SOLID ROCK WEALTH MANAGEMENT

WealthGuide

Greatest Lessons of the Great Recession

An Educational Resource From Solid Rock Wealth Management

Presented By Christopher Nolt, LUTCF

Introduction

On August 7, 2007, BNP Paribas, one of the largest banks in France, suspended investor withdrawals from three of its mutual funds after U.S. subprime-mortgage woes led to the "complete evaporation of liquidity."

This liquidity crisis was soon spread to other financial firms. Investors began to worry about risky loans and over-inflated asset prices. And a whole series of events was set in place that would lead to a near financial meltdown and global recession.

While investors may not remember all of these events, the worsening headlines and the dire predictions from financial "experts," few have forgotten how they felt in 2008 and early 2009 as markets continued to tumble. The fear and uncertainty and feelings of helplessness still haunt many investors. Even now, a dip in the markets or bad economic news can bring all the emotions of those times roiling back.

While the power of these emotions can't be ignored, we should not let emotion compromise our financial futures. Now that we are more than a half decade removed from the beginnings of the "Long" or "Great Recession," we have more perspective and can see more clearly. We can examine the facts and the evidence and draw some valuable lessons that can help us — as investors — stay focused on our long-term goals.

1. Don't let emotions drive investment decisions
2. Don't try to time the markets
3. Active managers do not consistently outperform in bear markets
4. Diversification still works
5. Don't take unnecessary risks with bonds
6. Rebalance your portfolio regularly
7. There may be no better alternative to buy-and-hold investing

Though we all have different goals, dreams and life circumstances, these seven lessons can apply to all of us, from day to day and year to year, across both bear and bull markets.

LESSON ONE

Don't Let Emotions Drive Investment Decisions

Letting your emotions guide the way you invest can have detrimental consequences for your portfolio, including dramatic underperformance. It is easy to understand how this happens. Our instincts tell us we have to do something now. Indeed, studies have shown that, time and again, investors tend to invest according to recent performance. When the stock market is going up, we tend to believe it will continue to go up, and we are driven by the desire to buy. When the market goes down, we are afraid it will continue to decline, and our fear causes us to want to sell.

The chart below demonstrates this by overlaying mutual fund returns (the bronze line) with the amount of money investors put in — or withdrew — from stock mutual funds (blue bars) since 1997. Money poured in after periods of good returns when prices were high, a record level just before the crash in 2000. Then, as prices came down, money flows slowed dramatically as fearful investors became more cautious close to the bottom in 2002, just before the market's dramatic rise in 2003. The same pattern of outflows occurred during the market decline in 2008.

"Don't just do something, stand there….The worst time for action is a period of distress — those are periods when we make mistakes."

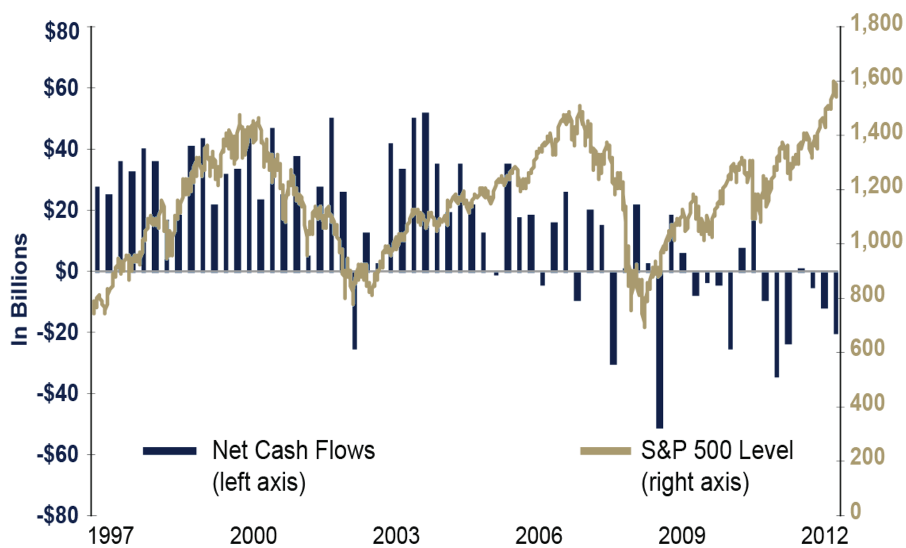
— Charles D. Ellis, author of "Winning the Loser's Game" and Chairman, Yale University Investment Committee.

