

## Chapter One



# What Happened?? What Happened!!

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WHEN *The Little Book That Saves Your Assets* first appeared in 2008, how little did any of us anticipate the steep and scary roller-coaster ride that was about to be experienced by economies, companies, financial markets, banks, governments, savers, workers, and retirees! Throughout 2008, crashing markets, widespread layoffs, loan losses, asset value write-downs, accelerated news flow, and extreme volatility severely tested the nerves, resources, patience, sanity, and resolve of investors,

regulators, CEOs, politicians, and mainstream citizens in the United States and all over the world.

And in March 2009, just when it seemed as if the global economy was about to plunge even deeper into the abyss, governments acted, markets rallied, and economies stabilized somewhat. A back-and-forth, halting, faltering resuscitation began, although quite anemic compared to previous recoveries. Even today, disagreement persists as to whether a final bottom has been reached and a multi-year secular bull market can begin to unfold. Such a scenario appears unlikely until: (1) debt and leverage are brought down to manageable levels; (2) politicians cooperatively and central bankers resolutely pursue policies to address imbalances (of savings, consumption, deficits, indebtedness, societal entitlements, and currency values); (3) outmoded patterns of thinking and behavior adjust to the new realities of technology, globalization, and demographics; and (4) meaningful structural reforms begin to be implemented.

At times during the past several years, it has seemed as if the wheels were coming off the car of the global economy. Throughout this tumultuous, trying, turbulent period, I have received a great many e-mails, handwritten letters, and telephone calls (as well as in-person visits and faxes!) from anguished, distressed, even emotionally destabilized investors and financial advisors seeking solace and guidance. Quite a number of these communications, however, bore

a different message. These missives—from, for example, a 70-year-old widow in Boston, a retired executive in San Antonio, a young couple in Orlando, an agribusiness owner in Brazil, and a biotechnology entrepreneur in California—expressed relief and thanks for *The Little Book That Saves Your Assets* having helped protect their portfolios and limit damage during the recent bout of financial carnage, and having prevented readers from giving up in despair just as a cyclical upturn was about to unfold. In their own, highly personal ways, these individuals recounted how they had understood, internalized, and applied the three major messages of this book to avoid disaster and then live to fight another day. These bedrock principles are: (1) adequate portfolio diversification (through having assets that truly zig when others zag); (2) judicious rebalancing (of asset weightings back to strategic asset allocation targets after dramatic price moves); and (3) active risk management (through *defensive* actions such as having extra cash or reducing exposure to economically sensitive assets, and *offensive* actions such as increased allocations to assets such as high-quality fixed-income securities).

It is indisputable that investors had to navigate extraordinarily volatile financial market conditions during the years 2008, 2009, 2010, and 2011. This four-year time period featured, in 2008, enormous financial system instability, bankruptcies, bailouts, and governmental rescues (see Exhibit 1.1 for selected key events).

**Exhibit 1.1 Key Events in 2008**


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|-------------------------------------|--|
| <b>Sunday, March 16, 2008</b>       | Government-assisted rescue of Bear Stearns   |
| <b>Friday, July 11, 2008</b>        | Bankruptcy of IndyMac Bancorp  |
| <b>Sunday, September 7, 2008</b>    | Conservatorship of Fannie Mae and Freddie Mac  |
| <b>Sunday, September 14, 2008</b>   | Bank of America acquisition of Merrill Lynch   |
| <b>Monday, September 15, 2008</b>   | Lehman Brothers bankruptcy   |
| <b>Tuesday, September 16, 2008</b>  | Federal Reserve capital injection into AIG   |
| <b>Tuesday, September 16, 2008</b>  | Reserve Primary Fund money market mutual fund suspension of redemptions  |
| <b>Thursday, September 25, 2008</b> | Office of Thrift Supervision seizure of Washington Mutual  |
| <b>Monday, September 29, 2008</b>   | U.S. House of Representatives' rejection of Troubled Asset Relief Program (TARP) bailout by a vote of 228 to 205, leading to a one-day decline of 8.8 percent in the S&P 500 index, to 1,106 |
| <b>Friday, October 3, 2008</b>      | Congressional passage of the TARP bailout  |
| <b>Sunday, November 23, 2008</b>    | Special government rescue package for Citigroup  |
| <b>Wednesday, December 10, 2008</b> | Revelation of Bernie Madoff Ponzi scheme   |

