Change Your Focus, Change Your Future

MARKET COMMENTARY BY JIM O'SHAUGHNESSY: JANUARY 20, 2009

As Barack Obama takes the oath of office as our 44th president, the markets are finding little to cheer in his message of hope. As I write, the S&P 500 is down more than five percent for the day and looks like it will test the November 20, 2008 low of 748. Both the long- and short-term performance of the market has been abysmal by historical standards, and the persistent gloom of investors shows little sign of lifting.

Investors now seem to viscerally understand how those who went through the Great Depression must have felt, and like them are bereft of hope for the future. As a consequence, we see more money sitting in money market funds than at any other time in the last 30 years, while at the same time we also see the market priced at valuations lower than at any other time since 1982. Yet I believe there truly is a silver lining in these storm clouds. I believe that if you can change your focus from the here and now and look out three, five and ten years, you can literally change your financial future.

As quantitative investors, we deal in facts and numbers, not opinion. I have no idea what the next three to six months in the markets will bring, but an analysis of the historical facts and numbers says that current market valuations are offering investors a gift that will probably not present itself again for a generation. As Emerson said, "numbers serve to discipline rhetoric. Without them it is too easy to follow flights of fancy, to ignore the world as it is, and to remold it nearer the heart's desire." Currently, investors are letting their current pessimism mold their hearts into a blackness driven by flights of fear, not fancy. Yet all of the historical evidence suggests otherwise.

It is instructive to look at what we might expect to happen in the coming 11 years. It is here that we may find the silver lining that should give investors hope and encouragement.

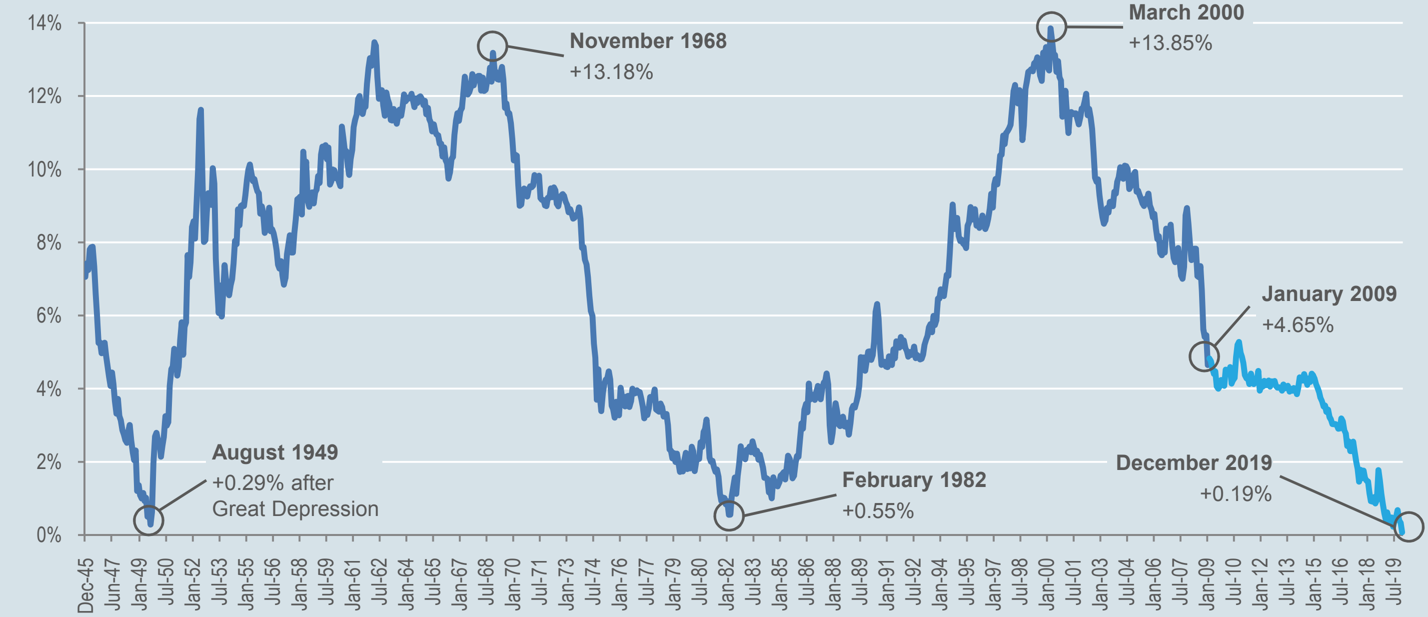
In 2002, I was commissioned by a large US pension plan to look at what a reasonable expected rate of return might be for them over the next 20 years, as required by ERISA regulations. I eventually published an expanded version of my study in my last book, *Predicting the Markets of Tomorrow*. What I found was that stock returns are mean reverting—if returns over the last 20 years have been stellar, the market generally spends the next 20-year period reverting down to the long-term mean. When returns have been poor over the previous 20 years, they generally spend the next 20 doing much better than the long-term average. When I did the original study in 2002, we were in the midst of a bear market and coming off the best 20-year real rates of return in history.