Some investors who pull out of the market during difficult times think they will be able to recognize when they can safely get back in to the market. But history shows us that market recoveries often occurred unexpectedly. We saw this in 2002 and again in 2009, with what were, in retrospect, strong bull markets that began without warning.

This is the nature of stock investing. Gains may come in powerful upsurges against a backdrop of discouraging financial and economic news. As the March 2009 rally demonstrated, a surprise rebound may frustrate investors who are waiting for a clear signal to return to the market. It's impossible to know when the top or the bottom of the market will occur, but investors who stayed the course since the lows of 2009 have seen nearly every U.S. stock asset class more than double since that time, more than making up for the losses of the Great Recession.

Buying High, Selling Low

January 1997 through December 2012



Source: Morningstar Jan. 2013. Market performance in this example is represented by the S&P 500 price index. Net cash flow data is provided by the Investment Company Institute and represents the net flows of funds they classify as equity funds. An investment cannot be made directly in an index. Past performance does not guarantee future results.

LESSON TWO

Don't Try to Time the Markets

Successful market timing requires overcoming two hurdles — knowing when to sell and when to buy.
To illustrate the difficulty of getting the timing decision right, let's take a look at the best and worst days in the S&P 500 over the last four decades.

Remarkably, 2008 will go down as the year that produced five of the 10 worst daily declines but also the top six best daily returns (both in percentage terms). This is a powerful example of how difficult it would be to successfully time the market to miss the worst days, yet participate in the all-important best days.

Best and Worst Days in the U.S. Stock Market

S&P 500 Index, January 1, 1970 through December 30, 2012

BEST TEN DAYS

Date	One-Day Return%
Oct. 13, 2008	11.58%
Oct. 28, 2008	10.79%
Oct. 21, 1987	9.10%
Mar. 23, 2009	7.08%
Nov. 13, 2008	6.92%
Nov. 24, 2008	6.47%
Mar. 10, 2009	6.37%
Nov. 21, 2008	6.32%
Jul. 24, 2002	5.73%
Sept. 30, 2008	5.42%

WORST TEN DAYS

Date	One-Day Return%
Oct.19, 1987	-20.47%
Oct. 15, 2008	-9.03%
Dec. 1, 2008	-8.93%
Sept. 29, 2008	-8.81%
Oct. 26, 1987	-8.28%
Oct. 9, 2008	-7.62%
Oct. 27, 1997	-6.87%
Aug. 31, 1998	-6.80%
Jan. 8 1988	-6.77%
Nov. 20, 2008	-6.71%

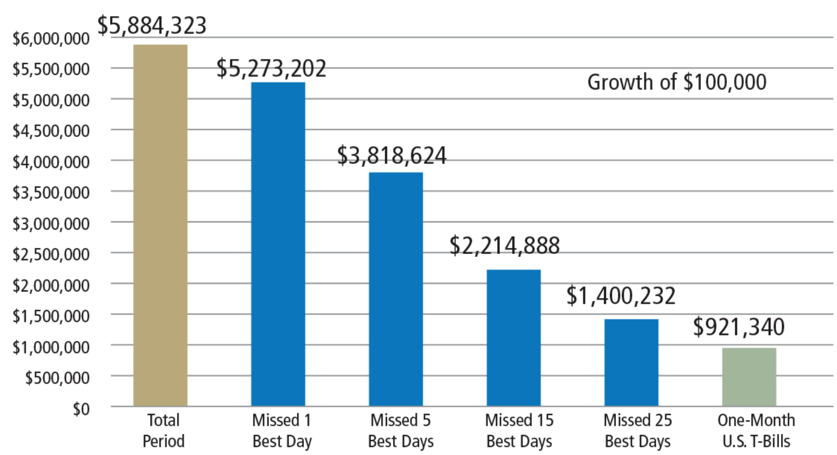
Source: Yahoo Finance (January 2013)

Past performance does not guarantee future results.

