



## Second Quarter 2009 Investment Report

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### Ding, Dong, the Wicked Witch is Dead

If you were a child the first time you saw *The Wizard of Oz*, chances are you covered your eyes at least once during the movie. That ugly, green-skinned witch or those creepy flying monkeys were most likely the culprits. Adults viewing the film for the first time probably did not cover their eyes. After all, they knew that the green skin was makeup and the monkeys were little people dressed in costumes.

That's not to say that adults never get scared when watching movies. Immediately after watching Alfred Hitchcock's bloody bathroom scene in *Psycho*, there were most likely thousands of women (and a few men) who thought twice about taking a shower when home alone. Or how about hitting the surf the same day you saw *Jaws*? Or thinking about satanic fears after viewing the head spinning, bile-spewing, possessed little girl in *The Exorcist*? Unfortunately, the fears felt from these movies are based on some reality. Knife wielding psychopaths do exist, some shark attacks do result in death, and even the Catholic Church recognizes the need for the casting out of demons through exorcism. Fear, then, is in the eye of the beholder, and can differ dramatically depending on the person and their upbringing, beliefs and experiences.

Fear in the stock market (you saw this coming, didn't you?) is a special kind of fear - sort of a combination of individual fear "I'm losing my wealth" and a herd mentality/groupthink fear "Everyone is selling, so it must be the right move." Bear markets are the perfect mad scientist laboratories for this topic, because although there have been a bunch of them over the years, each one is filled with its own special effects that allow investors to expect an ending different from the previous ones.

The 1973-74 bear market was related to hyper inflation, odd/even gas lines and federally mandated Wage and Price Controls. In 1987, it was based, in part, on those frighteningly complicated and leveraged derivative markets and the selling frenzy that ensued as they unwound themselves. Don't forget other bears that included incidents involving the demise of the Savings and Loan industry, the bankruptcy of Drexel Burnham Lambert and imprisonment of its junk bond king - Michael Milken, and many other spooky events that sent investors sprinting for the exits.

Our latest bear market may have been the first one for some investors. With no previous

experience, the chilling green-make-up and flying-ape-like financial events were also enough for these new investors to expect total devastation of all things stock and bond related. But there were enough scary scenes in this bear to give even experienced investors an excuse to panic. Devastating real estate markets, failures of reputable financial firms, frozen auction markets and companies needing massive direct government intervention in order to survive -- all acted as the bloody knives, wild feeding frenzies and soul-sucking demons that caused total fear and often irrational behavior in the financial markets.

In early March of this year, the fear and selling hit a crescendo. Direct comparison to the 1930's depression era was discussed ad nauseum on talk shows and in print. Predictions of a 5000, and lower, Dow Jones Average were commonplace. And just when it seemed as though the Wicked Witch of the West had cornered Dorothy and the end was near, a splash of water/market direction change appeared out of nowhere. From March 10 onward, the markets have had a remarkable rebound. From that bottom, the S&P 500 has bounced over 40%. Small caps, emerging markets and real estate have experienced even greater recoveries. It has been almost 4 months since that March bottom, and most economists are predicting a bottoming of the economy sometime in the next three months. Once again, it seems that the financial markets have discounted an improving economy several months prior to the event.

It appears as though the wickedest witch in over seventy years is dead. Clearly, all ghosts and goblins have not been put to rest. Fears of high deficits, and resulting inflation, are clearly on the minds of investors. Several lagging indicators, such as unemployment rates and real estate prices, are still looking pretty spooky. There is no guarantee that the current market direction will continue on its same trajectory. But there is a meaningful sense of relief that the worst is over. Our clients' long term investment objectives and asset class diversification have allowed them to stay the course and rebound. Had they been invested in the individual stock melodramas occurring during this historic bear market, chances are their portfolios would have suffered irreparable harm, either by being improperly diversified with dangerous concentrations as the market moved down, or not being in the market when it turned on a dime and moved upward at a time when few would have guessed the horror scenes were over. Now, (we shudder) they might even feel comfortable enough to watch Jim Cramer's Mad Money on CNBC... "if he only had a brain."

