March 2009

Investment Update

THE MUNCY BANK & TRUST COMPANY

INSIDE THIS ISSUE:

Points of interest:

- The Black Monday market crash of 1987 is an example of an unpredictable Black Swan event.
- The relatively few trading days when big price swings occur account for most or all of the market's return to investors.
- Such outliers are rare and unpredictable, making market timing a nearly impossible feat.

Those who try to time the stock market get nipped by Black Swans

Investors suffering during major bear markets are tempted to "time" the market: to sell and avoid the downturn, and then reinvest before the inevitable recovery.

It now seems obvious to these investors that anyone with half a brain should have foreseen last year's credit crisis and massive worldwide fall in asset prices. By selling out ahead they would have preserved their capital and been able to invest this year when stocks are bargains.

Not so, says Javier Estrada of the IESE Business School in Barcelona, Spain. His recent study shows that a small fraction of days determines most of an investor's gain, and that these abnormal trading days are impossible to predict.

"Much like going to Vegas, market timing may be an entertaining pastime, but not a good way to make money," he concludes.

A black swan was thought to be impossible until they were found in Australia. Rare and unpredictable black swan events govern stock market returns.

Many Black Swans

He studied the impact of so-called Black Swans—the unpredictable tiny minority of trading days encompassing abnormally large upward or downward price swings.

The term "Black Swan" comes from the age-old assumption that all swans were white, hence a black swan was considered an impossible event. That assumption was shattered by the 17th-century discovery of black swans in Australia.

Black Swans, Estrada writes, lay outside the realm of normal expectations because nothing in the past can convincingly point to their occurrence. They carry an extreme impact. After they occur, plausible explanations can be found for them, making it appear as if they were explainable and predictable, even though they were not.

A prime example is the Black Monday stock market crash of Oct. 19, 1987, when the Dow Jones Industrial Average dropped nearly 23 percent. In the Dow's 90-odd year history prior to Black Monday, it had fallen more than 10 percent in a day only twice, back in the 1929 crash when it fell by 12.8 percent one day and 11.7percent the next. Nothing had prepared investors for a one-day decline of 23 percent.

Big impact

Estrada studied daily returns in the United States and 14 international markets and found that a handful of days of abnormally high or low swings accounted for a major portion of the return to investors in all markets.

For instance, in the United States from 1900 through 2006, an investor turned a $100 investment

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NO PROFITS FOR THOSE WHO MISS HANDFUL OF DAYS IN THE MARKET

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into $25,746 (not counting dividend reinvestment).

If an investor missed just 10 days of that 106-year period, he would have cut his gains by an astonishing 65 percent to just $9,008.

And yet 10 days accounted for just 0.03 percent of the 29,190 trading days from 1900 through 2006.

Even more interesting, an investor who missed the 100 best days during that period ended up making nothing. Those days made up just 0.34 percent of the total trading days and determined whether an investor made any profit or not.

It would have been exceedingly difficult to find "the 0.34 percent of the time that determines whether or not any wealth is created at all!" Estrada wrote. "The odds against successful market timing are simply staggering."

Estrada concludes that Black Swans render market timing a "wild goose chase" and that investors should use diversified portfolios to mitigate their effects and should stick with their investments through thick and thin rather than trying to time markets.

Quick market moves surprise investors.

FAMILY WEALTH IS DOWN, INCOMES STAGNATE

The latest comprehensive survey of household finances by the Federal Reserve shows that the net worth of the average household has dropped since 2001.

It also showed that many Americans—with the exception of the top income earners—have had stagnant incomes in recent years.

The devastation of twin bear markets, one that began last year and one from 2000 to 2002, has erased any gains in assets for American households for the entire decade.

Down 2 percent

The survey performed by the Fed in 2001 showed that the average household net worth (adjusted for inflation) was $100,918. The latest available figures for October 2008 show the average net worth declined 2 percent to $98,900.

That figure may be even lower today since stock markets declined in November 2008 and during the beginning of 2009.

Meanwhile, the latest comprehensive Federal Reserve survey, which covers the period 2004 through 2007, shows that the average family in that period experienced a slight drop in median income, from $47,500 in 2004 to $47,300 in 2007.

Statistics indicated that income fell or stagnated in all income groups but one: there was an appreciable increase in income for the highest 10% of income earners over the period.

American households are falling behind on net worth and not seeing big increases in income, but are contending with more debt.

The average income for that group increased to $397,700 in 2007 from $331,900 three years earlier, the Federal Reserve said.

Although assets and income didn't rise for most Americans, debt did.

The average family owed $67,300 in various debts in 2007, up from $60,700 in 2004.

Second homes hurt

The biggest contributor to that increase was in debt from second homes, the Fed said. The average homeowner had a mortgage of $107,000 on a primary residence, and owed $3,000 in credit card balances. The average car loan was $13,000.

Meanwhile, the growth in households with excessive debt was troubling.

The number had grown by 20 percent to 14.7 percent of all households. Excessive debt is defined as owing more than 40 percent of household income in debts of various types.

"The devastation of twin bear markets… has erased any gains in assets for American households for the entire decade."

Active mutual funds do not protect against a bear market

Investors like to believe that active mutual fund managers—those who are allowed to buy and sell according to their predictions of the markets—can outperform during bear markets.