Getting the timing decision wrong can have a serious impact on your future returns. As the chart shows below, missing even a few of the best days of the market may defeat a market timing strategy.
If you had invested $100,000 in 1970 in the S&P 500 Index, it would be worth $5,884,323 in 2012. Missing just five of the best days would have cut your returns by $2 million to $3,818,624.

"Time In" vs. "Timing" the Market

Performance of the S&P 500 Index Daily: Jan. 1, 1970 - Dec. 31, 2012



Annualized Compound Return	9.94%	9.66%	8.84%	7.47%	6.33%	5.30%

Source: The S&P data are provided by Standard & Poor's Index Services Group. US bonds and bills data ©2013 Stocks, Bonds, Bills, and Inflation Yearbook™, Ibbotson Associates, Chicago (annually updated work by Roger G. Ibbotson and Rex A. Sinquefield). Indexes are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. S&P 500® is a registered trademark of Standard & Poor's Financial Services LLC. Past performance does not guarantee future results.

LESSON THREE

Active Managers Do Not Consistently Outperform in Bear Markets (or Bull Markets)

Every January, USA Today asks top investment strategists to offer up their outlook for the year ahead, including where they think the S&P 500 will end the year. Ahead of the calamitous market declines and economic turmoil just around the corner, all of the strategists' forecasts at the beginning of 2008 were predicting an up year in the markets.

Similarly, at the end of 2007, New York newspaper Newsday sampled "eight major Wall Street Securities firms" and came out with an average price target for the S&P 500 by the year-end 2008 of 1,653, representing a 12% rise on the previous year[1].

We now know the S&P 500 Index declined by 37% for the year 2008. None of USA Today's or Newsday's strategists even predicted the down direction of the market correctly. Also unforeseen, the bankruptcy or sale of many of these strategists' own firms.

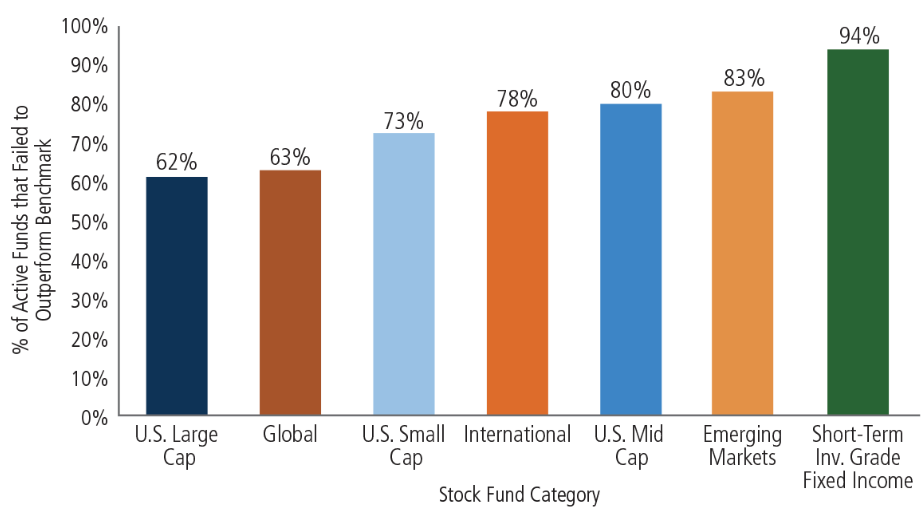
If experts can't even predict recessions or the direction of the markets, how can we expect active managers to successfully pick individual stocks whose performance is so sensitive to economic and market conditions?

Active managers attempt to outperform an index, such as the S&P 500 Index, by actively trading individual stocks and/or engaging in market timing — deciding when to be in and out of the market. Many investors believe that active managers earn their keep in bear markets, because they avoid losses by hand-picking superior individual stocks or by shifting out of stocks altogether before steep market declines occur.

