



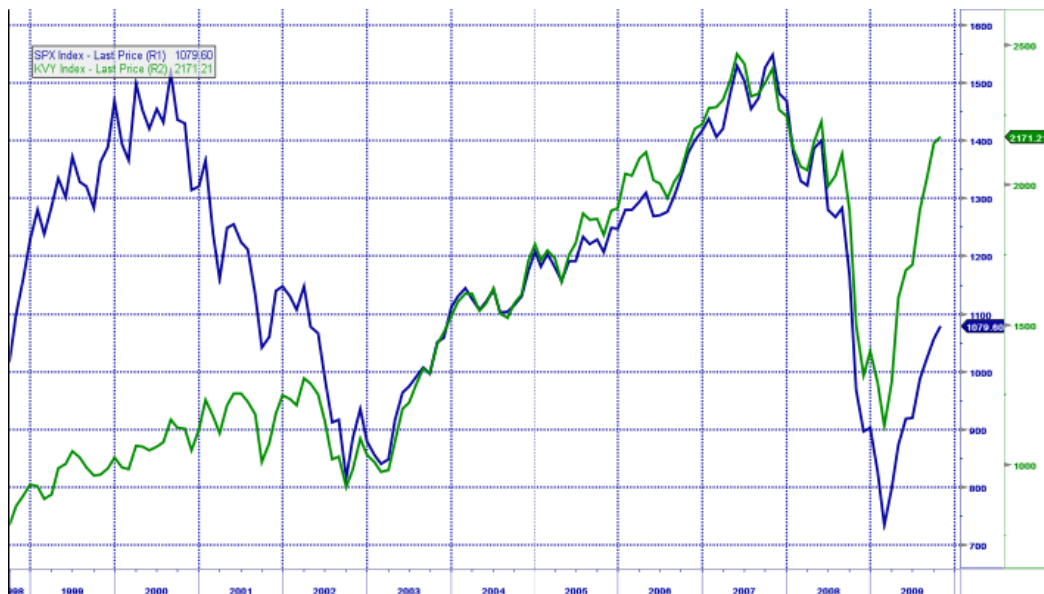
In Defense of Stocks

December 2009

The second bear market in a decade has brought forth a new wave of skepticism toward all risk assets and with that, many axioms have been questioned since the crisis began over a year ago. Among them has been the appeal of equities as a wealth building mechanism, and their ability to outperform bonds over most investment periods. A recent study produced for the New York Times in their Sunday Business section, looked at the last 3, 5, 10, 20 and 30 year historical returns and determined that bonds have outperformed stocks in all but the last thirty year time period. According to the Times' study, "In the last ten years, stocks have underperformed bonds by a significant margin. It is only in the much longer term that stocks have had the edge over most types of bonds." This is but one example of similar articles and studies that have been appearing in the media over the past year as the crisis unfolded.

The problem with this study, and the other studies like them, is that they all use the S&P 500 Index as the proxy for stocks as an asset class. This proxy is flawed in many ways, and especially so over the past ten years. So why is the S&P 500 Index not a reasonable proxy for stocks? To be most useful to investors, it would make sense when debating the merits of an asset class for studies such as these to choose an index that closely replicates the mechanics of common portfolio construction. The average investor's portfolio is structured to achieve diversification through the purchase of roughly equal dollar amounts of positions across various sectors of the economy. The S&P 500 Index, however, is computed on a market weighted basis, meaning that those stocks with the largest equity market capitalizations are much more influential in the index than the smaller issues. No attempt is made once a stock gains entry to the index to keep a balance between overall sector weightings. Had those doing the comparison used an un-weighted or equal weighted index, that is more in line with portfolio construction such as the Value Line Arithmetic Index, the results would have shown the returns on stocks to have been far superior to fixed income. Further, the last ten years in particular exacerbate the anomaly because of the tech/telecom bubble in the late 90's as shown in the graph below:

