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Fourth-Quarter and Full-Year 2010 Market Review

Does Diversification Still Work?

January 2011 - Despite widespread anxiety about a double-dip recession and European-country fiscal crises, strong company earnings led to double-digit gains for nearly all equity asset classes in 2010. Buoyed by optimistic signals that the economy was on the rebound, stocks inched ahead in the first quarter. However, a sluggish global economy, as well as concerns that European sovereign debt could spur another financial crisis, resulted in across-the-board losses in the second quarter. With the best September for stocks since 1939, all broad-market measures were above water through the first three quarters. Big advances in the fourth quarter sealed the upside for the year.

Domestic Small Caps were the top performer, swelling 15.4% to 17.1% for the quarter and 24.5% to 29.1% for the year. At the back of the pack was International Developed Large Cap, adding 6.7% and 8.2% for the quarter and year, respectively.

Suggesting a sanguine outlook for stocks, Standard & Poor's reported that in 2010, 243 companies in the S&P 500 index had raised dividends, 13 initiated dividends, and only five decreased or suspended dividends. This represented an additional payout to shareholders of $20.7 billion, a significant reversal from the dividend cuts of 2009 and 2008 totaling $37.3 billion and $21.5 billion, respectively.

Notwithstanding Federal Reserve actions to maintain low interest rates to invigorate the economy, bond yields shot up during the fourth quarter. At year-end, the yield on the 10-year Treasury note was 3.29%, up 78 basis points for the quarter and down 55 basis points for the year (the yield as of January 14th was 3.33%).

Bond yields bottomed out in October at levels not seen since the beginnings of the fall 2008 financial crises. Yields initially jumped in anticipation of the Fed's November 3rd announcement that, to keep rates low, it would implement additional "quantitative easing" by purchasing $600 billion of Treasury Securities by mid 2011. The yield on the 10-Year T-Note continued to rise through November. The next leg up came in December after lawmakers announced that they struck a deal to maintain current income tax rates for two more years, thereby creating fears among investors that future deficits and stimulus would spur inflation.

With higher interest rates and a stronger dollar, nearly all bond sectors lost ground in the fourth quarter. Municipal bonds sank 4.2% on worries that weak state and local government finances would result in greater supply, as well as defaults. The exception was U.S. Corporate High Yield, expanding 3.2%, as profits continued to improve company balance sheets. Even with the fourth-quarter fallback, all bond sectors finished 2010 above water. U.S. Corporate High Yield was the leader, leaping 15.1%, followed by International Emerging Markets, climbing 12.8%.

On the next page are rates of return for selected market indices for the fourth quarter of 2010, full-year 2010, and the three, five, and 10-year compound annual returns as of December 31, 2010.

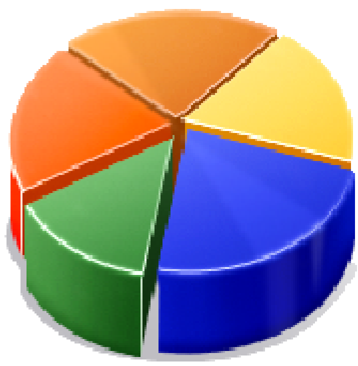
	4Q:2010	2010	3-Year	5-Year	10-Year
Equity (Stock) Indices					
Domestic Large Cap					
Russell 1000 - Growth	11.83%	16.71%	-0.47%	3.75%	0.02%
Russell 1000 - Value	10.54%	15.51%	-4.42%	1.28%	3.26%
Russell 1000 - Blend	11.19%	16.10%	-2.37%	2.59%	1.83%
Domestic Small Cap					
Russell 2000 - Growth	17.11%	29.09%	2.18%	5.30%	3.78%
Russell 2000 - Value	15.36%	24.50%	2.19%	3.52%	8.42%
Russell 2000 - Blend	16.25%	26.85%	2.22%	4.47%	6.33%
Real Estate (FTSE EPRA/NAREIT Global)	5.59%	20.03%	-4.67%	3.49%	NA
International					
MSCI EAFE Developed Large Cap	6.65%	8.21%	-6.55%	2.94%	3.94%
MSCI EAFE Developed Small Cap	11.84%	22.40%	-1.37%	3.17%	9.87%
MSCI Emerging Markets	7.36%	19.20%	-0.03%	13.11%	16.23%
Fixed-Income (Bond) Indices					
Barclays Capital					
Global Aggregate	-1.06%	5.83%	5.85%	6.72%	6.76%
U.S. Aggregate	-1.30%	6.54%	5.90%	5.80%	5.84%
U.S. Treasury TIPs	-0.64%	6.31%	4.97%	5.33%	6.90%
U.S. Corporate High Yield	3.22%	15.12%	10.38%	8.91%	8.88%
Municipal	-4.17%	2.38%	4.08%	4.09%	4.83%
International Emerging Markets	-1.23%	12.84%	8.89%	8.36%	10.49%

Source: russell.com, reit.com, mscibarra.com, barcap.com

Does Diversification Still Work?