Standard and Poor's has been measuring the performance of active managers against their index counterparts for several years now. Their May 2009 Indices Versus Active Funds Study specifically focused on the bear market of 2008 and concluded that "the belief that bear markets favor active management is a myth." In aggregate in 2008, actively managed funds underperformed the S&P 500 Index by an average of 1.67%[2].

Since 2008, these same studies continue to show that the majority of active managers fail to beat their benchmarks. As you can see from the chart below, from 2008 – 2012, the S&P 500 Index outperformed 78% of actively managed large cap mutual funds, and the S&P Small Cap 600 Index outperformed 80% of actively managed small cap funds.

Percentage of Active Funds that Failed to Beat Their Index
2008 – 2012



Source: Standard & Poor's Indices Versus Active Funds Scorecard (SPIVA), year end 2012. Index used for comparison: U.S. Large Cap – S&P 500 Index; U.S. Mid Cap – S&P MidCap 400 Index; U.S. Small Cap – S&P SmallCap 600 Index; Global Funds – S&P Global 1200 Index; International – S&P 700 Index; Emerging Markets – S&P/IFCI Composite; Short-Term Inv. Grade Fixed Income – Barclays 1-3 Year Government/Credit Index. Outperformance is based upon equal weight fund counts. For illustrative purposes only. Index returns do not include payment of any sales charges or fees an investor would pay to purchase the securities they represent. Such costs would lower performance. Past performance is not an indication of future results. Standard & Poor's®, S&P®, S&P 500®, S&P MidCap 400®, S&P SmallCap 600® and SPIVA® are registered trademarks of Standard & Poor's Financial Services LLC.

Active managers are further challenged by the fact that while overall the stock market historically delivers positive returns over the long run, it is actually a small group of stocks that is responsible for that positive return.

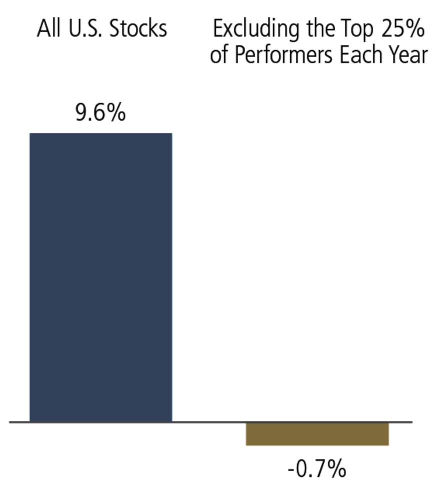
As the following chart illustrates, of the total U.S. stock market database from 1926 – 2012, only the top-performing 25% of stocks were responsible for the market's gain. The remaining 75% of the stocks collectively generated a loss of -0.6%. This example demonstrates the difficulty in selecting the individual stocks that will perform better — or even in-line with — the broad stock market.

Attempting to enhance your returns by seeking out the needles in the haystack introduces an additional layer of active risk and the potential for increased volatility. A portfolio of even the most carefully chosen stocks could easily wind up with none of the best-performing stocks in the market — and thus could possibly produce flat or negative returns for many years. As the historical performance of active managers demonstrates, very few of them are accomplished stock pickers.

Hedge funds, run by some of the smartest financial minds in the world, have had an abysmal track record — and they invest in almost anything in an attempt to make money in up and down markets: stocks, commodities, derivatives, mortgage backed securities, timber forests, insurance contracts, etc. In 9 of the last 10 years, hedge funds (as measured by the HFRX index) were beaten by the S&P 500.[3]

If the best financial minds with maximum flexibility can't beat the market, what hope is there for the rest of us? Not surprisingly, investors are increasingly pulling their money out of actively managed investments. They are tired of paying high fees for investments that year after year just don't perform very well.

The Impact on Returns of Missing the Top-Performing Stocks
1926 – 2012



Source: Results based on the CRSP 1-10 Index. CRSP data provided by the Center for Research in Security Prices, University of Chicago. Past performance is not indicative of future results. Indexes are unmanaged baskets of securities in which investors cannot directly invest. The data assume reinvestment of all dividend and capital gain distributions; they do not include the effect of any taxes, transaction costs or fees charged by an investment advisor or other service provider to an individual account. The risks associated with stocks potentially include increased volatility (up and down movement in the value of your assets) and loss of principal. Small company stocks may be subject to a higher degree of market risk than the securities of more established companies because they tend to be more volatile and less liquid.

