returns among large-cap blend stock funds.

Investment banking firms have long corralled the best and the brightest. Just ask them. Indeed, they have long cherry-picked the brightest minds from universities. If ever there was a group of smart investors, they would be at investment banks.

In early 2007, Merrill Lynch had a market cap of $86 billion. In fall 2008, they were rescued by Bank of America

after gaining certain Federal Reserve guarantees. Recent estimates suggest losses at Merrill might cost the government in excess of $100 billion.

Lehman Brothers is bankrupt.

Bear Stearns was rescued in the face of certain failure.

AIG, an insurance firm with a large investment arm, has been rescued from failure, and the cost of the government rescue continues to rise.

Where, then, is the smart money?

Where are the investment managers that can consistently produce market-beating returns?

Because markets are highly efficient, investors are best served if they assume that (or invest as if) there is no smart money and there are no smart investors. The reason is that, while it is easy to identify investment managers with good performance after the fact, no one has yet found a way to identify the good performers before the fact.

That is why the SEC requires the disclaimer about past performance.

## What Should Investors Do Now?

The first and foremost step investors should take is to have a plan: They should have an asset allocation strategy, and they should stick to it.

### Be Broadly Diversified

Investors should stay with the tried-and-true strategy of building a broadly diversified portfolio containing U.S. stocks, international stocks, and U.S. high-grade bonds.

In addition, you may want to (but do not have to) allocate a small portion of your portfolio to alternative assets such as real estate investment trusts (REITs, which own income-producing real estate such as office buildings, shopping centers, and apartments) and commodities.

The U.S stock market already contains a small exposure to REITs, so if you have investments in a broad-based stock market index, you are already invested in REITs. However, most real estate is privately owned, so if the idea is to construct an investment portfolio that mirrors the portfolio of all existing financial assets, you could easily justify a higher exposure than the one you are getting in the stock indexes—perhaps a 5% exposure to REITs beyond that already present in a stock index fund.

The same philosophy applies to commodities.

### Keep It Low Cost and Tax Efficient

Since markets are highly efficient, individuals should invest in passively managed, low-cost, and tax-efficient index funds and exchange-traded funds (ETFs).

Since markets are efficient, it is unlikely financial analysts can consistently find mispriced assets and thus add to investors' returns—especially after paying the costs of the effort. So, it does not make sense to pay the higher fees needed for an army of financial analysts to try to find such assets.

### Rebalance Periodically, and Don't Try to Time the Market

One good strategy is a fixed-weight strategy.

Suppose a couple has a target asset allocation of 60% stocks and 40% bonds. Unless circumstances change dramatically (for example, one spouse loses a job, or there is a death in the family) then periodically—perhaps once per year—they should rebalance the portfolio back to these original fixed weights, since changes in market valuations will cause the portfolio to stray from the original allocation.

There are other perfectly viable asset allocation plans. However, the main point to keep in mind is that you should resist the common practice of trying to "time" the stock market—substantially changing your exposure to the stock market based on the direction you think it may be headed. Substantial research shows that many investors enter the stock market or increase their stock exposure *after* the market has risen and exit or reduce their exposure *after* stocks have fallen—the most inopportune time for either move.

It is tough to be tenacious in bear markets and stick to your stock market holdings at a time when the valuations seem unbearably bleak. But history suggests that investors will hurt their returns if they listen to their gut and bail out, instead of listening to their mind and "bearing" with it.

### Have a Plan B

In the financial community, historical returns are often used to help estimate what the future might bring.

For example, at the turn of the century, estimates might have been generated from analyses of thousands of possible 30-year scenarios, based on randomly drawing 30 yearly returns from the 1926–1999 distribution of historical returns.

These procedures are used in the hopes that they can provide some guidance about the probable distribution of future returns.

But the 1926–1999 distribution would have predicted only an extremely small chance of two separate 50% decreases in the real value of the S&P 500 this decade.

Perhaps this very small predicted chance is what actually occurred. More likely, however, the simulations underestimated the range of future possible 30-year returns.

This should serve as a cautionary reminder that there is a difference between the risk that is implied from a known probability distribution (one that has already occurred, like the 1926-1999 returns) and the risk from an uncertain probability distribution.

Unknowable factors—like 9/11 and this financial crisis—remind us that the future comes from an uncertain distribution. While past returns are often used for some guidance, don't be fooled into thinking that "improbable" bad events can't happen.

Since "unexpected" things can happen to good people and good plans, it is important to have a Plan B: If things turn out worse than expected, how will you respond?

- If you are still working, you may be able to delay retirement.
- If retired, you may be willing and able to return to work.

- You may have to eliminate one or more goals from your wish list.
- You may have to reduce or eliminate discretionary spending for travel and dining out.
- You may have to move in with a family member.

We all need to remain flexible in the face of an uncertain future. ▲

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## For Further Reading

Link to these past *AAII Journal* articles at www.aaii.com for more on the topics discussed in this article.

***Balance & Diversification in Your Portfolio***
- "The Real-World Lessons From Investment Theory," by William Reichenstein and C. William Thomas, January 2006
- "10 Lessons You Should Learn From Recent Market History," by William Reichenstein, February 2003
- "Basic Truths About Asset Allocation: A Consensus View Among the Experts," by William Reichenstein, October 1996

***Complex Investments***
- "Due Diligence: 10 Steps to Avoiding Ponzi Schemes and Financial Fraud," by Karen C. Altfest, April 2009
- "Investment Products: If It Has to Be Sold, Don't Buy It!," by William Reichenstein and Larry Swedroe, November 2007
- "Hedging Your Portfolio With Mutual Funds," by John Markese, June 2006
- "What Are You Really Getting When You Invest in a Hedge Fund?," by William Reichenstein, July 2004

***Investing With Margin***
- "Margin Accounts: A Double-Edged Sword," by John Gannon, May 2005