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Bears Again Confounded by Market Reversal

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A *Groundhog Day*-like sense of repetition has revealed itself in the equity markets of late, as minor corrections have provided savvy investors with ample opportunities to learn from their mistakes while dooming those unable to do so. A January pullback gave those underweighted in equities the chance to get invested at (relative) bargain levels. Though this window closed in February, the bears got yet another "buy-low" opportunity in early March as Russia re-sparked the Cold War with its "invasion" of Ukraine and sent markets — especially their own stock and currency — plunging. This most-recent selloff was unwound the very next day, with some markets leaping to new all-time highs.

Investors should be doing cartwheels, but they just can't seem to trust this rally. This is not a market that investors should be light equities, never mind bearish or short. Why are investors so hesitant to embrace success? Apparently, neither the S&P 500's 175%-plus total return from its nadir five years ago nor its one-third surge in 2013 has been enough to draw investors back to a full allocation. How about the fundamental strength in the U.S. economy — including corporate profits, retail sales, housing and GDP — or a near doubling of world economic growth?

Perhaps it's a case of once bitten, twice shy. Or, in behavioral finance terms, investors are anchored back in the 2008 credit crisis and can't get over the pain that was inflicted upon their portfolios.

Lower Risk the New Driving Force for Investors

High returns over the past several years have not been a powerful enough force to get investors back into the market. What really got investors perked up was the disappearance of headline risk. Risk, in fact, has remained so low a more pertinent discussion might be whether we are entering a virtuous cycle in which good news is accepted as good news and bad news is quickly discounted. Today's lower risk inspires confidence not only because of its level but also because there seems to be a "stickiness" — or resilience — to it staying low.

For example, there were a number of events year to date that could have markedly raised risk levels:

- The wind-down of the Fed's asset-purchase program continues with conviction in late-January under new Fed Chair Yellen.
- A currency crisis strikes the emerging markets, in particular the "Fragile Five" of Turkey, Brazil, India, South Africa and Indonesia.
- The Russian "invasion" of the Ukraine raises tensions in Europe.

The first two events initially sent the CBOE Volatility Index — known as the market's "fear gauge" — spiking back to its historical average around 20 from a 13 handle, a big yawn in the grand scheme of things but enough to spook investors. In each instance, however, the VIX quickly returned to its previous lows. The most recent contretemps, which saw Russia awake from the afterglow of its Olympics to tighten its grip on a slipping Ukraine, barely registered a VIX response, with the index ticking up to only a 16 handle before retreating back into the 13s.

In what behavioral economists term "prospect theory", investors tend to — especially in markets like this — appreciate low risk twice as much as high return. This lower risk is driving investors back into this market, and it may continue to do so, boding well for future returns and the stickiness of low risk.

Executive Summary

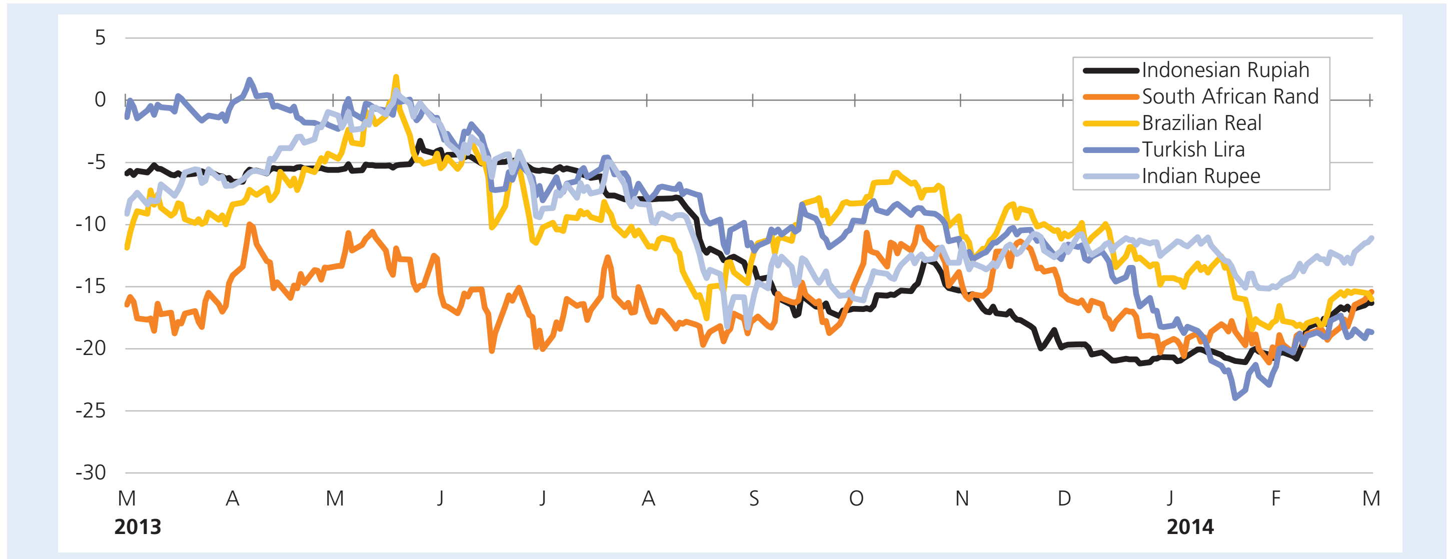
- **While recent equity pullbacks have provided under-exposed investors with attractive opportunities to re-enter the market, many remained spooked by memories of 2008.**
- **Risk has remained low in a virtuous cycle in which good news is accepted as good news and bad news is quickly discounted.**
- **Many emerging economies have struggled this year, but they are generally better positioned to withstand a currency assault than they were in 1997.**
- **A plan that effectively balances building wealth and controlling risk better positions investors to pursue their goals in all seasons.**