LESSON FOUR

Diversification Still Works

We believe that the Great Recession provided a powerful example of the true benefits of diversification.

In 2008, if you had been invested in just one asset class, such as the S&P 500, your net worth may have been down about 37%. However, if you diversified and built a portfolio that included bonds and cash, asset classes which both experienced positive returns in 2008, you would have been in better shape.

The chart below shows the performance of diversified portfolios vs. pure stock portfolios during and after the bear markets of 1973-1976 and 2007-2011.

It illustrates the hypothetical growth of $1,000, with the blue line representing a portfolio built with only stocks, and the green line representing a diversified portfolio of 35% stocks, 40% bonds and 25% T-bills. Over the course of both time periods, the diversified portfolio lost less than the pure stock portfolio.

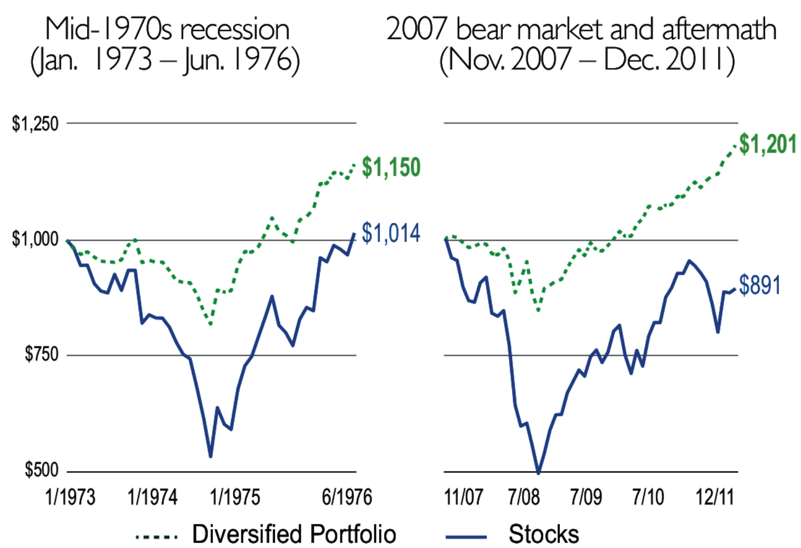
It is important to understand that risk can't be eliminated, not even through diversification. It's the price we pay for potential return. It is easy to understand the frustration and panic many investors felt in 2008 as all stock markets declined. Even those holding a mix of various types of stocks experienced significant losses.

But imagine how much worse the losses were for investors with significant concentration or exposure to certain companies, like Fannie Mae, Freddie Mac, AIG, Lehman Brothers, etc. They may have suffered substantial or even total losses.

Remember, though almost all stock investors experienced losses during the Great Recession, those who were well diversified and stayed invested have benefitted by the subsequent gains over the past several years. And those who were poorly diversified, or panicked and sold out at the bottom, may have compromised their financial futures irrevocably.

Diversification neither assures a profit nor guarantees against loss in a declining market.

Performance of Diversified Portfolios vs. Pure Stock Portfolios During & After Bear Markets



Source: Morningstar, January, 2013. Past performance is no guarantee of future results. Diversified portfolio: 35% stocks, 40% bonds, 25% Treasury bills. Hypothetical value of $1,000 invested at the beginning of January 1973 and November 2007, respectively. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Stocks in this example are represented by the S&P 500, bonds are represented by the 20-year U.S. Government Bond, and Treasury bills by the 30-day U.S. Treasury bill. The data assumes reinvestment of income and does not account for taxes or transaction costs. ©2012 Morningstar.

