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Markets Often Rebound Before The Economy

Given the extreme recent volatility of the stock market and the worsening economy, it's no wonder investors are on edge. Most have suffered significant setbacks during a recession that is already at record length and could continue for another year or more. It hardly seems like the right time to buy stocks. Yet while no one can know for sure when markets will turn around, that typically happens well before the economy gets going again.

The numbers don't lie. One recent study examined nine recessionary periods defined by the official arbiter, the National Bureau of Economic Research (NBER). According to NBER data charting recessions from 1953 through 2001, the stock market typically declines until sometime during the middle of the downturn and then begins to strengthen. Starting at the low point of each recession and continuing until six months after its official end, the Standard & Poor's 500 stock index averaged a gain of 36%. That compares with an average decline of 21% for the S&P during a period starting six months before the official onset of each recession and ending at its low point. The average return for an entire recessionary period, including the six months before and after the actual recession, was 8%, and the average recession lasted 11 months. The positive return is due to the role of the markets as a leading indicator, meaning that by the time the recession grips the economy, the markets are already looking forward to the eventual recovery. Similarly, much of the drop in the markets occurs in anticipation of the recession, many months before it is made official.

Throwing in the towel. Despite the hard data showing its benefits, buying stocks during the depths of a recession is bound to feel counterintuitive, particularly if you've spent months watching current holdings steadily lose value. Psychologically, it feels better to jump into the market after prices are already surging and getting out when they're falling. But it's exactly when most investors have finally given up on stocks—a situation market pros call capitulation—that the market is likely to bottom out and start climbing. Capitulation tends to happen when economic news is most dire.

Indications of things to come. In the end, of course, market movements are driven by supply and demand, and stocks won't improve this time just because they've risen under similar circumstances in the past. Still, history can provide important clues about where the economy and markets are likely to go, and economists consider the stock market a leading indicator—a preview of what may be to come for the economy.

Other *lagging* economic indicators

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Are We There Yet?

It goes without saying that the last 18 months have not been fun for investors. Some even wonder if this downtrend is unending. With many banks continuing to teeter on what seems like the brink of insolvency, layoffs seemingly soaring, and the stock market tanking along with corporate profits, one can look in the rearview mirror and find little to cheer.

The economy certainly does not appear to be ready for a turnaround at this precise moment. However, the pace of economic decline seems to have slowed in recent months, and we are beginning to see more positive news than we have in some time.

We agree with Warren Buffett's recent remarks: We "haven't the faintest idea as to whether the market will be higher or lower a month—or a year—from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over."

With the above in mind, we hope that economic forecasts of an upturn in economic activity in the second half of 2009 are on target and that the end of the tunnel is near. Remember that our nation has been through 32 previous recessions and every one of them came to an end. Yes, all bad things must come to an end.

Are we there yet? Only time will tell.

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Lessons From The Wall Street Giants' Fall

The March 2008 downfall of Bear Stearns Cos. was only the first of several failures of erstwhile Wall Street titans. Less than six months after the investment bank had to sell itself to JPMorgan Chase & Co. for next to nothing, Merrill Lynch & Co. was acquired by Bank of America Corp., and Lehman Brothers Holdings Inc. declared bankruptcy. What brought down these and other high-profile institutions was excessive risk and a lack of diversification—the same fatal flaws that doomed the retirement portfolios of employees at Bear Stearns and many other companies. For the Wall Street banks, the problem was massive bets on mortgage-backed securities. For the workers, it was holding too much stock in their own companies.

We've been down this road before. The 2001 collapse of Enron Corp. decimated its employees' retirement portfolios, and that outcome has repeated itself at many a corporate victim of irrational exuberance. Enron's fall cost 5,600 people their jobs, and many had most or all of their retirement money riding on Enron stock, which became worthless when the energy company declared bankruptcy in December 2001.

(In a settlement reached in September 2008, five banks that worked with Enron agreed to pay a record $7.2 billion to some investors, who will get an average of $6.79 per share of common stock. At Enron's peak, shares had sold for more than $90.)

When Bear Stearns was sold, the investment bank's 14,000 employees owned one third of the firm's stock, which had plummeted by 80% in preceding months. And more than 24,000 Lehman executives and workers may have lost most of their savings when their employer went bankrupt.

