February 2013 Newsletter
What is a Benchmark? And a Note on "The Sequester"

From the desk of Matt Brennan

In investing, a benchmark is a standard against which a portfolio's performance is compared. Oftentimes, it is an index of securities of the same or similar class. You can also consider comparisons by industry or by sector. A technology fund may be compared to a group of other tech funds or stocks. The goal is to have a basis for evaluating relative performance. In order to do this accurately, a benchmark must first be appropriate.

Think of the 40-yard dash. In most track and field circles, a time in the low 4 seconds is considered quite impressive. If you were training for a meet and looking for a way to gauge your progress, would you research the winning time of this year's Boston Marathon? That information would not be valuable to you because that is not the standard by which you are measuring yourself as you prepare for a sprint that will be over in 1/12th of 1 minute.

The same can be said for portfolio benchmarks. If I asked you "what did the market do yesterday ?" how would you respond? Some people might reference the Dow Jones Industrial Average closing value. This is an index of 40 United States Industrial Companies that is often considered a "broad" (see '40') representation of the overall U.S. stock market. A more accurate representation of the market might then be the S&P 500. There you are at least getting the 500 largest companies within the United States. But if 60% of the world economy exists outside of our borders, is an index of U.S. company stocks really *the market?* What about the FTSE 100 (Europe) or the NIKKEI (Japan)? What about things like gold and oil, or the futures markets for cattle? *'The market'* is an enormously complex and ever-changing concept. In behavioral finance, when things are complex and ever-changing, the human response is to try and simplify. Hence: Market indexes that are meant to tell us at any given time what *the market* is doing.

In 2012, the S&P 500 was up just shy of 12%. The natural response is to compare your own portfolio to the S&P and draw a conclusion. "How am I doing relative to the market?" If the goal of your portfolio was to be 100% in stocks, and to try and buy the best performing, largest U.S. based companies, then this would be a useful benchmark. The chart below is one that I believe we have shared in our Newsletter before. If this is your first time viewing it, please take a moment to look it over and draw your own conclusions.

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The Callan Periodic Table of Investment Returns

Annual Returns for Key Indices (1993–2012) Ranked in Order of Performance

1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
MSCI Emerging Markets 74.84%	MSCI EAFE 7.78%	S&P 500 Growth 38.13%	S&P 500 Growth 23.97%	S&P 500 Growth 36.52%	S&P 500 Growth 42.16%	MSCI Emerging Markets 66.42%	Russell 2000 Value 22.83%	Russell 2000 Value 14.02%	Barclays Agg 10.26%
MSCI EAFE 32.57%	S&P 500 Growth 3.13%	S&P 500 37.58%	S&P 500 22.96%	S&P 500 33.36%	S&P 500 28.58%	Russell 2000 Growth 43.09%	Barclays Agg 11.63%	Barclays Agg 8.43%	MSCI Emerging Markets -6.00%
Russell 2000 Value 23.77%	S&P 500 1.32%	S&P 500 Value 36.99%	S&P 500 Value 22.00%	Russell 2000 Value 31.78%	MSCI EAFE 20.00%	S&P 500 Growth 28.24%	S&P 500 Value 6.08%	Russell 2000 2.49%	Russell 2000 Value -11.43%
Russell 2000 18.88%	S&P 500 Value -0.64%	Russell 2000 Growth 31.04%	Russell 2000 Value 21.37%	S&P 500 Value 29.98%	S&P 500 Value 14.69%	MSCI EAFE 26.96%	Russell 2000 -3.02%	MSCI Emerging Markets -2.37%	MSCI EAFE -15.94%
S&P 500 Value 18.61%	Russell 2000 Value -1.54%	Russell 2000 28.45%	Russell 2000 16.49%	Russell 2000 22.36%	Barclays Agg 8.70%	Russell 2000 21.26%	S&P 500 -9.11%	Russell 2000 Growth -9.23%	Russell 2000 -20.48%
Russell 2000 Growth 13.37%	Russell 2000 -1.82%	Russell 2000 Value 25.75%	Russell 2000 Growth 11.26%	Russell 2000 Growth 12.95%	Russell 2000 Growth 1.23%	S&P 500 21.04%	MSCI EAFE -14.17%	S&P 500 Value -11.71%	S&P 500 Value -20.85%
S&P 500 10.08%	Russell 2000 Growth -2.43%	Barclays Agg 18.46%	MSCI EAFE 6.05%	Barclays Agg 9.64%	Russell 2000 -2.55%	S&P 500 Value 12.73%	S&P 500 Growth -22.08%	S&P 500 -11.89%	S&P 500 -22.10%
Barclays Agg 9.75%	Barclays Agg -2.92%	MSCI EAFE 11.21%	MSCI Emerging Markets 6.03%	MSCI EAFE 1.78%	Russell 2000 Value -6.45%	Barclays Agg -0.82%	Russell 2000 Growth -22.43%	S&P 500 Growth -12.73%	S&P 500 Growth -23.59%
S&P 500 Growth 1.68%	MSCI Emerging Markets -7.32%	MSCI Emerging Markets -5.21%	Barclays Agg 3.64%	MSCI Emerging Markets -11.59%	MSCI Emerging Markets -25.34%	Russell 2000 Value -1.49%	MSCI Emerging Markets -30.61%	MSCI EAFE -21.44%	Russell 2000 Growth -30.26%