LESSON FIVE

Don't Take Unnecessary Risks with Bonds

Prompted by the low-interest rate environment that preceded 2008, some investors began to stray from high-quality bonds in an effort to increase income yields or enhance returns in the bond component of their portfolio. Many investors do not fully understand the risks in bonds and often believe that all bonds are "safe."

Unfortunately, the credit risks in bonds become more apparent during bear market periods, and they became even more so during the Great Recession because of the severe credit and liquidity crisis that occurred. Bonds with any degree of credit risk suffered significant price declines, along with the stock markets.

In addition to credit and default risk, a bond's riskiness and performance potential are also closely tied to its maturity. The longer a bond's maturity, the more its price will move when interest rates rise or fall. During the extreme market environment of the Great Recession, long-term Treasuries generated the highest returns because interest rates declined sharply as investors sought the safe haven of U.S. government bonds. But it is important to remember that long-term bonds will generally suffer the most when interest rates rise.

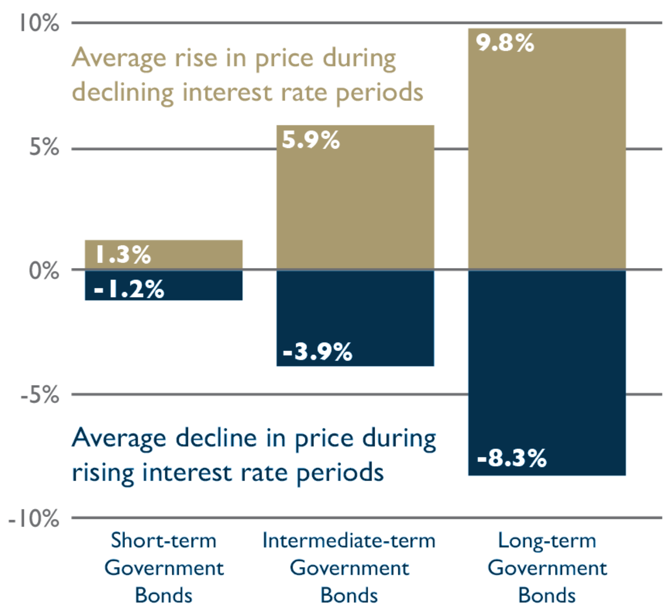
This graph illustrates the relationship between the length of a bond's maturity and its sensitivity to interest rates. The greater a bond's maturity, the greater the maturity risk.

From 1970–2012, shorter maturity bonds were relatively insensitive to movements in interest rates, dropping an average of –1.2% when interest rates rose and gaining an average of 1.3% when interest rates fell. Bonds with longer maturities were the most sensitive, dropping an average of –8.3% when interest rates rose and gaining an average of 9.8% when interest rates fell.

We believe the primary role of bonds in a long-term portfolio is to reduce the portfolio's overall volatility. That is why we recommend high-quality, short-term bonds. We believe that other bonds do not offer an attractive risk reward profile over longer periods of time.

Bonds and fixed income funds will decrease in value as interest rates rise.

Fixed Income Maturity Risk
1970-2012



Source: Morningstar, January, 2013. Short-term government bonds are represented by the one-year U.S. government bond for 1970–2012. Intermediate-term government bonds are represented by the five-year U.S. government bond and long-term government bonds by the 20-year U.S. government bond. An investment cannot be made directly in an index. The data assumes reinvestment of all income and does not account for taxes or transaction costs. For the annual periods 1970 through 2012, each year was categorized as a year when yields rose or a year when yields fell. The price changes during all years when yields rose were then averaged. The same was done for years in which yields declined. The price change was isolated, as opposed to the total return, so that the effect would be more pronounced.

LESSON SIX

Rebalance Your Portfolio Regularly

Rebalancing should be a part of any investor's long-term portfolio; it helps ensure that your portfolio remains aligned with your goals and risk tolerance. Because of the movements in markets, portfolios tend to change or "drift" over time and move away from their original asset allocation — unless they are rebalanced.

Asset classes associated with high degrees of risk tend to have higher rates of return than less volatile asset classes. For this reason, a portfolio that is not rebalanced periodically may become more volatile (riskier) over time. So rebalancing may help to minimize the losses from bear markets.