S&P 500 Index vs. Value Line Arithmetic Since Sept 30 1998

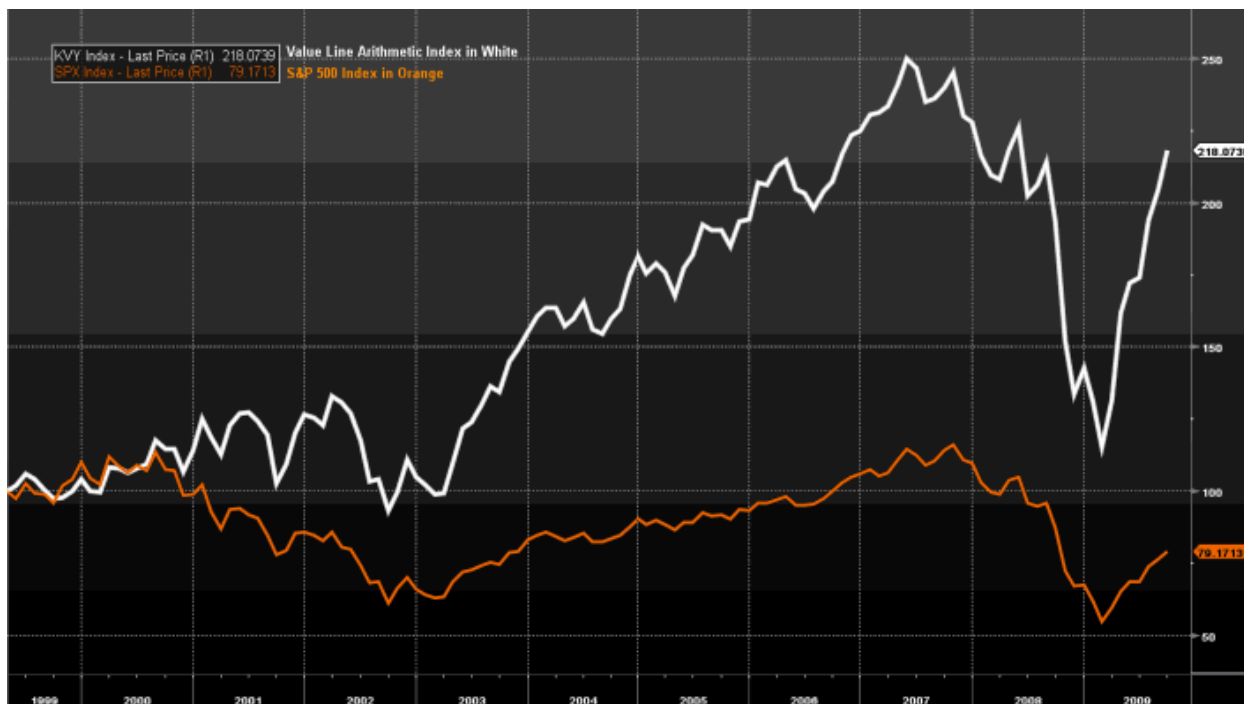


The S&P500 Index (shown in blue) was especially top-heavy ten years ago, with the top 20 stocks representing over 41% of the value of the entire index (versus 33% now), thereby further masking how the average stock might have performed. The late 1990's also exemplify the distortion one sector (or related sectors) can have on the overall index, as has happened before with financials and energy. The twenty stocks that had the largest market weight in 1999 included some of the hardest hit issues when the bubble deflated including:

- Microsoft and General Electric each lost over \$300 billion in market value
- Lucent and Cisco each lost over \$200 billion
- Nortel, Lucent, WorldCom and AOL all lost significant amounts of value or disappeared altogether
- As a group, the top twenty lost over \$2.4 trillion in value.

Because of that, the ten year look back for stocks using the S&P 500 Index shows a negative result as opposed to a more than doubling of the Value Line equal weighted Index. To the extent someone owned a truly diversified basket of stocks, the S&P 500 Index is not representative of their performance nor is it representative of stocks in general as an asset class. The chart below shows the divergence in return between the S&P 500 Index and the Value Line for the same ten year period:

S&P 500 Index vs. Value Line Arithmetic Index - Total Return



One final point about the recent ten year cycle; even at the trough of the market on March 9th, the Value Line Index still showed a positive return of over 12% for the trailing ten year period not including dividends.

This is not meant to imply that we are raging bulls on equity markets currently, rather to state that we feel strongly about the wealth building potential of a broad portfolio of adequately diversified stocks.

Given that this asset class has been through two brutal bear markets, a terrorist attack and the worst financial crisis since the Great Depression, and still managed to double, speaks to its resilience.

It is common for panics to cause the rules to be rewritten as weaknesses are exposed in times of distress. However, it is vital, as we look back on the recent crisis from an investment standpoint, that we draw the right conclusions and avoid superficial analysis. When given simple comparisons of equities versus bonds, an investor needs to determine what proxies are used to represent each asset class; often what is obvious is not necessarily true. It is also wrong to conclude that because the recent bear market was so democratic, causing distress in almost all asset classes, that diversification of one's portfolio is a failed strategy. What has been demonstrated is that diversification has its limits in a time of crisis, especially at a point when the viability of the financial system is in doubt. But through the dislocation, those that were diversified came out much better as the panic abated. There is no question that investors will come away from the latest crisis changed from the experience, what is not certain is that they will have learned the right lessons.

Sam Katzman
Chief Investment Officer
Constellation Wealth Advisors
212-697-7400
sam@cwallc.com