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"Sell in May" and Other Follies of Investing

Douglas Coté, CFA
Chief Market Strategist

Although May was a disappointment for equities, it was a block party for bond investors. The sudden realization that the June end of QE2 will mean the beginning of a Fed tightening cycle pummeled commodity-based equity sectors such as energy, and most of the rest of the market keeled over too. There's no doubt that the return to a normal Fed funds rate won't be pretty; however, it is a sign that the economy is getting back to normal — not a "new normal", just normal. So, too, is the fact that the expansion has steamed merrily along on the back of strong fundamentals, even as investors in both Europe and the U.S. lose sleep over sovereign debt concerns. Corporate earnings are accelerating, manufacturing remains at boom levels, and consumer spending — the biggest driver of the U.S. economy — has increased each of the last 12 months. "Sell in May and walk away"? Good in theory, bad in practice.

It seems that this adage includes the selling of bonds as well. The consensus of some market "experts" — the big bond houses, in particular — was not only to sell long-dated U.S. Treasury bonds but also to sell short, borrowing bonds at the current price with the intention of buying them back at a significantly lower price. Oh, how the mighty have fallen. This has been a disastrous bet for the year and especially for May, as Treasuries rallied 370 basis points (3.7%). The bond rally nicely offset some of the equity pain, as you would expect from a well-diversified portfolio.

Global Perspectives Market Model — May 2011

Index	Wgt	May-11	YTD	2010	2009	2008	2007	2006	1 year	3 years	5 years	10 years
Equity												
S&P 500	10%	(1.1)	7.8	15.1	26.5	(37.0)	5.5	15.8	26.0	0.9	3.3	2.6
S&P 400 Midcap	10%	(1.5)	10.3	24.9	35.0	(37.3)	6.7	9.0	31.1	4.3	5.5	6.7
S&P 600 Smallcap	10%	(1.0)	9.1	25.0	23.8	(32.0)	(1.2)	14.1	28.3	4.7	3.8	7.3
U.S. REITs	10%	1.0	12.5	23.5	21.0	(41.5)	(20.2)	30.2	26.6	(2.6)	(0.7)	8.4
EAFE	10%	(2.8)	6.7	8.2	32.5	(43.1)	11.6	26.9	31.0	(3.7)	2.2	5.8
Emerging Markets	10%	(2.5)	1.0	9.8	93.5	(59.3)	59.1	56.6	21.5	(3.5)	13.3	18.7
Average		(1.3)	7.9	17.7	38.7	(41.7)	10.2	25.4	27.4	0.0	4.6	8.3
Fixed Income												
Corporate	10%	1.4	4.1	9.0	18.7	(4.9)	4.6	4.3	9.5	8.6	7.3	6.5
U.S. Treasury 20+	10%	3.7	4.1	9.4	(21.4)	33.7	10.2	0.9	4.6	6.6	7.5	7.1
Global Aggregate	10%	(0.1)	4.3	5.5	6.9	4.8	9.5	6.6	12.0	6.0	6.9	7.3
High Yield	10%	0.5	6.0	15.1	58.2	(26.2)	1.9	11.8	18.2	12.0	9.4	8.8
Average		1.4	4.6	9.8	15.6	1.9	6.5	5.9	11.1	8.3	7.8	7.4
60/40 Portfolio		**(0.2)**	**6.6**	**14.5**	**29.5**	**(24.3)**	**8.8**	**17.6**	**20.9**	**3.3**	**5.8**	**7.9**

Source: FactSet

Yes, constructing a portfolio of non-correlated risk assets does work for both downside protection and upside participation. Cash, a riskless asset, is anathema to this strategy.

Did we say cash? While cash — which by our definition also includes short duration or near-cash assets — is helpful in terms of downside protection, it offers little to no yield in the current environment and does not provide the upside needed to offset the type of equity selloff we experienced in May. As Albert Einstein pointed out, the most profound benefit of investing is the power of compounded returns. In our opinion, a close second is the benefit of adding low-correlation/high-return assets in a portfolio to increase safety and reduce volatility. Cash does neither of these, and we dare say it is an inappropriate holding for achieving longer-term wealth objectives like retirement.

Bonds, on the other hand, are something to behold. In good times, they provide stable income and nice compounded returns. In bad times, they are truly extraordinary — as they rally, throw off some capital gains, offset negative equity return with negative correlation and still provide a good yield. Sure, equities are the star performers, but the stability of stock returns is elusive except over longer time frames. Bonds do it all but are generally underappreciated.

Bonds certainly performed as advertised during May, while the equity markets seemed to have lost their way. The equity headwinds included a revival of the euro crisis with an additional three-notch downgrade of Greek debt by Fitch Ratings and U.S. federal debt put on negative watch for a future ratings downgrade by Standard & Poor's. Meanwhile, "don't fight the Fed" remains a truism in the markets. The FOMC announced the June end of QE2, which was the shot heard 'round the world as the beginning of a tightening regime. Commodities did not like this much; silver, for example, dropped an astounding 27% in five trading days. Oil also hit a slick, slipping 15% in a couple of weeks. And much like Animal Kingdom's run at the May 7th Kentucky Derby, long shot health care charged down the stretch to overtake energy as the top-performing sector for the year.