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
MSCI Emerging Markets 56.28%	MSCI Emerging Markets 25.95%	MSCI Emerging Markets 34.54%	MSCI Emerging Markets 32.59%	MSCI Emerging Markets 39.78%	Barclays Agg 5.24%	MSCI Emerging Markets 79.02%	Russell 2000 Growth 29.09%	Barclays Agg 7.84%	MSCI Emerging Markets 18.63%
Russell 2000 Growth 48.54%	Russell 2000 Value 22.25%	MSCI EAFE 13.54%	MSCI EAFE 26.34%	MSCI EAFE 11.17%	Russell 2000 Value -28.92%	Russell 2000 Growth 34.47%	Russell 2000 26.85%	S&P 500 Growth 4.65%	Russell 2000 Value 18.05%
Russell 2000 47.25%	MSCI EAFE 20.25%	S&P 500 Value 5.82%	Russell 2000 Value 23.48%	S&P 500 Growth 9.13%	Russell 2000 -33.79%	MSCI EAFE 31.78%	Russell 2000 Value 24.50%	S&P 500 2.11%	S&P 500 Value 17.68%
Russell 2000 Value 46.03%	Russell 2000 18.33%	S&P 500 4.91%	S&P 500 Value 20.81%	Russell 2000 Growth 7.05%	S&P 500 Growth -34.92%	S&P 500 Growth 31.57%	MSCI Emerging Markets 19.20%	S&P 500 Value -0.48%	MSCI EAFE 17.32%
MSCI EAFE 38.59%	S&P 500 Value 15.71%	Russell 2000 Value 4.71%	Russell 2000 18.37%	Barclays Agg 6.97%	S&P 500 -37.00%	Russell 2000 27.17%	S&P 500 Value 15.10%	Russell 2000 Growth -2.91%	Russell 2000 16.35%
S&P 500 Value 31.79%	Russell 2000 Growth 14.31%	Russell 2000 4.55%	S&P 500 15.79%	S&P 500 5.49%	Russell 2000 Growth -38.54%	S&P 500 26.47%	S&P 500 15.06%	Russell 2000 -4.18%	S&P 500 16.00%
S&P 500 28.68%	S&P 500 10.88%	Russell 2000 Growth 4.15%	Russell 2000 Growth 13.35%	S&P 500 Value 1.99%	S&P 500 Value -39.22%	S&P 500 Value 21.17%	S&P 500 Growth 15.05%	Russell 2000 Value -5.50%	S&P 500 Growth 14.61%
S&P 500 Growth 25.66%	S&P 500 Growth 6.13%	S&P 500 Growth 4.00%	S&P 500 Growth 11.01%	Russell 2000 -1.57%	MSCI EAFE -43.38%	Russell 2000 Value 20.58%	MSCI EAFE 7.75%	MSCI EAFE -12.14%	Russell 2000 Growth 14.59%
Barclays Agg 4.10%	Barclays Agg 4.34%	Barclays Agg 2.43%	Barclays Agg 4.33%	Russell 2000 Value -9.78%	MSCI Emerging Markets -53.18%	Barclays Agg 5.93%	Barclays Agg 6.54%	MSCI Emerging Markets -18.17%	Barclays Agg 4.21%

- **S&P 500** measures the performance of large capitalization U.S. stocks. The S&P 500 is a market-value-weighted index of 500 stocks that are traded on the NYSE, AMEX, and NASDAQ. The weightings make each company's influence on the Index performance directly proportional to that company's market value.

- **S&P 500 Growth** and **S&P 500 Value** measure the performance of the growth and value styles of investing in large cap U.S. stocks. The indices are constructed by dividing the market capitalization of the S&P 500 Index into Growth and Value indices, using style "factors" to make the assignment. The Value Index contains those S&P 500 securities with a greater-than-average value orientation, while the Growth Index contains those securities with a greater-than-average growth orientation. The indices are market-capitalization-weighted. The constituent securities are not mutually exclusive.

- **Russell 2000** measures the performance of small capitalization U.S. stocks. The Russell 2000 is a market-value-weighted index of the 2,000 smallest stocks in the broad-market Russell 3000 Index. These securities are traded on the NYSE, AMEX, and NASDAQ.

- **Russell 2000 Value** and **Russell 2000 Growth** measure the performance of the growth and value styles of investing in small cap U.S. stocks. The indices are constructed by dividing the market capitalization of the Russell 2000 Index into Growth and Value indices, using style "factors" to make the assignment. The Value Index contains those Russell 2000 securities with a greater-than-average value orientation, while the Growth Index contains those securities with a greater-than-average growth orientation. Securities in the Value Index generally have lower price-to-book and price-earnings ratios than those in the Growth Index. The indices are market-capitalization-weighted. The constituent securities are not mutually exclusive.