Most Equity Markets Erased January's Losses in February

Index	Feb-14	YTD
Equity		
S&P 500	4.6	1.0
S&P MidCap 400	4.9	2.7
S&P SmallCap 600	4.5	0.4
Global REITs	4.2	3.4
EAFE	5.6	1.3
Emerging Markets	2.3	(5.6)
Average	4.3	0.5
Fixed Income		
Corporate	1.0	2.9
U.S. Treasury 20+	0.9	6.9
Global Aggregate	1.4	2.5
High Yield	2.0	2.7
Average	1.3	3.7
Overall Average	**3.1**	**1.8**

Source: FactSet, FTSE NAREIT, ING U.S. Investment Management

The "Fragile Five" Currencies Have Stabilized of Late After Weakening for Much of 2013



Source: FactSet

Another Strong Reporting Season, and Markets Have Followed Suit

S&P 500 year-over-year earnings growth of 8.7% in the fourth quarter was the best we've seen since fourth quarter 2011 and represents a nearly 50% improvement over consensus expectations as of end-2013. The underlying strength of these fundamental profits sent equity markets close to near all-time highs in February, as the S&P 500 climbed 4.6% for the month, bested by midcaps (up 4.9%) and followed closely by small caps (up 4.5%). Fixed income also enjoyed a positive month across the board; notably, long U.S. treasuries were up almost 1% as soft economic data drove yields down. Perhaps the biggest story of the month was the about-face in emerging markets, with the MSCI Emerging Market Index gaining 3.3% in February.

Emerging Markets Are Different this Time

Despite the market rebound, some are concerned that emerging markets might be having a *Groundhog Day* moment of their own, with the recent currency turmoil leading many investors to think they've woken up in the middle of the 1997 Asian currency crisis. Truly, some of the countries that experienced a strong influx of hot money in recent years

The Lack of a Pattern for Asset Class Returns Argues for Broad Global Diversification

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
NAREIT/REIT 13.9%	BC U.S. 10.3%	MSCI EM 55.8%	NAREIT/REIT 31.6%	MSCI EM 34.0%	NAREIT/REIT 35.1%	MSCI EM 39.4%	BC U.S. 5.2%	MSCI EM 78.5%	NAREIT/REIT 28.0%	BC U.S. 7.8%	Global REIT 29.8%	R2000 38.8%
BC U.S. 8.4%	NAREIT/REIT 3.8%	R2000 47.3%	MSCI EM 25.6%	MSCI EAFE 14.0%	MSCI EM 32.2%	MSCI EAFE 11.6%	T-Bill 1.6%	MidCap 40.5%	R2000 26.9%	NAREIT/REIT 7.3%	MSCI EM 18.6%	MidCap 34.8%
R2000 8.2%	T-Bill 1.7%	MidCap 40.1%	MSCI EAFE 20.7%	MidCap 12.7%	MSCI EAFE 26.9%	Global AA 10.4%	Global AA -27.8%	MSCI EAFE 32.5%	MidCap 25.5%	SP500 2.1%	MSCI EAFE 17.9%	SP500 32.4%
MidCap 8.2%	Global AA -3.4%	MSCI EAFE 39.2%	MidCap 20.2%	NAREIT/REIT 12.2%	Global AA 19.2%	BC U.S. 7.0%	R2000 -33.8%	Global AA 30.2%	MSCI EM 18.9%	Global AA 0.0%	MidCap 17.3%	MSCI EAFE 23.3%
T-Bill 3.8%	MSCI EM -6.2%	NAREIT/REIT 37.1%	R2000 18.3%	Global AA 10.4%	R2000 18.4%	MidCap 5.6%	SP500 -37.0%	NAREIT/REIT 28.0%	SP500 15.1%	T-Bill 0.0%	R2000 16.3%	Global AA 11.9%
Global AA -0.8%	MSCI EAFE -15.7%	Global AA 32.2%	Global AA 15.4%	SP500 4.9%	SP500 15.8%	SP500 5.5%	NAREIT/REIT -37.7%	R2000 27.2%	Global AA 15.1%	MidCap -1.5%	SP500 16.0%	Global REIT 2.2%
MSCI EM -2.6%	MidCap -16.2%	SP500 28.7%	SP500 10.9%	R2000 4.6%	MidCap 15.3%	T-Bill 4.7%	MidCap -41.5%	SP500 26.5%	MSCI EAFE 8.2%	R2000 -4.2%	Global AA 14.9%	T-Bill -13.9%
SP500 -11.9%	R2000 -20.5%	BC U.S. 4.1%	BC U.S. 4.3%	T-Bill 3.0%	T-Bill 4.8%	R2000 -1.6%	MSCI EAFE -43.1%	BC U.S. 5.9%	BC U.S. 6.5%	MSCI EAFE -11.7%	BC U.S. 4.2%	BC U.S. -1.5%
MSCI EAFE -21.2%	SP500 -22.1%	T-Bill 1.0%	T-Bill 1.2%	BC U.S. 2.4%	BC U.S. 4.3%	NAREIT/REIT -15.7%	MSCI EM -53.3%	T-Bill 0.1%	T-Bill 0.1%	MSCI EM -18.2%	T-Bill 0.0%	MSCI EM -2.3%