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The following year, 2009, brought massive fiscal and monetary stimulus by the United States and China, altered accounting rules for banks' assets, stress tests for large financial institutions, and quantitative easing (money printing) by the U.S. Federal Reserve (see Exhibit 1.2 for selected key events).

In 2010, investors faced financial rescue packages for Greece and Ireland, the creation of a multi-hundred-billion-dollar European stabilization fund for Eurozone countries, the

**Exhibit 1.2 Key Events in 2009**


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|--------------------------|--|
| <b>February 17, 2009</b> | Passage of \$787 billion fiscal stimulus package in the United States  |
| <b>February 25, 2009</b> | Announcement of stress tests for 19 U.S. banks   |
| <b>March 18, 2009</b>    | Federal Reserve Quantitative Easing plan   |
| <b>March 23, 2009</b>    | Approval of \$585 billion fiscal stimulus package in China   |
| <b>April 2, 2009</b>     | Financial Accounting Standards Board (FASB) draft proposal on mark-to-market accounting rules for financial institutions |
| <b>April 30, 2009</b>    | Bankruptcy of Chrysler Corporation   |
| <b>June 1, 2009</b>      | Bankruptcy of General Motors Corporation   |
| <b>October 20, 2009</b>  | Revelation by newly elected Greek government that its budget deficit is 12.5 percent of GDP, not 3.8 percent             |
| <b>November 25, 2009</b> | Announcement by Dubai World of its proposal to delay debt repayments due to financial difficulties                       |

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oil well blowout in the Gulf of Mexico, a “flash crash” in U.S. stock prices, a second round of Federal Reserve quantitative easing, and the passage of further fiscal stimulus measures by the U.S. Congress (see Exhibit 1.3 for selected key events).

And then 2011 brought major leadership turnover in Tunisia, Egypt, Ireland, Portugal, Greece, and Italy, among other countries, a magnitude 9.0 earthquake in Japan, a second rescue package for Greece, a downgrade by Standard & Poor’s of the credit rating of the United States, and the provision of €490 billion in low-interest, three-year loans to banks by the European Central Bank (see Exhibit 1.4 for selected key events).

The year-by-year effects of these momentous changes are shown in Exhibit 1.5, detailing the investment

### **Exhibit 1.3 Key Events in 2010**

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|--------------------------|---|
| <b>March 24, 2010</b>    | Congressional passage of landmark health care legislation   |
| <b>April 20, 2010</b>    | Blowout of Macondo oil well in the Gulf of Mexico   |
| <b>May 2, 2010</b>       | Eurozone and International Monetary Fund (IMF) agreement on a €110 billion, three-year Greek rescue package   |
| <b>May 6, 2010</b>       | “Flash crash” in U.S. stock prices  |
| <b>May 9, 2010</b>       | Establishment of a European Union (EU) €500 billion stabilization fund, with an additional €250 billion contributed by the IMF  |
| <b>November 3, 2010</b>  | Federal Reserve announcement of second round of quantitative easing   |
| <b>November 22, 2010</b> | Ireland’s acceptance of an €85 billion rescue package from the EU and the IMF   |
| <b>December 18, 2010</b> | Passage of U.S. fiscal stimulus legislation, including extension of tax cuts and jobless benefits, one-year reduction of individual payroll taxes, and other measures |

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### **Exhibit 1.4 Key Events in 2011**

