

Perspective

January 2011 By Davis Riemer



DHR Investment Counsel, Ltd.
The Fine Art of Wealth Management

In the story “Silver Blaze,” Sherlock Holmes offers suggestions to a Scotland Yard Detective, struggling to solve the mystery of a burglary that Holmes had already de-mystified. (Note: A night-time burglar did not alarm the watchdog.)

Detective Gregory: *Is there any other point to which you would wish to draw my attention?*

Holmes: *To the curious incident of the dog in the night-time.*

Gregory: *The dog did nothing in the night-time.*

Holmes: *That was the curious incident.*

Journalist: *Have I omitted any significant economic events of the year?*

Economist: *The curious incident of the double dip.*

Journalist: *There was no double dip.*

Economist: *That was the curious incident.*

This *Perspective* has some interesting charts with helpful discussion, as well as comments to accompany our annual report *Performance Review of Selected Investments* (included separately.) Of course, we also offer some New Year’s Resolutions. Like Inspector Gregory, we must think not only about what did happen, but also about what did not or might not happen. While I’m no match for Holmes, I do think that 2010 continues to show that DHR has figured some of this out.

The first chart in this *Perspective* shows the performance of the U.S. stock market last year, set against a short list of major events of the year. Quite a list it is, too. You have probably seen a copy in at least one newspaper or magazine. During the year, prompted in part by the election, survey after survey sought to discover the major concern of the American public, which, as it turned out, was eloquently described by ex-President Clinton: “*It’s the economy, stupid!*” Many worried about losing their jobs, many others hoped to regain one. Many feared losing their homes, many others hoped to regain one. Throughout the year, we all feared a “double dip” and the terrifying consequences it seemed (perhaps still seems) to portend. Yet

it remains only a possibility, “out there” in the future, scaring us. Elsewhere in this *Perspective*, you will find the line “Markets Climb a Wall of Worry.” So they did in 2010. Stock markets often de-link their performance from popular perception, which provides another reason for ignoring popular perception and conventional wisdom when crafting investment strategy.

Today’s survey would likely say “Joblessness,” “Housing,” “Deficit,” and quite rightly, too. The nation is ill, our people worried. Nevertheless, DHR cannot develop strategy to deal with those matters, although we can develop strategy to handle investment in securities. While it might

seem strange in common sense terms, research demonstrates that investors often do better by ignoring fears, and remembering the curious incidence (note plural) of incorrect forecasts.

Over the last two years, investors have worried about “the Deficit.” Like Californians worrying about “The Big One,” we don’t know exactly what to expect or when what-we-had-not-expected will occur. Some fascinating recent research, rigorous in breadth and statistical analysis, examined a number of basic economic questions in this area. The conclusions apply today to our concerns about what to do with portfolios. I have reproduced a few below.

Do large deficits stifle long-run economic growth?

YES

Are deficits related to higher long-term interest rates?

YES

Do deficits predict bond or equity returns?

NO

Does low future economic growth imply low future equity returns?

NO

What implications do the above statements have for our portfolios? The first one leads to the conclusion that we should diversify globally. Some, but not all nations have deficits. Who can forecast which of them will emerge sooner and more strongly from their troubles?

Which nations will generate better returns? A classic problem in forecasting, to which the answer is: diversify.