Bonds are great, especially during equity sell-offs, but don't expect us to sell equities in May. It is not due just to our natural predisposition against hoary clichés — it's all about fundamentals. With first quarter 2011 earnings season just about finished, the S&P 500 not only has cruised to bottom-line EPS growth of 18.8% — the seventh-consecutive quarterly upside surprise — but top-line sales have also surprised at a strong 9.0%. We remain comfortably ensconced in a synchronized global expansion, and businesses have begun to put the

First Quarter 2011 Earnings Are Off to the Races

Sector	Reported			Earnings Growth			Earnings Surprise		
	Actual	/	Total	Percent	Positive	Negative	Percent	Positive	Negative
Energy	41	/	41	39.8%	25	14	4.0%	24	14
Materials	30	/	30	55.4%	24	4	12.5%	25	4
Industrials	57	/	59	32.6%	49	7	9.0%	20	12
Consumer Discretionary	78	/	79	11.0%	53	21	5.2%	51	19
Consumer Staples	38	/	41	5.5%	26	12	1.9%	20	12
Health Care	51	/	52	6.2%	44	7	7.6%	46	4
Financials	81	/	82	15.0%	49	22	11.1%	54	20
Information Technology	73	/	75	25.3%	51	19	9.0%	55	11
Telecommunication	8	/	8	0.5%	3	4	4.4%	2	2
Utilities	33	/	33	0.1%	19	14	1.1%	14	16
S&P 500	490	/	500	18.8%	343	121	7.1%	332	114

Note: Earnings Growth is the percentage change in the cumulative share weighted EPS Earnings from that of a year ago. Surprise Percent is the share weighted average of the ratio of actual company earnings vs. the consensus estimate.

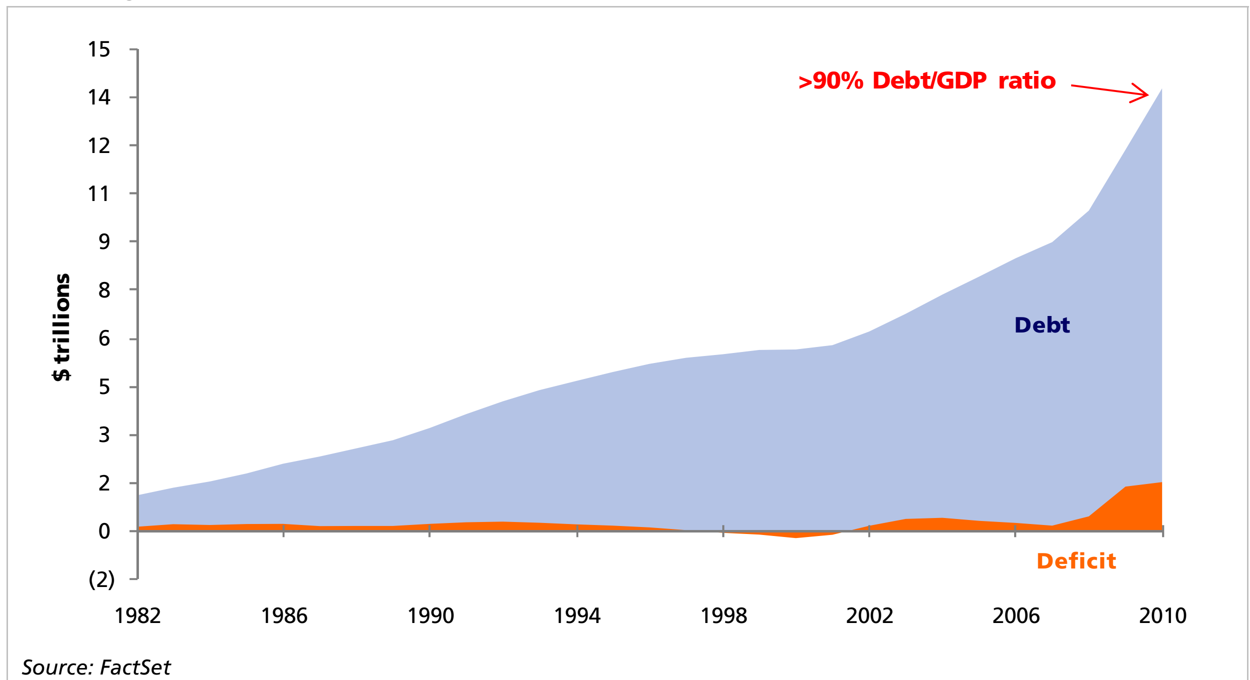
Source: Bloomberg, Standard & Poor's

$2 trillion on their balance sheets to work, taking a short cut to growth by purchasing competitors at price tags or multiples not seen since 1999.

In the depth of the last crisis, bond and equity prices moved in lockstep — mostly down — causing many investors to lose faith in the power of diversification. But the equity pull-back this month, as treasuries roared ahead, is a short but genuine demonstration of how diversification can help investors be successful.

As for "sell in May and walk away"? It's nice to think you can time the market, but do you really want to miss the next rally? ■

S&P Recognized the Unsustainable Debt Burden in the U.S.



Source: FactSet

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