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|--------------------------|--|
| <b>January 14, 2011</b>  | Resignation of Tunisian President Zine el-Abidine Ben Ali  |
| <b>January 22, 2011</b>  | Resignation of Irish Prime Minister Brian Cowen  |
| <b>February 11, 2011</b> | Ouster of Egyptian President Hosni Mubarak   |
| <b>March 11, 2011</b>    | Earthquake of magnitude 9.0 in Japan   |
| <b>March 23, 2011</b>    | Resignation of Portuguese Prime Minister Jose Socrates   |
| <b>July 22, 2011</b>     | Second Greek financial rescue package including an additional €109 billion from the public sector and as much as €50 billion from private-sector bondholders |
| <b>August 5, 2011</b>    | Downgrade of the U.S. long-term debt rating from AAA to AA+ by Standard & Poor’s   |
| <b>October 31, 2011</b>  | Chapter 11 bankruptcy of MF Global   |
| <b>November 9, 2011</b>  | Resignation of Greek Prime Minister George Papandreou  |
| <b>November 12, 2011</b> | Resignation of Italian Prime Minister Silvio Berlusconi  |
| <b>December 8, 2011</b>  | Announcement of European Central Bank long-term refinancing operation (LTRO) of three-year, low-interest loans, with a first allotment of €490 billion       |

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## Exhibit 1.5 Investment Performance of Asset Classes

### Asset Class Total Return (In U.S. Dollars)

| Equities                             | 2008   | 2009    | 2010   | 2011   | 2002-2011<br>(10 Yr. CAGR) | 2002-2011<br>Std. Dev. | 2002-2011<br>S&P 500 Correl. |
|--------------------------------------|--------|---------|--------|--------|----------------------------|------------------------|------------------------------|
| S&P 500                              | -37.0% | +26.5%  | +15.1% | +2.1%  | +2.9%                      | 20.5                   | 1.00                         |
| S&P 500 Equal-Weighted               | -39.7% | +46.3%  | +21.9% | -0.1%  | +6.3%                      | 25.6                   | 0.97                         |
| (RSP)                                |        |         |        |        |                            |                        |                              |
| MSCI Canada                          | -45.5% | +56.2%  | +20.5% | -12.7% | +11.1%                     | #9                     | 0.92                         |
| MSCI Europe                          | -46.4% | +35.8%  | +3.9%  | -11.1% | +4.4%                      | 27.1                   | 0.94                         |
| MSCI Japan                           | -29.2% | +6.3%   | +15.4% | -14.3% | +3.0%                      | 19.6                   | 0.78                         |
| MSCI Australia                       | -50.7% | +76.4%  | +14.5% | -11.0% | +12.8%                     | #6                     | 0.89                         |
| MSCI Emerging Markets <sup>(1)</sup> | -53.2% | +79.0%  | +19.2% | -18.2% | +14.2%                     | #5                     | 0.88                         |
| MSCI Latin America                   | -51.3% | +104.2% | +14.9% | -19.2% | +18.9%                     | #1                     | 0.87                         |
| MSCI EMEA                            | -55.6% | +68.1%  | +23.8% | -20.2% | +14.4%                     | #4                     | 0.85                         |
| MSCI Emerging Markets Asia           | -52.8% | +74.2%  | +19.4% | -17.3% | +12.5%                     | #7                     | 0.87                         |

(Continued)