Note: "Global AA" includes 10 asset classes, equally weighted: S&P 500, S&P 400 Midcap, S&P 600 Smallcap, MSCI U.S. REIT Index/FTSE EPRA REIT Index, MSCI EAFE Index, MSCI BRIC Index, Barclays U.S. Corporate Bonds, Barclays U.S. Treasury Bonds, Barclays Global Aggregate Bonds, Barclays U.S. High Yield Bonds. For illustration only.

Source: FactSet, ING U.S. Investment Management

have been left struggling as the Fed began to taper, but there are important distinctions between the emerging markets of 1997 and today, namely:

- Better economic policies
- Stronger foreign currency reserves
- Flexible exchange rates
- Lower government debt levels relative to GDP
  - — The International Monetary Fund reports that debt-to-GDP for developing Asia has declined from 40% in 2000 to 30% in 2014.
  - — Debt-to-GDP for all developing and emerging economies has fallen from 49% to 34% over that same period.

In 1997, many Asian economies — including Thailand and Indonesia — were pegged to the U.S. dollar. Today the only Asian economies pegged to the U.S. dollar are Hong Kong and China, which pegs its currency within a band. However, China has the world's largest balance of foreign currency reserves, with $3.8 trillion. Indeed, many of the emerging markets currently under pressure are feeling the impact of their own poor domestic conditions and/or economic mismanagement in addition to the stimulus unwind that has begun in the developed economies. Argentina, for example, was not a significant recipient of foreign investment, and thus blame for its current economic woes can't be placed solely at the feet of the Fed.

The fact that the emerging markets are better equipped to handle a currency assault makes a replay of 1997 less likely. In addition, the variety of issues confronting the emerging markets — both good and bad, from domestic and foreign sources — lessens the likelihood of contagion.

Moreover, investors must resist the temptation to paint all of the emerging markets with the same brush. There are always global risks, but many emerging markets offer high growth and compelling valuations. The IMF reports that GDP growth in emerging economies was 4.5% in 2013, while developing Asia posted growth of 6.3%. And emerging markets are generally trading at only 11 times earnings.

Build Wealth but Have a Plan for Volatility

In *Groundhog Day,* Bill Murray's arrogant weatherman finds himself locked in a time loop, seemingly doomed to re-live the same day over and over. Ultimately, he accepts his predicament for what it is: an opportunity for self-improvement, a chance to break free from the selfish and self-destructive instincts that have ruled his life. As he says in his umpteenth delivery of the February 2 forecast, "When Chekhov saw the long winter, he saw a winter bleak and dark and bereft of hope. Yet we know that winter is just another step in the cycle of life."

So it is for investment portfolios. Every dip in the market should not send investors headlong into despair and defensiveness; rather, they should be treated as opportunities to re-assess market expectations and personal goals.

Of course, if winter is just another step in the cycle of life, so, too, is summer. While risk has been low of late, a portfolio should assume a range of risk probabilities and not just the prevailing condition. This is harder than it sounds. It takes conviction and discipline. But by establishing a plan that effectively balances building wealth and controlling risk, an investor will be better positioned to pursue his or her goals in all seasons. ■

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