LAZARD

Investment Focus

# Learning FROM THE PAST

During volatile market cycles, investors often make hasty choices, seeking the security of cash rather than holding on to equities. While it is understandable that investors may want to respond to market movements in some way, we believe it is essential not to be guided by emotion.

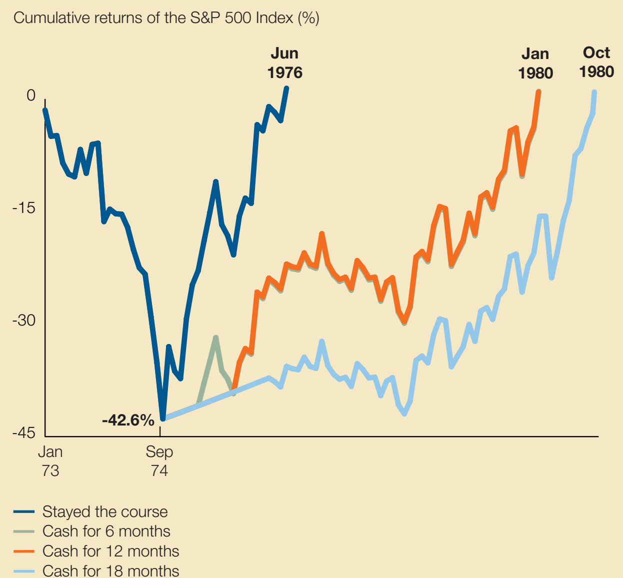
Looking at historical return data helps bring the market's instability into perspective. A recent study from Putnam Investments showed that the 12 bear markets experienced since 1948 lasted an average of 14 months, during which the S&P 500 Index lost an average of 22.4%; but each of them was followed by a bull market that lasted 45 months, on average, and saw a 123.9% average gain in the S&P 500 Index.[1]

In 1973-74, the U.S. stock market fell by almost 43% over the course of 21 months. Notwithstanding an unstable political environment and a gloomy economic outlook, stocks eventually recovered. As shown in Exhibit 1, only by staying invested could an investor have captured the fullest effect of the rebound. Seeking safety in cash for just six months would have pushed back the portfolio's rebound considerably.

In order to study the effects of sitting on the sidelines with investments in cash and missing the initial phases of a recovery, we examined the recovery of the S&P 500 Index following the market trough in 1974. If we look at this case closely, we see that staying in the market, even through a 43% decline, would have brought an investor back to prior levels in less than two years (as shown in Exhibit 1).

However, if that investor had moved his or her portfolio to cash at the bottom and kept it there for just 6 months, it would have taken another 3.5 years to return to pre-decline levels.

**EXHIBIT 1:** PROLONGING RECOVERY



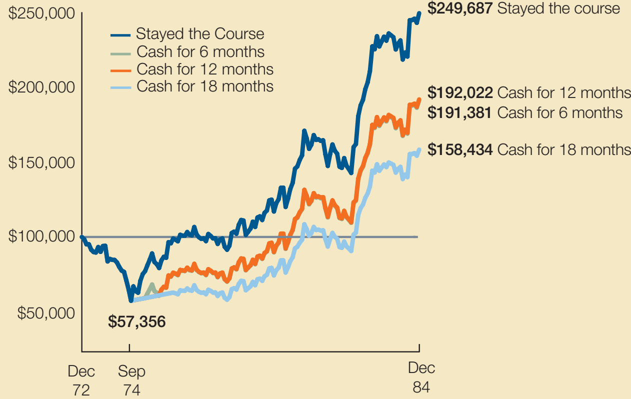

Source: Frank Russell

Shown for illustrative purposes only; does not reflect the performance of any portfolio managed by Lazard.

Monthly data used for all calculations. Assumes historical monthly index returns and an annualized return of 6.235% (based on the 30-day T-bill return for October 1974) for any period in cash. The index is unmanaged and has no fees. It is not possible to invest directly in an index. Past performance does not guarantee future results.

**EXHIBIT 2:** POTENTIAL LONG-TERM COSTS OF HIDING IN CASH

1973-1974 Market Decline

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It appears that sitting out the equity market for 18 months would have pushed the portfolio's recovery back even further.

By ten years after the event, the effect of sitting out the market is clear: the investor who stays out accepts a considerable handicap in achieving his or her long-term goals (Exhibit 2).