The data lead me to conclude that for the 20 years between January 1, 2000 and December 31, 2019, returns would contract substantially from those enjoyed by investors between 1980 and 1999. Using mean reversion as well as several other more traditional methods, I forecast a real annual rate of return (stripping inflation out) between January 1, 2000 and December 31, 2019 for the S&P 500 of between three and five percent per year. At the time, I was met with reactions that bordered on disbelief—even with a bear market in full swing, most investors polled still expected double digit returns from equities over the longer term. Little did I know that most of the carnage would happen over the next seven years. Between January 1, 2000 and January 20, 2009, the S&P 500 has lost nearly half of its value, posting a real loss of more than 47 percent, the worst nine year return since 1926!

Yet it is instructive to look at what we might expect to happen in the coming 11 years. It is here that we may find the silver lining that should give investors hope and encouragement. As the graph of 20-year rolling returns on top of the following page shows, if the S&P 500 compounds at a real annual rate of return of six percent per year from now until the end of 2019, we will still see a 20-year return through 2019 that is *worse* than the 20 years following the Great Depression! As I have said in earlier commentaries, while our current economic conditions are worrisome, they are nowhere near as bad as the conditions during the Great Depression, when unemployment reached 25 percent; GDP fell by nearly a third and land values were cut in half.

Rolling Real 20-Year Compound Average Growth Rate of the S&P 500

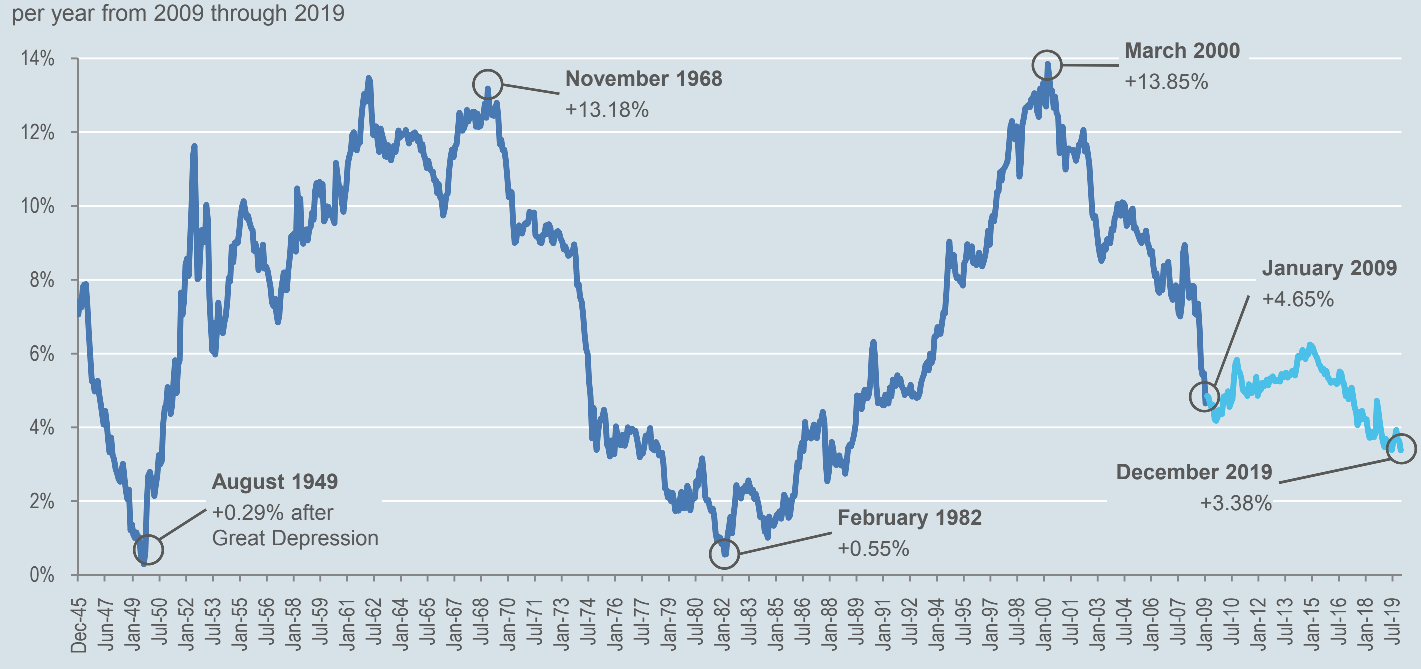
20-year Real Average Annual Return through December 31, 2019 if the S&P compounds at a Real Annual Rate of Return of 6 percent per year from 2009 through 2019.