Index funds, the reasoning goes, are stuck with the downward trend, since they must remain fully invested at all times and will follow the general trend.

A new study by The Vanguard Group, one of the largest mutual fund companies, has turned that common wisdom on its head.

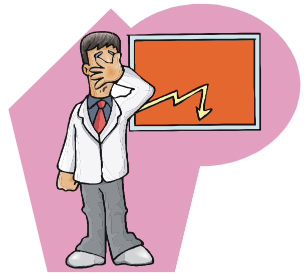
It found that even though as much as 60 percent of active funds beat the indexes in a particular bear market, that did not predict how well they would do in the next bear market. Instead, a different group of funds outperformed during the next down cycle.

Missing the bull

Even worse, the majority of active funds—including those who had done well during the bear market—lagged behind when a subsequent bull market asserted itself.

"The combination of cost, security selection, and market-timing proves a difficult hurdle to overcome in any market environment," wrote author Christopher B. Philips.

The study looked at six market declines of more than 10 percent in the United States and five in Europe, all since 1973.



Active fund managers claim they can beat bear markets, but a new study disputes that.

The study found that a majority of active funds beat the indexes during three of six U.S. bear markets and two of five European bear markets.

Timing is hard

That inconsistency of success looks worse from the finding that a majority of market-beating funds did not repeat their performance in the next bear market, making it difficult for an investor to identify bear market winners in advance.

This probably occurs because the actively-managed funds have taken a defensive position relative to the market.

Obviously it is very hard to time the market's shifts accurately, and these funds do not reallocate to stocks quickly enough to participate in the inevitable market upturn.

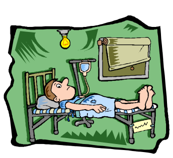
The study confirms the value of an indexed investing approach. "We conclude that an indexed investor is not at a disadvantage when investing in bear or bull markets," Philips wrote.

"Even worse, the majority of active funds… lagged behind when a subsequent bull market asserted itself."

Young and sick, higher incomes, & more

Long term care insurance is typically purchased in anticipation of needing nursing care at home or in a facility after retirement.

However, new statistics from Unum, a large long term care insurer, shows that almost half of its policy claims were made by people under age 65.



The average age for younger clients making claims was 53, and the average claim lasted for 31 months, Unum said.

Brain and nervous system injuries were the leading causes for claims.

Traditionalists win

Men who hold a traditional view about a woman's place at home earn more money than those who are more liberal, according to a study published in the *Journal of Applied Psychology.*

The traditionalists earn $8,500 more on average, the study found. However, women with more traditional views earned less than their counterparts who thought it was ok to work outside the home. The study speculates men who believe in traditional roles may negotiate harder for more pay or that employers may discriminate against more liberal men.

Indexes win again

Over the last five years Standard & Poor's stock indexes have beaten the majority of actively managed funds, the company said.

The S&P 500 beat almost 69 percent of large-cap stock funds, its SmallCap 600 fund beat 78 percent of small-cap funds, and its bond indexes beat 75 percent of bond funds.

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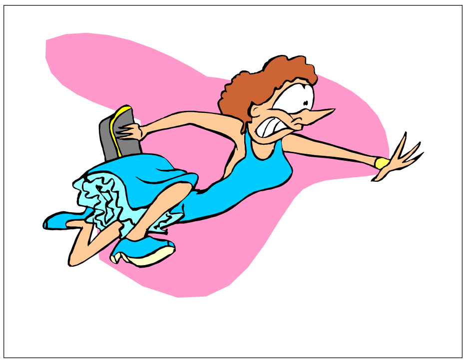
WITH IMPECCABLE BAD TIMING, MUTUAL FUND INVESTORS FLEE

The record for individual investors is clear: they have lousy market timing.

The easiest indicator of what investors are doing with their money are the monthly statistics on inflows and outflows from mutual funds.

Statistics inevitably show that investors pile into funds at the top of bull markets and flee their funds at the bottoms of bear markets.



Mutual fund investors grabbed their purses and wallets and fled stock and bond funds in 2008.

This seemed to happen once again during the fourth quarter of 2008, when the Standard & Poor's 500 Index hit a low that was 52 percent below its high of a year earlier. Despite bouncing up and down since then, the S&P 500 low has stayed in the same range since November.

Mutual fund data from Morningstar show that investors fled from both stock and bond funds during the quarter, with the biggest exodus coming from foreign and emerging market investments. Morningstar said fund owners sold their international shares at a rate three times faster than they sold domestic stock funds.

The bond sell off occurred during the credit crisis as corporate and municipal bonds declined in value. Some $40 billion exited mutual funds investing in those areas.

Investors gobbled up shares of funds holding U.S. Treasury securities, even as the yields on those securities neared zero.

Several studies have shown that even though mutual funds on average post good long-term returns, the average investor underperforms his or her own fund because of inefficient market timing.

One glimmer of hope appeared at the very end of the year, Morningstar said.

Between Dec. 1, 2008 and Jan. 11 of this year, mutual funds had net inflows of $11 billion, indicating that some investors were dipping their toes in the water again, perhaps on the belief that recent lows will be the bottom of this bear market.