- **MSCI EAFE** is a Morgan Stanley Capital International Index that is designed to measure the performance of the developed stock markets of Europe, Australasia, and the Far East.

- **MSCI Emerging Markets** is a Morgan Stanley Capital International Index that is designed to measure the performance of equity markets in 21 emerging countries around the world.

- **Barclays Aggregate Bond Index** (formerly the Lehman Brothers Aggregate Bond Index) includes U.S. government, corporate, and mortgage-backed securities with maturities of at least one year.

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This chart shows the annual returns for key market indices from 1993 through 2012. If asked to sum up this chart in one word, I would say "Random." I love this chart because of the year-by-year observations one can make.

In 2011, the worst performing asset class was Emerging Markets, which was down -18%. It would be pretty tough to accept a recommendation to buy into this group of stocks on December 31st, 2011, but if you did, you would be buying the best performing asset class of 2012! (up 18%)

Another item to highlight, in the past 20 years, there were only 2 years where bonds (Barclays Aggregate) had a negative return: 1994 (-3%) and 1999 (-1%). Contrast these "bad" years with 2002 when the S&P 500 was down -28%, or 2008 when Emerging Markets were down -53%!

In 1999, the S&P 500 finished up 22%. At the end of that year, many investors probably pulled out their year-end statements and asked "How did I do relative to the market?" If they then rushed to buy the S&P 500, they would have realized a loss of -28% the following year.

In that same year, 2000, the Russell 2000 Value index was up 22%. That's a 50+% difference between two indexes that are tracking U.S. stocks!

The message here is two-fold. The first is obviously the classic "past performance is not indicative of future results" that has become a standard disclaimer in the investment management field. The second is that diversification matters. A portfolio with just 1% bonds will never produce the same returns as a portfolio that is 100% stock. That can be a good thing. While the annual performance of various market indices is useful information, is it meaningful to you? A 68 year-old retiree may be more concerned with "Do I have enough income from my portfolio to meet my costs of living?" Or, "If something happens to me, will my spouse have enough money?"

The idea of a benchmark is inherently imperfect. Think about it. We all have a unique set of goals and objectives in our lives that are personal and important to us. To determine our progress, we look to broad and generic measurements to validate or to lament where we are. Our job as your advisors is to maintain focus on building a solid plan for the future and to manage the risks that may jeopardize this plan. A portfolio is an important part of this. Our holistic approach to Wealth Management means that we take into account all the various moving pieces of your financial life (taxes, estate planning, cash flow analysis, insurance planning) and work with you to create a financially unassailable future. Markets will rise and fall over time, and hopefully we will be positioned to profit

from these fluctuations. Having a long-term plan and understanding why your portfolio is invested the way it is remains our primary focus.

A brief note on "The Sequester"

In just a weeks' time, March 1st to be precise, we will witness the commencement of $1.2 trillion in automatic government spending cuts that are set to take affect over the next 10 years. It is highly likely that these cuts will have a short-term impact on the investment markets as well as the economy. These budget cuts have been deemed necessary and have been delayed for some time now. This forced action was born out of the Budget Control Act back in 2011 and was intended to be an automatic trigger for spending reduction in the absence of bipartisan resolutions in Congress. We may have (temporarily) averted the fiscal cliff with the last minute agreement on taxes at year-end, but the last round of talks did absolutely nothing to address the Sequester.

If no deal is reached, 2013 will see $85 billion in spending cuts that will effect defense and non-defense departments equally. Estimates vary, but it is possible that these cuts will reduce economic growth by ½ percentage point. Out of our current 2% annual growth, this is a 25% reduction for 2013. (JP Morgan Market Bulletin – February 2013) Cuts may be seen in a variety of areas in every day life. Housing may be impacted by reductions in urban development spending. News reports have discussed the price of beef skyrocketing on scarcity with fewer meat inspectors leading to less meat for public sale. Airports may become more congested with reductions in TSA funding. While none of these on the surface seem to be of great significance, the cumulative effect could be further decline in growth.

GDP growth has been sluggish at best (witness last quarters' negative growth), and this slowing would be coming at a time when we are struggling to revive consumption and to turn around our economy. To date, the Government and the Federal Reserve Board have been trying to stimulate consumption through pumping up the money supply and lowering the costs of borrowing. Automatically shutting off Uncle Sam's spending spigot in certain areas would presumably have the opposite effect. Consumers were taken aback last month by having 2.5% less in their paychecks to spend due to the expiration of the FICA holiday. Now they are faced with further austerity measures which are unlikely to loosen personal purse strings.

Last month we wrote about the potential disconnect we are seeing between the stock market and the economy. The Sequester could be the trigger for some type of market pull-back or correction. There is

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also the possibility that Congress further extends the deadline for addressing these cuts, and temporarily delays the impact. Markets may respond favorably to a delay, much as they did back in January, but eventually spending will need to be addressed and painful cuts will be made.

We look forward to discussing all of this with you soon.

Best Regards,

Matt

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