Think about earning six percent annually after inflation over the next 11 years—what investments might even come close? Ten-year treasury notes currently yield only 2.36 percent—*before* any inflation is taken into account. What about gold, commodities or real estate? Does anyone think that these historically low-yielding investments can return six percent per year after inflation? Historical data suggests that they will not. And what would returns have to be over the next 11 years to get within the lower end of my three to five percent forecast? The graph below shows that if the S&P 500 compounds at an annual real rate of return of 12 percent over the next 11 years, the 20-year return for the index would be just 3.38 percent for the 20 years ending December 31, 2019!

Rolling Real 20-Year Compound Average Growth Rate of the S&P 500

20-year Real Average Annual Return through December 31, 2019 if the S&P compounds at a Real Annual Rate of Return of 12 percent per year from 2009 through 2019



Can you imagine *any other investment* that might do as well over the next 11 years?

An Even Shorter Time Horizon

Many people say that looking at 20-year returns is all well and good, but most are far more interested in what might happen over the shorter-term, like the next three to five years. The chart below shows the real average annual return over all rolling periods since 1926—as noted above, we have recorded the worst ten-year returns since 1926, but it is instructive to look at other awful periods and more importantly, what happened in the subsequent one-, three-, five- and ten-year periods. The table to the right shows the 12 worst ten-year periods for the S&P 500 since 1926. *Three of them have occurred in the last three months*, yet look at what happened after the other rocky periods—the *average* ensuing three-year period saw real gains of 11.46 percent per year, the average ensuing five-year period gained 13.49 percent and the average return over the next ten years was a very healthy 10.75 percent per year. Note that none of the subsequent returns were negative.

At the Crossroads, Which Path Will You Take?

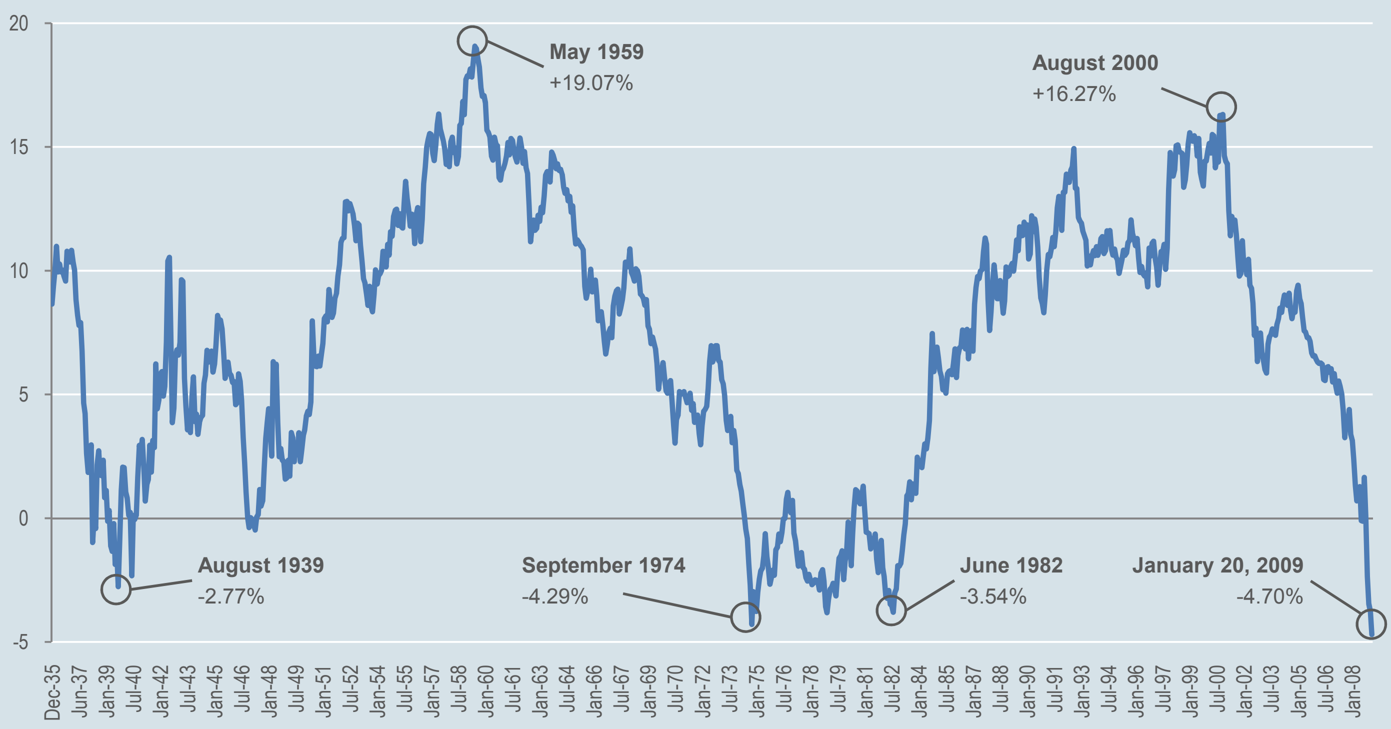
I, like you, am deeply disappointed by the market's performance over the last nine years. What's worse is that the last several months have been among the most punishing in the

