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Navigating Markets During March Madness

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What could be more exciting, heart-wrenching, surprising and, at times, confounding than college basketball during March, as 68 teams vie for a trip to the NCAA Final Four and ultimately a championship? How about trying to navigate the capital markets through their own version of March Madness? During the month, we were forced to address a number of bracket busters: Japan's devastating earthquake/tsunami and subsequent nuclear disaster; Libyan civilians being shelled by their dictator, only to be rescued at the last minute by France; renewed concerns about the European periphery; $105 oil wreaking havoc on global GDP growth prospects; and a U.S. government on the brink of complete shutdown. Markets were pummeled during the first two weeks of the month, losing almost 5% through March 16 and at one point falling into the red for the year. But that was only the first half; in an epic comeback, March not only won the game but won the championship with the best first quarter performance since 1998.

Like basketball, investing comes down not only to the fundamentals but also the discipline to stick with them even when the game seems to be going against you. While the fundamentals continue to be supportive — corporate profits have reached their highest level ever and are continuing to accelerate, manufacturing is at boom levels, the consumer has returned, and emerging markets continue to expand rapidly — many investors have shown a marked lack of discipline.

Global Perspectives Market Model: U.S., Developed and Emerging Market Equities Defy Risks With Positive First Quarter

Index	Wgt	Mar-11	YTD	2010	2009	2008	2007	2006	1 year	3 years	5 years	10 years
Equity												
S&P 500	10%	0.0	5.9	15.1	26.5	(37.0)	5.5	15.8	15.6	2.4	2.6	3.3
S&P 400 Midcap	10%	2.3	9.0	24.9	35.0	(37.3)	6.7	9.0	25.2	8.3	4.5	8.0
S&P 600 Smallcap	10%	2.9	7.4	25.0	23.8	(32.0)	(1.2)	14.1	24.0	7.0	2.5	8.1
U.S. REIT	10%	(1.8)	5.6	23.5	21.0	(41.5)	(20.2)	30.2	19.7	(2.9)	(3.4)	8.2
EAFE	10%	(2.2)	3.4	8.2	32.5	(43.1)	11.6	26.9	10.9	(2.5)	1.8	5.8
Emerging Markets	10%	5.7	3.3	9.8	93.5	(59.3)	59.1	56.6	12.2	2.2	12.6	19.7
Average		1.2	5.8	17.7	38.7	(41.7)	10.2	25.4	17.9	2.4	3.4	8.9
Fixed Income												
Corporate	10%	(0.1)	0.9	9.0	18.7	(4.9)	4.6	4.3	7.5	7.5	6.5	6.2
U.S. Treasury 20+	10%	0.1	(1.6)	9.4	(21.4)	33.7	10.2	0.9	7.5	3.0	5.7	6.2
Global Aggregate	10%	0.5	1.2	5.5	6.9	4.8	9.5	6.6	7.1	3.9	6.9	7.0
High Yield	10%	0.3	3.9	15.1	58.2	(26.2)	1.9	11.8	14.3	12.9	9.1	8.6
Average		0.2	1.1	9.8	15.6	1.9	6.5	5.9	9.1	6.8	7.1	7.0
60/40 Portfolio		**0.8**	**3.9**	**14.5**	**29.5**	**(24.3)**	**8.8**	**17.6**	**14.4**	**4.2**	**4.9**	**8.1**

Source: FactSet

The financial media is of no help in this regard, though they do stand ready with punchy sound bites that purport to explain market movements that are not so easily explained. In recent years they have graced us with such chestnuts as "new economy", "new normal", "lost decade" and the latest (and most distracting) "risk on, risk off". "Risk on" refers to when markets go up, and "risk off" is when markets go down. Great insight, right? The problem is that while understanding returns is straightforward and intuitive, the concept of risk is poorly understood, easily manipulated and intimidating to investors. So what is risk?

Risk is commonly thought of as losing money on investments. While that is correct, it's only half the story; risk is also opportunity lost. We are in the third year of a bull market with a cumulative return near 100%. Instead of participating in the markets, many investors have been caught like deer in the headlights, stunned by the extreme conditions of recent years and unable to accept the normal risks appropriate for their investment policy. Investors have two basic options. They can 1) give up longer-term upside in exchange for eliminating downside risk in the near term, or they can 2) accept that maintaining a prudent level of risk is the only way to build wealth. The notion that an investor can wake up every morning and decide between "risk off" and "risk on" is misleading at best.