That's the double whammy—losing a job and your savings—that can hit people who devote too much of their portfolios to shares in their own companies. What can make matters even worse is a tendency to invest additional assets in the same industry. Imagine the Bear Stearns employee who had supplemented a retirement plan loaded with Bear stock with holdings in Lehman Bros. and Merrill Lynch.

Companies, of course, tend to encourage employees to invest where they work, often matching 401(k) contributions and paying bonuses in company shares. They may also restrict workers from diversifying out of concentrated positions. Yet, as these unfortunate examples prove once again, finding a way to create a broadly diversified retirement portfolio needs to be every investor's top priority. There are many ways to mitigate an over-reliance on stock in your company, and we can work with you to make sure you won't suffer the same fate as your firm if it's pulled down during these difficult times. ●

Ensuring A Smooth, Smart IRA Rollover

When retirement finally beckons and you begin to tap the funds in your 401(k) or other retirement plan, you can expect to give the IRS its share—at ordinary income tax rates as high as 35% of any withdrawal. But if you don't need the cash immediately, a better option may be to transfer the money to an individual retirement plan, or IRA.

A properly executed rollover to an IRA postpones current tax on the funds you transfer and keeps the money growing tax-deferred. (You can do this when changing employers as well as at retirement.) Eventually, you must make taxable withdrawals, but not until the year after the year in which you turn age 70½. It's also possible to transfer money from an existing IRA to another IRA, to get a better menu of investments, say, or to consolidate accounts.

Though making a successful rollover isn't difficult, several pitfalls could lead to unnecessary taxes. Avoid these six common mistakes.

1. Not meeting the rollover deadline. The tax law requires you to complete a rollover within 60 days of receiving funds from your cashed-out retirement plan. Otherwise, the distribution is fully taxable on the current year's return, and you could face a 10% penalty for a premature withdrawal if you're under age 59½. That could get pretty expensive—50% or more of the value of your account when you consider federal and state taxes along with the 10% federal penalty and possible state penalties.

2. Not arranging a trustee-to-trustee transfer. Unless you make other arrangements, your company's retirement plan administrator will impose 20% income tax withholding on a payout, even if you intend to meet the 60-day deadline. Though you may recoup the money when you file your taxes, you'll have to come up with the cash before then to complete a tax-free

What A Difference A Year Makes In 10-Year Returns

Would you invest in an asset that has been in the red for an entire decade? That's the question a lot of investors will be asking themselves during the year ahead. The stock market rout in late 2008 resulted in the average annual return for stocks during the past 10 years to be a negative number, and that's bound to make many people hesitate to commit the lion's share of their portfolios to such a seemingly underwhelming investment. But the future for stocks looks much brighter than the recent—and not so recent—past.

Ten-year returns don't exactly lie, but their story is much more complicated than you'd expect, according to a recent report from Vanguard Investment Counseling and Research—"The 'Lost Decade': Rational Expectations in Uncertain Markets," by Francis M. Kinniry Jr. and Christopher B. Philips. Kinniry and Philips point out that during the past decade, the stock market has gone through several extraordinary periods—first, the runaway bull market of the late 1990s, then the brutal bear of 2000 through 2002, and finally the vertigo-inducing dive during the last months of 2008. For years, the great markets of the late '90s buoyed long-term performance numbers. But now, as they fall out of 10-year calculations, the results begin to look pretty bleak.

For the decade ending June 30, 2008, the broad U.S. stock market returned just 3.53% a year—and that, of course, was before the end-of-year meltdown. That's worse than bonds, which had an average annual gain of 5.68% during the same period. But just a few years earlier, long-term stock performance looked much better, according to the Vanguard report. At the end of 2002, coming out of the most punishing bear market in 70 years, the 10-year average annual return for stocks was a respectable 8.74%, and just two years later, as 2004 came to a close, that average had risen to 11.92%. Three years later still, however, the average annual return for the preceding 10 years had plunged by almost half, to 6.29%. The reason? Returns from 1995 through 1997, three years during which annual gains averaged nearly 30%, had dropped out of the equation.

Those returns from the 1990s, though exceptional, came during a decade that saw average returns of almost 20% a year, according to the Vanguard report. That's starkly different from the 2000s, which may well produce average annual returns of less than zero. Looking at those numbers, you might logically conclude that owning stocks isn't what it used to be, and that you ought to pare back your portfolio's equities, perhaps replacing them with bonds, which have outperformed all other asset classes so far this decade.