The last 10-year period had its share of financial scandals and stock market drama. The decade opened with the after affects of the technology and telecom stock bust. As stock prices deflated, accounting frauds such as Enron and WorldCom were exposed. Wall Street provided its share of shenanigans with dubious independence by investment bank research analysts, as well as late-trading and market-timing irregularities by mutual and hedge funds.

At the same, a residential real estate bubble was brewing. This emanated from unsupported mortgage lending and ratings agencies rubber-stamping sub-prime loans with investment-grade labels. All of this culminated in bringing the financial system to the brink of disaster, with bank and corporate failures, bailouts by Uncle Sam, and the federal takeover of Fannie Mae and Freddie Mac. Even one of the oldest money market funds "broke the buck," and more would have followed if not for government intervention and fund-sponsor support.



Diversification provided little protection during the crises, as stocks and bonds collapsed between September 2008 and March 2009, sending many investors to the sidelines. With investors seeking a safe haven, the price on U.S. Treasury securities was bid up, making it the only major asset class to advance in 2008. As stock prices tumbled, the Madoff and several other Ponzi-type schemes were revealed, further weakening investor confidence in capital markets.

Whew, it's no surprise that the financial media would have you believe that stocks generated a zero return over the past decade! In fact, for the 10 years ending December 31, 2010, the Standard & Poor's 500-stock index slipped 4.8%, the worst showing since the 1930's Great Depression (the S&P 500 began 2001 at 1320.28 and closed 2010 at 1257.64). Included in this downdraft was the 38.5% bludgeoning in 2008.

However, the media attention focuses on the S&P 500 "price" index, which ignores dividends. Historically, dividends have contributed a substantial portion of total return. Disregarding dividends would be similar to overlooking the interest paid on a certificate of deposit. This makes no sense!

A better barometer would be the S&P 500 "total return" index, which includes dividends. For the 10 years ending December 31, 2010, this index generated a compound annual return of 1.4%, or a total return of nearly 15% for the decade. Although nothing to write home about, it certainly beats the loss everyone would have you believe existed.

Another shortcoming of the S&P 500 is that it only includes the largest companies in the United States (largest as measured by market capitalization, which is stock price multiplied by shares outstanding). What if you simply added the returns of small U.S. companies? Let's assume you had a portfolio allocated 70% to the S&P 500 and 30% to an index of small U.S. companies, such as the Russell 2000. The 10-year compound annual return for the Russell 2000 was 6.3%. The combined compound annual return for the 10 years would have been 2.9% ((1.4% x 70%) + (6.3% x 30%)).

If you had ventured overseas and invested in large companies in developed countries, the 10-year compound annual return as measured by the MSCI EAFE International index would have been 3.9%. Combining this with the S&P 500 results in a compound annual return of 2.2% ((1.4% x 70%) + (3.9% x 30%)) for the 10-year period.

For the risk-averse investor, U.S. bonds would have been a great place to invest. The Barclays Capital U.S. Aggregate bond index generated a 10-year compound annual return of 5.8%. A 70-30 mix of the two indexes would have provided a blended compound annual return of 2.7% ((1.4% x 70%) + (5.8% x 30%)).

Does Diversification Still Work?

You betcha! To paraphrase Mark Twain, reports of diversification's demise are premature.

Although diversification supplied negligible shelter during the market storm from September 2008 through March 2009, maintaining a diversified portfolio over longer periods has improved returns. While none of the above combined returns come close to the long-term average annual returns of stocks over the past century (i.e., approximately 10%), they certainly beat the gains provided by a portfolio narrowly invested in large U.S.-focused companies. Combining the returns of large U.S. companies with virtually every other asset class presented in the chart on page two results in a higher overall return.

The enhanced return generated by putting your eggs in multiple baskets is the essence of asset allocation and diversification. While most assets fall simultaneously during a crises, eventually the various types of stocks and bonds revert to their different patterns, capturing the benefits of diversification.

The best approach for an individual investor is to ignore the financial media and stick to a long-term plan of global portfolio diversification designed to meet the investor's goals. By broadly diversifying, an investor will obtain the returns from the top-performing asset classes.

And remember, good periods for the market usually follow dismal ones. The 1940s and 1950s were much better than the 1930s, and the 1980s and 1990s were superior compared with the 1970s. As the current century transforms from a child to a teenager, hopefully the market returns of the 2010s will be higher than the 2000s.

Kalorama Wealth Strategies can help you create a plan to invest your assets in a manner providing diversification and professional management. For more information, please see our web site at www.kaloramawealth.com.

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