### Exhibit 1.5 Investment Performance of Asset Classes (Continued)

| Equities                                       | 2008   | 2009   | 2010   | 2011   | 2002-2011<br>(10 Yr. CAGR) | 2002-2011<br>Std. Dev. | 2002-2011<br>S&P 500 Correl. |
|--|--------|--------|--------|--------|----------------------------|------------------------|------------------------------|
| <b>Fixed Income</b>                            |        |        |        |        |                            |                        |                              |
| Barclays Aggregate                             | +5.2%  | +5.9%  | +6.5%  | +7.8%  | +5.8%                      | 2.2                    | -0.38                        |
| Credit Suisse High Yield                       | -26.2% | +54.2% | +14.4% | +5.5%  | +9.1%                      | 20.5                   | 0.84                         |
| U.S. Treasury 10-Year                          | +20.3% | -9.9%  | +8.1%  | +17.0% | +6.6%                      | 9.0                    | -0.82                        |
| JPM Non-US Bonds                               | +11.4% | +3.9%  | +6.8%  | +5.9%  | +7.7%                      | 7.7                    | -0.06                        |
| JPM Emerging Markets                           | -9.7%  | +26.0% | +11.7% | +9.2%  | +11.6%                     | #8                     | 0.79                         |
| Debt (EMBI)                                    |        |        |        |        |                            |                        |                              |
| <b>Alternative/Absolute Return Investments</b> |        |        |        |        |                            |                        |                              |
| NAREIT Real Estate Investment Trusts           | -37.7% | +28.0% | +28.0% | +8.3%  | +10.2%                     | #10                    | 0.84                         |
| Alerian MLP Index                              | -36.9% | +76.4% | +35.9% | +13.9% | +15.5%                     | #3                     | 0.91                         |
| HFRI Hedge Fund Weighted Composite             | -19.0% | +20.0% | +10.3% | -4.6%  | +5.9%                      | 11.9                   | 0.93                         |
| HFRI Hedge Fund of Funds                       | -21.2% | +11.5% | +5.7%  | +5.2%  | +3.3%                      | 10.3                   | 0.85                         |

|  |        |        |        |        |        |     |       |
|--|--------|--------|--------|--------|--------|-----|-------|
| Barclays CTA Managed Futures                     | +14.1% | -0.1%  | +7.1%  | -3.2%  | +5.4%  | 5.5 | -0.58 |
| Handy & Harman Spot Gold                         | +5.8%  | +24.4% | +29.5% | +10.1% | +18.8% | #2  | 0.37  |
| Barclays Treasury Inflation Protected Securities | -2.4%  | +11.4% | +6.3%  | +13.6% | +7.6%  | 5.8 | 0.21  |
| Barclays Global Inflation Protected Securities   | -7.7%  | +13.2% | +3.9%  | +10.7% | +8.6%  | 8.4 | 0.39  |
| <b>Cash</b>                                      |        |        |        |        |        |     |       |
| U.S. Treasury Bills (90-day)                     | +1.9%  | +0.2%  | +0.1%  | +0.1%  | +1.9%  | 1.8 | -0.11 |

**Note:** 1. Selected related indices' 10-year total return CAGR were: MSCI China, +15.2%; Shanghai Composite, +2.9%; MSCI India, +16.3%; and Bombay Sensex, +16.8%.

**Sources:** Cambridge Associates LLC, Russell Investments, Hedge Fund Research, Barclays Trading Group, Morgan Stanley & Co. LLC Research, MSCI Barra, FactSet, and Morgan Stanley Investment Strategy. Data are as of December 30, 2011. Indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include expenses, fees, or sales charges, which would lower performance. Past performance is no guarantee of future results.

performance of 24 classes and subclasses of assets. In 2008, the total return of the Standard & Poor's 500 index was -37.0 percent, the MSCI Emerging Markets index -53.2 percent, the Credit Suisse High Yield (junk) bonds index -26.2 percent, and the HFRI Hedge Fund Weighted Composite index -19.0 percent. Contradicting those pundits who said there was no place to hide during the financial hurricane of 2008, portfolio shelter, refuge, and profit were generated by: U.S. Treasury 10-year bonds, +20.3 percent; the Barclay Commodity Trading Advisors Managed Futures index, +14.1 percent; Handy & Harman Spot Gold, +5.8 percent; the Barclays Aggregate bond index, +5.2 percent; and U.S. Treasury bills (90-day), +1.9 percent.