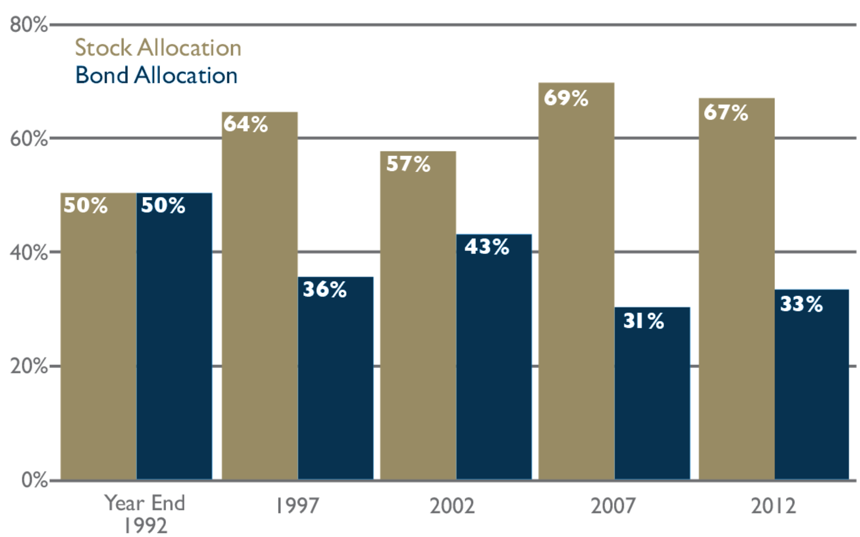
Please note, there may be tax consequences associated with rebalancing a portfolio.

This chart illustrates the effect of different growth rates on a static (unbalanced) portfolio over a 20-year period. At year-end 1992, the target asset mix began with a 50% allocation to stocks and a 50% allocation to bonds.

The proportion of stocks in the portfolio grew from 1992 to 1997, when it accounted for 64% of the portfolio. Subsequent market fluctuations caused the stock allocation to drop to 57% by 2002, rise again to 69% in 2007, and drop again to 67% in 2012. This allocation is drastically different from the 50/50 portfolio the investor started out with. Losses on the more aggressive asset mix would have been even more severe than on the original portfolio allocation.

Rebalancing will not benefit your portfolio every time or in every market environment, but diligent rebalancing on a set schedule can help keep emotions out of the process. For most people, it may make only a marginal difference. But unless you're really good or really lucky at calling turning points in the business cycle, then it is probably the best you can do. However, it will help ensure that your portfolio stays close to your stated risk tolerance so that you aren't taking less, or more, risk than you are comfortable with.

Importance of Rebalancing
1992-2012



Source: Morningstar. Small stocks are represented by the Ibbotson® Small Company Stock Index. Large stocks are represented by the Standard & Poor's 500® index, which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. Intermediate-term government bonds are represented by the five-year U.S. government bond. An investment cannot be made directly in an index. The data assumes reinvestment of income and does not account for taxes or transaction costs.

LESSON SEVEN

There May Be No Better Alternative to Buy-and-Hold Investing

Before abandoning academic and time-tested strategies such as buy-and-hold investing, investors should understand that there is very little empirical evidence that suggests a better alternative.

While buy-and-hold investing can be painful and frustrating and difficult to stick to during extreme volatility, everything we know about investment theory and practice suggests that staying the course will remain an effective approach long after those proclaiming the death of buy-and-hold have disappeared.

Now that several years have passed, we can reflect on the performance of the market since 2008-2009 with a more temperate and rational perspective.

Despite all of the anguish investors experienced from October 2008 through September 2009, the S&P 500 Index was down less than 7%. And international markets, which suffered the steepest declines during the bear market, were up 3.2%.[4]

If you had a globally-diversified stock portfolio with 60% domestic and 40% international, your portfolio was down less than 3% for the year.[5]

And those with a balanced portfolio which included a 40% bond allocation had returns of 0.5% for the year.6 Of course, past performance is not indicative of future results.

Buy-and-hold investing cannot guarantee a profit or protect against a loss. Diversification does not guarantee a profit or protect against a loss.