Worst Rolling 10-Year Returns Since 1926

10 Years Ending:	10-Year Real Avg. Annual Return	Real Average Annual Return over the next: 1-Year	3-Years	5-Years	10-Years
1/20/2009*	-4.70%	?	?	?	?
Nov-78	-3.82%	2.71%	3.17%	8.59%	10.15%
Jul-82	-3.82%	56.96%	22.03%	23.95%	14.19%
Dec-74	-3.77%	26.80%	8.67%	5.40%	6.39%
Dec-08	-3.77%	?	?	?	?
Oct-78	-3.56%	0.22%	4.77%	6.75%	8.78%
Jun-82	-3.54%	47.26%	20.31%	22.12%	14.06%
Nov-74	-3.48%	17.16%	5.60%	3.42%	5.92%
May-82	-3.48%	43.13%	16.57%	21.00%	13.57%
Nov-08	-3.46%	?	?	?	?
Dec-78	-3.29%	4.85%	3.86%	8.61%	9.76%
Mar-82	-3.24%	33.49%	18.18%	21.56%	13.90%
Average	**-3.66%**	**25.84%**	**11.46%**	**13.49%**	**10.75%**

Rolling Real 10-Year Compound Average Growth Rate of the S&P 500 (%)

10-Year Real Average Annual Return through January 20, 2009



market's history and watching the market go down month after month wears on people's convictions and hopes for the future. Every study conducted shows that the vast majority of investors make the wrong choice at the wrong time. Even professional investors have let what's happened recently affect how they pick stocks. It could not be a worse time to try and change horses, since I believe we are nearly across the treacherous stream. One of the best parts of being a quantitative investor is that as emotional as you might get personally, it will never affect the way you select securities. We use time-tested methods that have proven themselves over many market cycles, and while we—along with virtually everyone else—have done poorly over the short-term, we will not let that lead us to making ill-advised changes to our investment methodology.

What worked best in 2008—being in cash—does not work well over long periods of time. Our stock selection models are designed to add value to the market during more normal markets, not in markets where investors ignore fundamental data in making their investment decisions. While our time-tested strategies do not do well when markets are acting irrationally, they do very well when markets return to sanity. The good news is, as we have seen from all of our backtests and actual returns, investors never ignore the underlying fundamental data for long periods of time. When the markets return to paying attention to valuations, our strategies usually perform exceptionally well. As I noted in my last commentary, buying cheap stocks which are moving in the right direction works especially well when the economy is emerging from recessions, so I believe we are well positioned to outperform the overall market over the next three, five and ten year period.

I urge you to do as I have done, and act on these facts. Not investing in the face of an unknowable future is a decision, but it is a bad one. Letting yourself get overpowered by what has been happening recently will rob you of returns well into the future. Let history serve as your guide and remain committed to equities and to using time-tested strategies. If your target allocation for equities is 60 percent and you are currently at 40 percent, rebalance your portfolio to your target allocation. If you have money on the sidelines, start adding it to the equity market now—even if you are early, five to ten years from now you will barely remember that you got in a little too soon. As the saying goes, "A crisis is a terrible thing to waste." Stocks are cheaper than they have been in a generation, yet most have lacked the fortitude to make the leap. If history is any indicator, those that do will be richly rewarded.

O'Shaughnessy Asset Management, LLC

Six Suburban Avenue, Stamford, CT 06901 | 203.975.3333 | www.osam.com