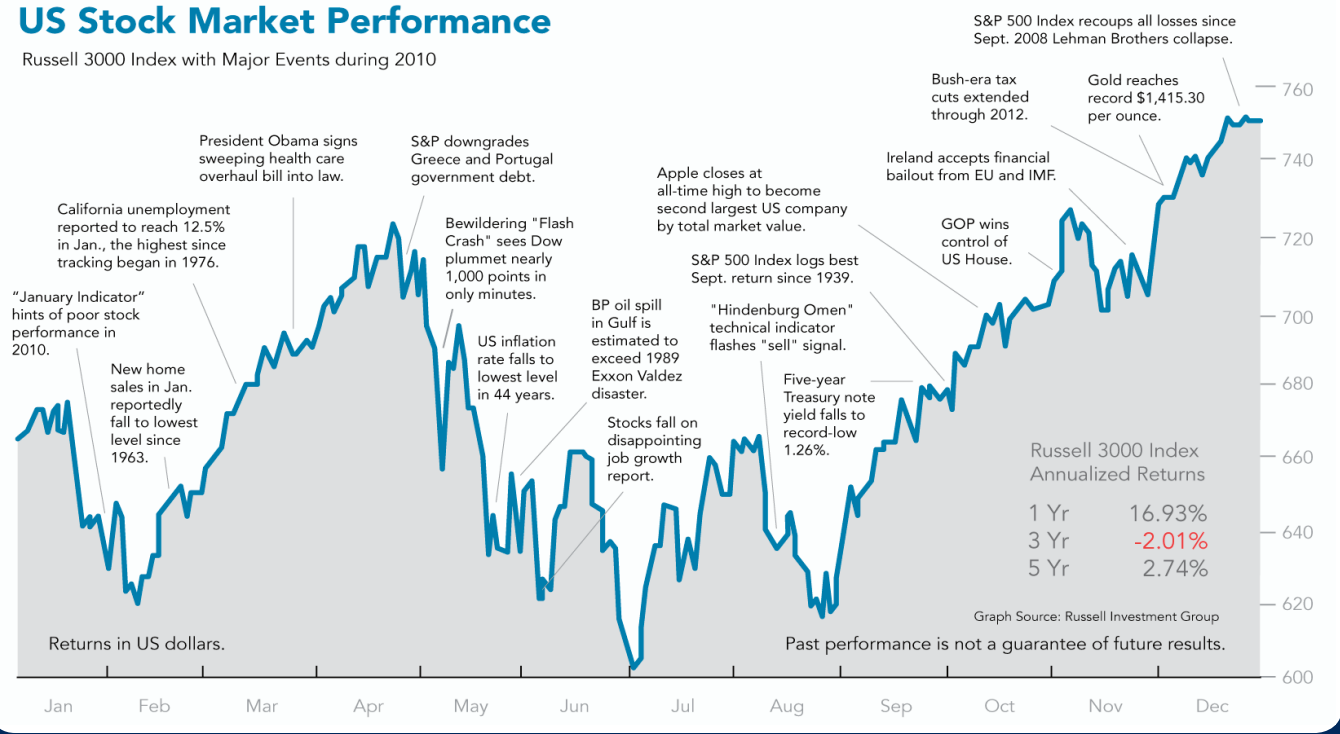
The second one supports our bond investment strategy. As a method of protecting principal, we have always followed a relatively short maturity strategy. Supported by research, it is especially helpful now.

The third means “we don’t know, do we?” If the size of a deficit does not predict returns, then returns will vary according to other factors, as yet not foreseen. With a nod to Mr. Rumsfeld, “We don’t know what we don’t know.”

The fourth means that, at least for investment results if not for jobs and housing, perhaps the future will not be as bad as we fear.

US Stock Market Performance

Russell 3000 Index with Major Events during 2010



The preceding chart on page 2 on “US Stock Market Performance” combines the news with the market movements, using the Russell 3000 index, a measure of the broad US market. (The index prices for the R3000 run down the right hand side.) You might enjoy noting the performance following each of the indicated major events. By mid-year, the accumulation of events in the preceding six months had had a pretty depressing effect. (Darkest

before dawn.) As is often the case with such charts, the ensuing results seem counter-intuitive. (It looks like the “Hindenburg Omen” missed the mark. The Hindenburg Omen “signals” an increased probability of a stock market crash, by using a combination of technical factors that attempt to measure the health of the stock market.) (See also: “Resolutions” elsewhere in this piece.)

Survey of Long -Term Performance

As of December 31, 2010

Index	Annualized (%)					
	1 Year Ending 12/31/2010	3 Year Ending 12/31/2010	5 Year Ending 12/31/2010	10 Years Ending 12/31/2010	20 Years Ending 12/31/2010	Since Inception (Inception date)
US Large Company Stocks						
S&P 500 Index	15.06	-2.85	2.29	1.41	9.14	9.87 (01/1926)
US Small Cap Stocks						
Russell 2000 Index	26.85	2.22	4.47	6.33	10.84	11.72 (01/1976)
US Value Stocks						
Russell 1000 Value Index	15.51	-4.42	1.28	3.25	10.09	12.18 (01/1976)
US Real Estate Investment Trust Stocks						
Dow Jones US Select REIT Index	28.07	0.01	2.32	10.42	11.52	12.53 (01/1976)
International Stocks						
MSCI World ex USA Index	8.95	-6.33	3.05	3.98	6.16	9.53 (01/1976)
MSCI Emerging Markets Index (gross div.)	19.20	-0.03	13.11	16.23	12.17	14.06 (01/1988)
Bonds						
S&P Long -Term Corporate Bonds	12.20	7.93	5.90	7.58	8.16	5.90 (01/1926)
S&P One -Month US Treasury Bills	0.11	0.63	2.25	2.19	3.45	3.62 (01/1926)

The S&P data are provided by Standard & Poor's Index Services Group. Russell data copyright © Russell Investment Group 1993-2010, all rights reserved. MSCI data copyright MSCI 2010, all rights reserved. Dow Jones data (formerly Dow Jones Wilshire) provided by Dow Jones Wilshire. US long-term bonds, BB, and inflation data © Stocks, Bonds, BB, and Inflation Yearbook™, Wharton Associates, Chicago (annually updated work by Roger G. Wharton and Rex A. Siquefied). Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results.