Portfolio construction is critical for those looking to participate in bull markets and to withstand temporary downturns. That said, it's difficult to implement effectively. Typically, investors have too little exposure to volatile, high-return, low-correlation, less-liquid investments such as emerging markets, small caps, high yield and even frontier markets. In the 2008 Great Recession, many observers were quick to proclaim that diversification failed. On further review, however, it was the lack of *true* diversification that failed — most institutional and retail portfolios were overexposed to developed markets at a time when emerging markets either went unscathed or quickly recovered. Certainly, one could argue that 2008 was a 100-year storm. But things also looked pretty bad during the first two weeks of March. Did you sell or even think of selling? To stay on course during periods of howling volatility requires a global perspective with respect to portfolio construction and your market outlook.

The market outlooks of investors are most often — and incorrectly — driven solely by price changes. We understand that price is the ultimate arbiter of value in the long term; in the near term, however, the market can be dead wrong. Take, for example, last August when the S&P 500 bled 4.5% before surging 20% in the final four months of 2010. We think a better and less volatile approach is to focus on the economic value — or fundamentals — that drive the market forward. The March head fake by the Dow

Annual Returns for World Markets Show Volatile Emerging Markets (EME) Have Consistently Generated the Highest Returns

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	YTD
EME (2.4%)	Pac Ex- (5.8%)	EME 56.3%	Pac Ex- 29.6%	EME 34.5%	Europe Ex-UK 36.4%	EME 39.8%	Japan (29.1%)	EME 79.0%	EME 19.2%	Europe Ex-UK 7.9%
Pac Ex- (9.4%)	EME (6.0%)	Pac Ex- 47.0%	EME 26.0%	Japan 25.6%	Pac Ex- 33.2%	Pac Ex- 31.7%	S&P 500 (37.0%)	Pac Ex- 73.0%	Pac Ex- 17.1%	S&P 500 5.9%
S&P 500 (11.9%)	Japan (10.1%)	Europe Ex-UK 43.6%	Europe Ex-UK 22.4%	Pac Ex- 14.8%	EME 32.6%	Europe Ex-UK 17.5%	Europe Ex-UK (45.0%)	UK 43.4%	Japan 15.6%	UK 3.8%
UK (14.1%)	UK (15.2%)	Japan 36.2%	UK 19.6%	Europe Ex-UK 11.3%	UK 30.7%	UK 8.4%	UK (48.3%)	Europe Ex-UK 33.9%	S&P 500 15.1%	Pac Ex-Japan 2.8%
Europe Ex-UK (22.0%)	Europe Ex-UK (19.9%)	UK 32.1%	Japan 16.0%	UK 7.4%	S&P 500 15.8%	S&P 500 5.5%	EME (47.1%)	S&P 500 26.5%	UK 8.8%	EME 2.1%
Japan (29.3%)	S&P 500 (22.1%)	S&P 500 28.7%	S&P 500 10.9%	S&P 500 4.9%	Japan 6.3%	Japan (4.1%)	Pac Ex- (50.0%)	Japan 6.4%	Europe Ex-UK 2.4%	Japan (4.9%)

Source: MSCI, Standard & Poor's, FactSet

and the subsequent 600 basis point turnaround was truly something to behold, but only from the perspective of a disciplined investor.

So what is the market outlook? We've repeatedly pounded the table about corporate earnings, so let's turn our attention to manufacturing, employment and M&A. Manufacturing was very strong in 2010; while it historically has pulled back from its highs fairly rapidly, the current rally has continued to accelerate, with the ISM Manufacturing Index hitting 61.4 in February, its highest point since 2004. Payrolls have also picked up the pace, bringing the unemployment rate below the all-important 9% threshold in the latest reading. That said, the lightning pace of M&A is the strongest indication that upside risk should be a major concern for those investors underexposed to the equity markets; even after the strongest quarter for deals since 2007 — highlighted by the announced acquisition of T-Mobile by AT&T for a gargantuan $39 billion — more are likely.

As Measured by Correlation, Emerging Markets, REITs and Bonds Have Been the Best Diversifiers

Long-Run Correlation (since 1990)

	Std Dev	Cash	Bonds	Intl FI	Lg Cap	Sm Cap	Intl Eq	Emg Eq	REITS	Hdge Fds
Cash	0.59	1.00	0.06	(0.11)	0.04	(0.04)	(0.02)	(0.09)	(0.05)	0.07
Bonds	3.81		1.00	0.49	0.15	0.04	0.11	0.01	0.18	0.06
Intl FI	8.72			1.00	0.15	0.07	0.41	0.13	0.22	0.11
Lg Cap	15.21				1.00	0.80	0.73	0.69	0.57	0.73
Sm Cap	19.70					1.00	0.65	0.69	0.65	0.82
Intl Eq	17.71						1.00	0.72	0.49	0.71
Emg Eq	24.22							1.00	0.45	0.81
REITs	20.55								1.00	0.44
Hdge Fds	7.03									1.00

Short-Run Correlation (past 24 months)