Conclusion

As bad as things were during the Great Recession, in the years since 2009 there have been many other events to worry investors — many of which were labeled a “crisis” by the media:

- European Debt Concerns
- U.S. Debt Ceiling
- U.S. Credit Rating Downgrade by S&P
- Fiscal Cliff Debate
- Sequestration
- Unrest in the Mideast

Despite the fact that there is always something to worry about, capitalism is still going strong. Companies all over the world continue to produce, invent and provide service — and investors are still investing in them.

The greatest lessons learned from the Great Recession reinforce the principles of our Asset Class Investing philosophy with its focus on discipline, diversification and reason.

- Don’t let your emotions drive investment decisions. Doing so may cost you more over time.

- Don’t attempt to time the markets. Few professional money managers have done it successfully and consistently.

- Spread your nest egg across a mix of different asset classes — and diversify broadly within each asset class.

- Don’t take unnecessary risks with bonds. The role of bonds is to provide stability and dampen the volatility of your stock portfolio.

- Rebalance whenever a part of your portfolio gets too far out of whack, even when doing so may seem uncomfortable.

- There was no alternative strategy to buy-and-hold that would have saved investors in 2008/2009, and there is scant empirical evidence supporting a better long-term alternative.

- Don’t go it alone. Investors who work with an independent financial advisor to develop a prudent, long-term financial plan will be better prepared to weather the inevitable ups and downs of the market and progress towards achieving their long-term goals.

Perhaps the most important lesson of all is to make sure our reactions to events beyond our control don’t change the one thing we can control — our behavior.

Resources

1. 2008 Outlook for Investors’, Newsday, (December 31, 2007)

2. Standard and Poor’s May 2009 Indices Versus Active Funds Study

3. http://www.economist.com/news/finance-and-economics/21568741-hedge-funds-have-had-another-lousy-year-cap-disappointing-decade-going

4. International markets are measured by the MSCI EAFE Index.

5. Source: Morningstar January 2013. Domestic represented by the S&P 500 Index and international represented by the MSCI EAFE Index.

6. Source: Morningstar January 2013. Bonds represented by Citigroup World Government Bond 1-5 Year Hedged Index.

Chris Nolt is the owner of Solid Rock Wealth Management, Inc. and Solid Rock Realty Advisors, LLC, with offices in Bozeman, Montana and Fountain Hills, Arizona. Solid Rock Wealth Management and Solid Rock Realty Advisors are dedicated to helping people effectively grow and preserve their wealth. We use a comprehensive planning approach with a team of financial professionals, which addresses retirement planning, investment planning, estate planning, tax planning, charitable giving and risk management. Our wealth preservation strategies are designed to help our clients reduce taxes, increase retirement income and maximize the amount of wealth they pass on to their heirs and favorite charitable organizations.

Solid Rock Wealth Management

Solid Rock Wealth Management is an independent, fee-only registered investment adviser. We offer globally diversified portfolios of no-load, low-cost institutional asset class mutual funds and exchange traded funds. Are portfolios are diversified among as many as 15 asset classes and market sectors and are comprised of holdings in roughly 12,000 companies in 45 different countries. Our model portfolios range from conservative (100% fixed income) to aggressive (100% equities) and are designed to achieve optimal returns for your level of risk tolerance.

Solid Rock Realty Advisors

Solid Rock Realty Advisors assists investors who are seeking secure income producing real estate investments. We specialize in office buildings leased to the U.S. Federal Government and primarily work with investors who are purchasing properties through a 1031 tax-deferred exchange. These fee-simple real estate properties offer long-term leases guaranteed by the full faith and credit of the U.S. government with competitive cap rates and professional property management.

Chris Nolt, LUTCF

Chris grew up in Lewistown, Montana. He received a Bachelors degree in business from Montana State University in 1987 and entered the financial services industry in 1989. For over 25 years, Chris has been helping people reduce taxes, invest wisely and preserve their wealth. Chris has earned the designations of Certified Retirement Financial Advisor and Life Underwriter Training Council Fellow.

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