The “Survey of Long Term Performance” chart displays some interesting data which both complements and also extends in time the results displayed in DHR’s *Performance Review of Selected Investments*. Note that the “Survey” displays indexes only, not funds or portfolios, and that many of the same indexes appear in DHR’s *Performance Review*. Also note the significant variation in “Inception Dates,” which vary up to fifty years. Those who construct and maintain

investment indexes take them back in history as far as good data can be obtained. Prior to the 1970’s, the data on international investing was not recorded. Initially, we had only the Dow Jones Industrial Index and then the Standard and Poors 500 index. Now, the increased interest in index methodologies has caused a proliferation of them. Nonetheless, the availability of reliable historical information limits the extent to which we can extend them back into time.

We always note that past performance says nothing about future performance, but nevertheless historical information is valuable. One should focus on two primary concerns – return (as shown in a compound annualized way) and risk (as shown by variability in returns.)

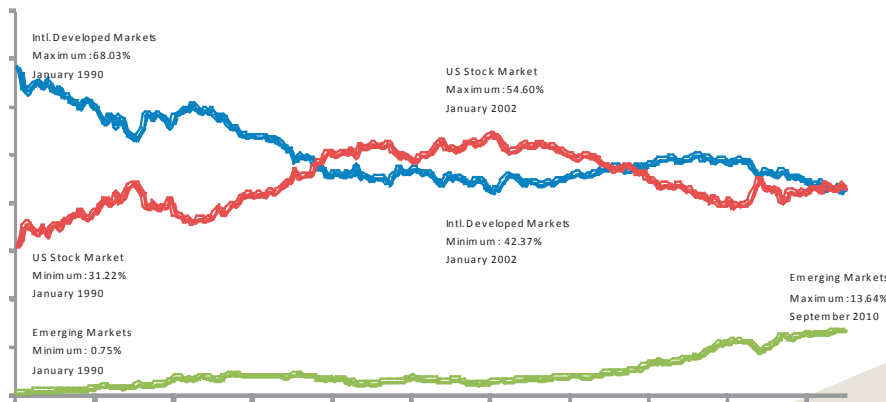
In the far right “inception” column of the “Survey,” one can see long-term results. Also, by choosing any row and reading along it, one can see that short period results vary substantially from those of long periods. Even results for twenty year periods vary from the long term average in a way

that must be acknowledged. This long term data again confirms that, in diversified portfolios, stocks have outperformed bonds, value has outperformed growth and small cap companies have outperformed large cap companies. Theory tells us to expect that those return tendencies will persist. However, risk means that we do not know whether future results will confirm theory *in the time frame relevant to us*. Charts that look backward over this much time also bring another point to mind - a lot of bad things happened during those years, and still we marched on. Now, however, we must look forward and decide: *How shall we now march on?*

Value of Stock Markets around the World

January 1990 –December 2010

	Number of Countries	Number of Stocks	Total Value	Weights		
				December 31, 2010	Change from Previous Quarter	01/90-12/10 Average
United States	1	2,951	14.22 Trillion	43.38%	▲ 0.47%	44.64%
Developed Markets	23	3,680	14.10 Trillion	43.02%	▼ -0.43%	50.38%
Emerging Markets	21	2,782	4.46 Trillion	13.60%	▼ -0.04%	4.98%
Total	45	9,413	32.77 Trillion	100.00%		



- Global market capitalization weights are not static; they vary across time.

Developed markets' securities and commodities data provided by Bloomberg . Emerging markets' data provided by International Finance Corporation . The Russell 3000 Index is used as the proxy for the US market. The proxies for the non-US developed and emerging markets are the respective developed country and emerging country portions from the MSCI All-Country World IMI ex USA Index . The proxies for the UK, Canada, and Australia are the relevant subsets of the developed market proxy .

By dividing the world's markets into three components, the chart on page 4 reflects the way we diversify our portfolios internationally – the U.S, all other Developed Markets and Emerging Markets. The chart covers the twenty years ending in December and compares the value of the U.S. stock market to the group of markets of all other Developed nations and then to those of Developing nations. It says nothing about proportional investment, (allocation policy), but shows the change in relative size of those three components of global equity. Note the similarity in number of Developed and Developing markets, and the difference in total number of stocks available for investment in each of the categories. One can, without much challenge, assert that the Emerging Markets represent great long-term investment opportunity. But how long is “long?” How can we be sure of “long enough?” The time frame necessary to profit from that assertion might be

described by John Kenneth Galbraith: “The only thing we know for sure about the long term is that in the long term we are all dead.” Nevertheless, the same conclusion can apply. We all know change will occur, but do not know the magnitude, direction or timing.