The next year, 2009, was a different story altogether. Investors who espoused the three principles of diversification, rebalancing, and risk management were able to limit the downside damage to their portfolios in 2008, and to participate in the 2009 and 2010 upswing in risk asset prices. The biblical dictum that "the last shall be first, and the first shall be last" was in many cases applicable over this two-year time span. In 2009, for example, the total return of U.S. Treasury 10-year bonds (a big winner in 2008) was -9.9 percent and the Barclay CTA Managed Futures index generated a return of -0.1 percent. By contrast, many of the big losers of 2008 turned into big winners in 2009, with significant upside moves on a total return basis in the MSCI

Emerging Markets index, +79.0 percent, the Credit Suisse High Yield (junk) bond index, +54.2 percent, and the Standard & Poor's 500 index, +26.5 percent. In 2010, the total return of the MSCI Emerging Markets index was +19.2 percent, the Credit Suisse High Yield (junk) bond index was +14.4 percent, and the Standard & Poor's 500 index was +15.1 percent.

Several additional points are worth noting in Exhibit 1.5. First, at 2.9 percent per annum, the *compound annual growth rate* (CAGR) total return in U.S. dollars, including dividends, of the Standard & Poor's 500 index for the 10-year period from 2002 through 2011 was the *lowest* (except for 90-day U.S. Treasury bills at +1.9 percent per annum) of all of the assets in the table. The standard deviation of annual returns (a measure of returns volatility, described later in this book, in Chapter Eight) for the S&P 500 over the 2002 to 2011 period was 20.5. The *next lowest* 2002–2011 compound annual growth rate was generated by the MSCI Japan index, +3.0 percent per annum.

Second, the *best-performing* return from 2002 through 2011 was generated by the MSCI Latin America index, 18.9 percent compounded annually, but with a 47.7 standard deviation of annual returns. As a partial example, the volatility of Latin American equities can be seen in the wide swings in returns in 2008 through 2011: –51.3 percent, +104.2 percent, +14.9 percent, and –19.2 percent, respectively.

The 2002–2011 correlation of annual returns (a measure of co-movement, described later in this book, in Chapter Eight) of the MSCI Latin America index with the S&P 500 index was a relatively high 0.87. The *next best-performing* 2002–2011 compound annual growth rate was generated by Handy & Harman Spot Gold, at 18.8 percent per annum.

How are investors to cope with returns volatility and financial market turbulence such as the tumultuous conditions that unfolded during the 2008 to 2011 period? Exhibit 1.6 contains several points to keep in mind.

#### **Exhibit 1.6 Points to Keep in Mind**

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- The world is experiencing time compression due to CNBC, Blackberry, Android, iPhone, YouTube, Facebook, Blogs, and Twitter.
  - Markets usually change when beliefs change, not fundamentals.
  - Investors potentially make more money when asset markets are going from horrible to bad conditions rather than going from good to great conditions.
  - Value and safety are price dependent: at the right price level, high risk assets can be safer, and at the wrong price level, high-quality assets can be riskier.
  - Liquidity usually catalyzes securities prices before the economy.
  - Psychological effects linger from the 2000–2002 and 2008–2009 bear market episodes.
  - Sometimes investors fear being out of the market versus being in the market.
  - An upside surprise usually depends on confidence, growth, profits, and/or supportive policy measures.
  - A downside surprise usually depends on an external shock, an internal imbalance, and/or policy errors.
  - Long-term term issues remain: debt, deficits, dollar, derivatives, and demographics.
  - A long-term bottoming in risk asset prices depends on compelling valuations, societal revulsion with the status quo, and structural reform.
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In my opinion, among the most important points from this list for investors to remain constantly aware of are: (1) markets usually change when beliefs change, not fundamentals; (2) investors potentially make more money when asset markets are going from horrible to bad conditions than when they are going from good to great conditions; (3) value and safety are price-dependent: at the right price level, high-risk assets can be safer, and at the wrong price level, high-quality assets can be riskier; and (4) a long-term bottoming in risk asset prices depends on compelling valuations, societal revulsion with the status quo, and structural reform.