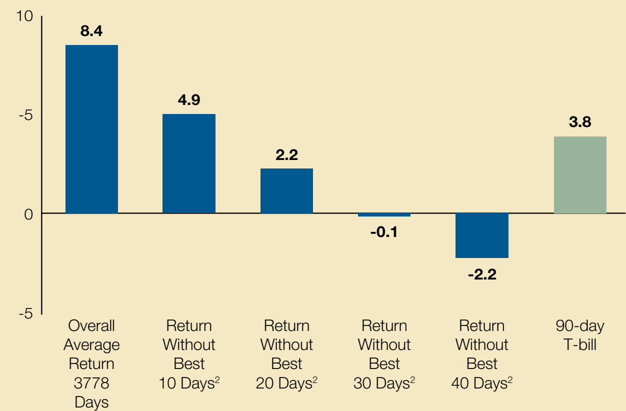
Assessing past market performance offers guidance on how we might see patterns of performance going forward. Lazard believes it is always prudent to reassess investment goals, risk tolerance, and investment time horizon in order to determine if one's current asset allocation fits one's needs. Given a sound plan, it may be prudent to stick with equity allocations, rather than attempting to time the market. Human emotion, however, often leads investors to redeem their shares during a market downturn. Unfortunately, it is close to impossible to determine when is a good time to get back into the market.

For example, in the 20 years following the market bottom on October 3, 1974 (after a long and drawn-out period of market decline), missing the one best[2] day in the market knocked 0.48% off of a potential investor's 15-year annualized returns. The impact of one half of one percent, when compounded over 20 years, is huge. Missing the best 5 or 10 days had an even greater impact over the long term.

No matter what study is consulted, the difficulties of market timing are well-known. Exhibit 3 shows just how severe the consequences can be if one tries and fails to time the market.

Previous recoveries have tended to be strongest in their early stages. As we see in Exhibit 4, the lion's share of the recovery in the 12-month period after the market bottomed is generally experienced in the first 6 months.

**EXHIBIT 3:** NO SUCH THING AS A SIMPLE DECISION




As of September 30, 2008

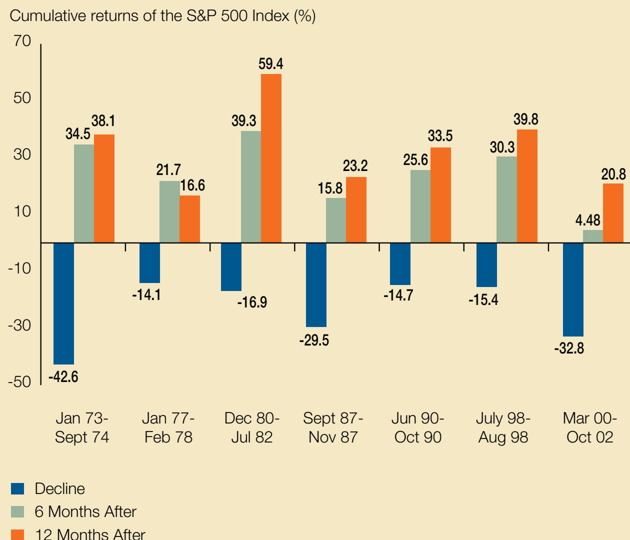
Source: Bloomberg, Factset, Lipper

The 90-day T-bill return is an indication of the return for investments in cash over the time period under consideration, and it is provided for comparative purposes only.

The index is unmanaged and has no fees. It is not possible to invest directly in an index. Past performance does not guarantee future results.

Historically, bear markets end. Investors may be better off staying the course throughout these volatile markets. We would encourage investors to work with their advisors to develop a solid investment plan (based on their specific goals and risk tolerances), and, in our opinion, stick to that plan. Also, we would suggest establishing an ongoing schedule for rebalancing portfolios based either on changes in the market, or on factors like goals or risk tolerances.

**EXHIBIT 4:** RECOVERIES ARE USUALLY STRONGER IN THE EARLIER STAGES




Source: Lipper

Monthly data used for all calculations. The index is unmanaged and has no fees. It is not possible to invest directly in an index. Past performance does not guarantee future results.

## DISCLOSURES/RISKS:

1 Andrew Coen, "Investors should not panic in downturn, study says," Investment News, September 15, 2008, http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20080915/REG/309159984

2 The "best" days to be invested are defined as the days on which the S&P 500 Index delivered its highest returns for the given period based on historical data.

Adapted from a paper originally published in September 2002. Revised and re-published on October 22, 2008.

The S&P 500 Index is an index of 500 industrial, utility, transportation, and financial companies of the U.S. markets (mostly NYSE issues). It is a capitalization-weighted index calculated on a total return basis with dividends reinvested.

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