But that would be the wrong conclusion, suggest Kinniry and Philips. There's nothing you can do about what has already occurred; what's important for investors is what's to come, and Vanguard, one of the world's biggest fund managers, is decidedly bullish on stocks. Though equities are indeed riskier than bonds, that's exactly why they tend to outperform fixed-income investments, and Vanguard's analysts believe the current market offers an equity risk premium of seven. By definition, that's a return seven percentage points higher than the return on "risk-free" Treasuries. Vanguard expects that during the next 10 years, stocks could potentially produce average annual real returns, ie., net of inflation, of 9.5%.

The risk premium is based on the idea that for investors to take on stocks' higher risks, they need the motivation of potentially higher returns. And the market's recent volatility only drives home the point that stocks do bring real risks, and that short-term returns often fall as well as rise. From 1982 through 1999, there was only one down year in the stock market. But that was an anomaly, a departure from the stock market's long history of producing a negative return one year in every four.

That fact, in turn, reminds investors of another truism—that to benefit from stocks' long-term returns, you have to be in the market long term. If you sell when stocks fall, you will have paid the price of investment risk but you won't be there for the gains that inevitably follow. To contain the risk of the market going still lower before it rebounds, a prudent strategy may be to "average" into the markets over the next six to 12 months, meaning that you should keep adding to your investments over time, rather than all at once.

Vanguard's optimism about stocks is based on several factors. Price-to-earnings ratios are low, and though the economy may not recover for a few years, the stock market typically rebounds well in advance of a return to economic growth. But there's also the fact that stocks, statistically speaking, are due for a nice run after such as steep fall.* Investors miss it at their own peril. ●

***Past performance is not a guarantee of future return.**

rollover. To avoid the issue, instruct your plan to send funds directly to the new IRA.

3. Not rolling over sufficient funds. If you don't use a trustee-to-trustee transfer—say, you need to use the funds for 60 days—you must deposit the exact amount in the IRA that you received as a distribution. Any shortfall is subject to tax (plus a possible early withdrawal penalty).

4. Making this an all-or-nothing proposition. You don't have to roll over your entire retirement account balance. If you need cash now, you could take a partial taxable distribution and transfer the rest to your IRA. Alternatively, to better manage the tax implications, you could transfer the entire amount and do a separate distribution from the IRA.

5. Rolling over to the wrong IRA. You can make a tax-free rollover only to an IRA you own. Mistakenly transfer the funds to your spouse's IRA or another account, and the distribution is taxable.

6. Making too many rollovers. A "rollover" is when you take possession of the funds before re-depositing them in an IRA. While you are allowed multiple "transfers" per year, you are only allowed one "rollover." Subsequent rollovers within the same year will be treated as a taxable distribution.

If you'd like our help in arranging a safe, tax-free rollover or transfer to an IRA, please give us a call.●

Markets Often Rebound

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reflect what has already occurred. For example, a higher unemployment rate typically develops because the economy is struggling; when demand for goods and services slackens, companies often respond by reducing their payrolls. Similarly, inflation may keep rising for months after upward pressure on prices, reflecting an economy at its peak, has already largely dissipated.

Stock prices, in contrast, are based on what investors consider to be a company's prospects. When the economy is at its worst, the road ahead may begin to seem comparatively bright, and company earnings could start to rebound even while current statistics continue to paint a gloomy picture. And when investors finally stop selling and start buying, rising demand for stocks will push up prices.

Chances are that this time, as in the past, the stock market will strengthen well before the economy and point the way forward for investors. But keep in mind that the sample size of this study is very small; only nine recessions occurred between 1953 and 2001. Also, the current economic crisis is largely viewed as the worst since the Great Depression, so the rebound may take longer than past recessions.

As always, it's crucial to stick with a long-term investment plan that reflects your goals, timetable, and risk tolerance. We are closely following developments in the economy and investment markets and would be happy to discuss whether any adjustments to your portfolio might be in order. ●

Average return from six months before recession starts until recession low point	Average return from recession low point until six months after recession ends	Average total return from six months before recession until six months after recession
-21%	+36%	+8%

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