

Is the Market Peaking?

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After a brief sabbatical, I'm back by popular demand (well, maybe not so popular). I'll write a column every other month, with additional columns in the case of big market events. Why, you might ask, would I not write more frequently? The world doesn't change every 24 hours—and neither should our response to the market. My mission in this column has always been to provide market observations that may help investors keep focused on objectives and strategies for success over the long haul. I hope you'll find these observations useful in your journey.

Historically, the market gives off signals. The question is what should investors do — or not do — when the market presents these signals?

Last week, the equity markets sold off, with the Russell 1000® losing 5%, the Russell 2000® down 7%, the MSCI EAFE (Europe, Australasia, Far East) and EM (Emerging Markets) indexes both off 6%. During the previous six to eight weeks, key market indexes had hit all-time highs. The Russell 1000 and 2000, the S&P 500, and the MSCI EAFE and EM, all broke past records. Only the NASDAQ hadn't hit a peak, (and considering it would take an 85% return from its present level to get there, we probably won't see that peak any time soon).

Neither irrational exuberance nor "the sky will soon fall" mentality is an appropriate interpretation of this market-peaking signal. One reason I feel that the chances of continuing severe declines from this level are slight owes to signals being given off by individual investor behavior. While standard models of valuation are important, the investment flow decisions of individuals have (over the last couple of decades) provided clues regarding the coming returns we might expect from different equity asset classes.

As mentioned above, the equity markets have turned in excellent returns over the last few years. For the last 4½ years the equity returns for U.S., non-U.S. developed and non-U.S. emerging markets have averaged 15%, 26% and 38% per year. Strong earnings, growing world trade, buy outs, share repurchase and restrained inflation have provided a wonderful environment for equity investors. However, the pattern of investor flows into U.S. equity mutual funds has not shown the type of euphoria generally associated with market peaks. To understand why this might be source of encouragement for equity investors requires a review of recent market history.

First, it is important to emphasize that over the last four years, the markets have digested concerns such as terrorism, global warming, hurricanes and the potential for other bad news and yet remained strong. Allowing the daily news to shape our investment decisions can be short-sighted and ultimately inconsistent with our long-term investment goals.

Now here's the history lesson:

For U.S. equity mutual funds the average annual inflow from Dec. 1996 to May 2007 was \$81 billion. At the end of the astonishingly rewarding late 1990s (a real peak in the market) the inflow for the 12 months ending Oct. 2000 was \$337.6 billion — more than four times the average annual rate.

You don't have to be a student of history to know that buying a lot of equities leading up to Oct. 2000 did not prove to be a

wise investing move. Individual investors got in at precisely the wrong time, buying high. Following this huge inflow, the 12-month return on the Russell 3000 was -25.1%. This is a classic example of the costs of buying in the midst of market euphoria.

How about the flip side? After the popping of the tech bubble, and the extended suffering that U.S. equity investors experienced from 2000 through 2002, U.S. mutual fund investors redeemed \$54.9 billion of their U.S. equity investments for the 12 months ending March 2003 (that's \$135 billion below the average annual inflows!). You can guess what happened next. During the next 12 months the Russell 3000 was up 38.2%. And the hits just keep on coming. For the 12 months, ending in April 2004, an above average inflow of \$111.6 billion occurred, and over the next 12 months the Russell 3000 was up 7%. So individual investors got out just in time to miss 38% and made it back in time to get seven percent.

The experience on non-U.S. emerging market mutual fund flows isn't a lot better. From 1991 through Oct. 1997, the average amount of money flowing into emerging markets mutual funds annually was about \$2 billion. For the 12 months ending Nov. 1997 the inflows had grown to over \$4 billion. Right on cue, the emerging markets returns (MSCI EM) were a negative 24.6% through Nov. 1998. People lost a quarter of their emerging markets portfolio. This disappointment coupled with strong U.S. equity returns (Russell 1000 up 22%) caused the inflows for the year ending April 1999 to be negative \$1.4 billion. Do we need to say what happened next? You guessed it; the next 12 months produced emerging markets returns of 20%.

I think you get the point. So what's happening lately? We're in the midst of another big outflow of U.S. equities, down \$34.6 billion for the 12 months ending in May 2007. Yet, for the last 12 months, the Russell 3000 is up 22.6%. Why is it that people are pulling out of U.S. equities this time? It surely can't be running from bad performance. The answer lies in the astonishingly strong performance of non-U.S. stocks. Over this same time, the emerging markets have been up 38%. It looks like individual investors are chasing emerging markets just as they chased U.S. equities before the 2000 tech bubble burst.

Admittedly, the economic growth expectations for emerging markets are stronger than for the U.S., but returns like these have historically been in jeopardy when everyone recognizes them. Emerging market equities might continue their run in the coming months, but history teaches us that peaks in activity — highs or lows — shouldn't cause investors to make dramatic changes to their portfolios. In fact, investing decisions based on emotions rather than information and strategy can put the individual investor at a disadvantage.

I share these anecdotes to illustrate the risks associated with chasing performance. It is impossible to ignore big market events, but interpreting them in a disciplined frame of mind can help you avoid the potential pitfalls that have historically characterized investor behavior. My hope is that this column will be of some help in your investment journey.

Until next time, here's to your quest.

All mutual fund flow data from The Investment Company Institute. Index returns from Morgan Stanley Capital Index group, Russell Investments and Bloomberg.

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Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, representative of the U.S. small capitalization securities market.

MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure developed market equity performance in 21 developed market countries in Europe, Australasia, and the Far East.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

S&P 500 Index: An index, with dividends reinvested, of 500 issues representative of leading companies in the U.S. large cap securities market

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