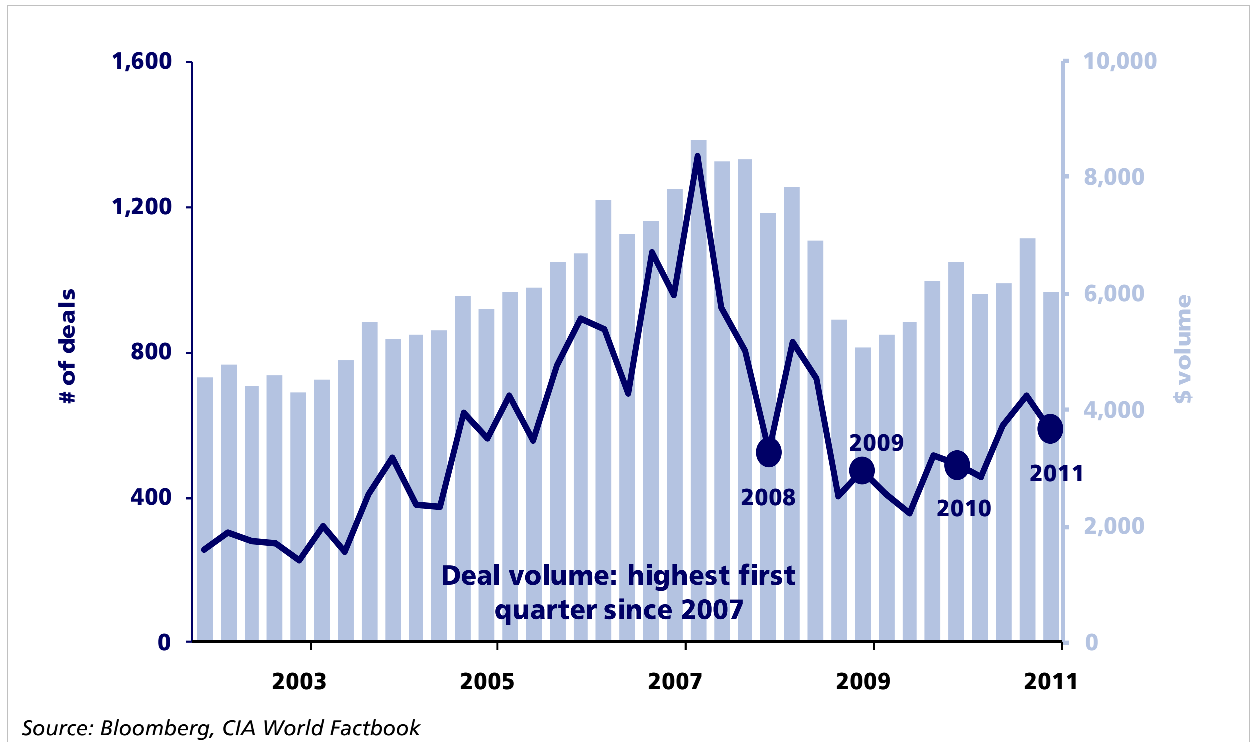
	Std Dev	Cash	Bonds	Intl FI	Lg Cap	Sm Cap	Intl Eq	Emg Eq	REITS	Hdge Fds
Cash	0.02	1.00	(0.19)	0.29	0.31	0.25	0.41	0.41	0.19	0.38
Bonds	3.07		1.00	0.57	0.63	0.40	0.74	0.66	0.44	0.59
Intl FI	11.05			1.00	0.11	(0.04)	0.15	0.12	0.19	0.02
Lg Cap	20.42				1.00	0.94	0.92	0.87	0.83	0.84
Sm Cap	26.33					1.00	0.83	0.80	0.85	0.78
Intl Eq	24.04						1.00	0.93	0.79	0.89
Emg Eq	25.54							1.00	0.69	0.90
REITs	36.49								1.00	0.66
Hdge Fds	6.28									1.00

Indices:
Cash – 3 Month T-Bill
Bonds – Barclays Aggregate
Intl FI – Barclays Global Agg ex-US
Lg Cap – S&P 500
Sm Cap – Russell 2000
Intl Eq – MSCI EAFE
Emg Eq – MSCI Emerging Equity
REITS – FTSE NAREIT US
Hdge Fds – HFRI Composite

Source: Barclays Capital, MSCI, Russell Investments, Standard & Poor's, Citigroup, FTSE, NAREIT, HFR, FactSet

To cut down the nets in Houston Connecticut had to rely on strong basketball fundamentals while also taking risks and making fewer mistakes. Investors would be well advised to take a similar approach to portfolio management and get back to their market-oriented asset allocation. ■

Risk-Taking Is Back: M&A Activity Reached Levels not Seen Since 2007



Source: Bloomberg, CIA World Factbook

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