If an investor wants to reduce the volatility of the “bottom line” of value of a portfolio, then it certainly does pay to diversify globally. If one ignores currency and other risks (and we do not) then one can build a case for investing an equal amount in the U.S. and other Developed Markets. (We invest approximately “60/40”.) Given the changing nature of global economic activity and the accelerating rate of growth in Emerging Markets since 2006, it makes sense to dedicate a reasonable portion of capital to them. Last, one needs to wait for the full benefits of diversification to pay off - *and they almost certainly will.*

These comments accompany DHR's *Performance Review of Selected Investments*. You might find it helpful to have the report available to you as you read this.

Our funds performed satisfactorily over the year 2010. In fact, most of them had performance exceeding their benchmarks, demonstrating that their management strategies continued to provide benefits to our portfolios. A few of them fell below their benchmark, but for reasons that do not cause any concern about them, especially because the amount by which they fell below ranges from small to trivial.

At DHR, we “tilt” our portfolios away from an exact replication of the market as a whole and towards small cap and value stocks. Strong and ample evidence shows that, by doing this consistently over the course of time, we should achieve returns higher than the market's. Of course, one never knows whether any given “short-term” period will demonstrate the expected result of the long-term. We are happy to report that, again last year, the “small cap premium” return appeared. You can see this by a comparison of the returns of small cap and large cap asset classes, in both domestic and international markets. Ditto the “value premium.” So far, so good.

Our investment in international stocks did not reward portfolios as generously last year as the domestic market did. Nonetheless, you will see that, when measured against their relevant benchmarks, our international funds did very well. A few of them - funds of emerging markets and international small companies in particular - added meaningfully to total portfolio return. DHR does not invest globally in the hopes that international returns will exceed domestic returns. We do it because it diversifies, reduces portfolio fluctuation over time, and by doing those two things, it increases portfolio bottom line performance. Those benefits often require time to show up and do not reveal themselves in annual returns.

An old saying goes: “Markets Climb a Wall of Worry.” What have investors worried about lately more than real estate? How did our REIT investments actually perform last year? They climbed right up the Wall of Worry. Domestic REITs outperformed international ones, but both increased the bottom line nicely.

Insurance premiums cost money, and when nothing goes wrong, one might wonder whether to continue paying them. So it went with bonds last year. The return numbers were quite small and so our bond allocations amounted to insurance premiums.

About the longer term, for example ten years, what might be said? In the interest of brevity, this: In the “Ten Year Growth of a Dollar” column, locate the S&P500 row. Then, compare that number to all the rest in the column. Conclusion? Diversify! Neither greed nor fear, but simple diversification, consistently maintained, brings a higher probability of satisfaction than any other strategy.

Resolutions for the New Year

Most of the readers of this *Perspective* are DHR clients, for whom the following list (adapted from Brad Steiman of DFA) will sound familiar. Most of us strive in many areas of our lives to maintain rational control over our impulses. Sometimes we succeed. Sometimes we fail. Almost all of us find it hard to follow a sensible diet or a sensible investment strategy all the time. So, in all things – moderation; if you must stray when managing your well-being or your wealth, do it in moderation. Chocolate cake is OK, on occasion. Financial speculation might be OK, too – but not with serious capital. Perhaps, familiar or not, this list might prove useful as a gentle reminder of the way DHR works with clients. Furthermore, lest it seem “preachy,” please know that I have to say the same things to myself all the time.

I will not:

1. Confuse entertainment with advice. The financial media is in the entertainment business and their message can compromise my long-term focus and discipline, leading me to make poor investment decisions.
2. Search for tomorrow’s star money manager. Capital markets will be my guru because there, for the taking, I will find a positive expected return on my capital – and my success does not require failure on the part of another.
3. Invest based on a forecast—neither mine nor anyone else’s. The urge to form an opinion will never go away, but I won’t act on it because no one can reliably predict the future. It is, by definition, uncertain.

I will:

4. Ensure my portfolio is appropriate for my objectives and only take risks worth taking.
5. Keep a long-term perspective and consider how long my portfolio is to be invested when I determine a time frame for evaluating results.
6. Pursue my plan and continue to invest new capital because time in the market matters more than timing the market.

DHR Investment Counsel, Ltd.
A Registered Investment Advisor