## Actively Unproductive

This is not the first time we have discussed the differences between active and passive investment management in these reports, and it clearly won't be the last. But at the risk of sounding repetitive, we want to point out two independent sources that once again show the poor performance of actively managed portfolios, whether in mutual funds or third party money managers. Passive investing, you may remember, is when portfolio vehicles are invested in a manner mirroring an index or asset class -- where no attempt is made at stock picking or market timing. Dixon Hughes Wealth Advisors clients' equity portfolios are built with unique, no-load institutional asset class mutual funds that are passive and have consistently outperformed index benchmarks in the small, value and small-value domestic, international and emerging market asset classes.

In *InvestmentNews'* April 20, 2009 edition, it was reported that 71% of large cap, 76% of mid cap, and 86% of small cap managed accounts underperformed their corresponding domestic S&P indexes over the 5 year period ending 12/31/08. Foreign stock, investment grade and municipal bond funds also showed a meaningful underperformance when compared to their index categories. The surprise here is that many investors believe that during a bear market, actively managed funds have the ability to place some or all of their funds in cash, whereas indexes are always 100% invested in equities. It only seems reasonable that when markets are dropping, active management should be able to outperform if only for this "cash" advantage. Yet, even with that seeming advantage, the performance of the majority of actively managed mutual funds underperformed across the board in all major asset classes.

*The Wall Street Journal's* June 22, 2009 edition cited a recent survey by consulting firm Greenwich Associates whereby one in five institutional investors have recently shifted money away from active management and into passive index strategies. Also cited was Bank of New York Mellon Group that forecasted a record number of active managers being replaced in the second half of this year.

Why is this the case? First of all, financial markets are efficient. Even with erratic price movements, public company information is legally available to all. Consequently, most analysts know the same information about a company and have no inherent advantage over any other analyst. Second, there are much higher costs involved in active management, from paying the gurus who are making the buy and sell decisions, to the transaction costs, to the invisible costs of moving the markets when large orders are transacted on the bid and offer prices. Altogether, these costs make it nearly impossible to consistently outperform the indexes over any meaningful time horizon. In addition, there are tax consequences stemming from the continual turnover in the portfolio, which leads to capital transactions, which lead to capital gains taxes that must be paid in taxable accounts. Passive investing has but a fraction of the above costs, and is meaningfully more tax efficient. When combined with Nobel Prize winning Modern Portfolio Theory, it allows for a superior methodology for long term growth and maintenance of wealth.

## Second Quarter 2009 Asset Class Returns

	<b>2nd Qtr</b>	<b>'09 YTD</b>
<b>S &amp; P 500</b>	15.97%	3.21%
<b>Large Cap Value</b>	23.58%	2.83%
<b>Medium Cap</b>	18.35%	8.31%
<b>Small Cap</b>	24.09%	7.35%
<b>Small Cap Value</b>	23.94%	2.39%
<b>Micro Cap</b>	24.76%	4.63%
<b>Real Estate</b>	30.03%	-11.69%
<b>Intermediate Income</b>	2.14%	1.36%
<b>Long Term Income</b>	2.85%	-3.49%
<b>Int'l Large Cap</b>	25.17%	7.62%
<b>Int'l Large Cap Value</b>	33.93%	12.30%
<b>Int'l Small Cap</b>	31.49%	17.35%
<b>Int'l Small Cap Value</b>	31.78%	14.41%
<b>Int'l Emerging Mkts</b>	34.14%	34.23%
<b>Int'l Em. Mkts Value</b>	44.78%	41.37%
<b>Int'l Em. Mkts Small</b>	47.06%	44.94%
<b>Pacific</b>	23.90%	6.83%
<b>European</b>	26.33%	5.10%
<b>Int'l Real Estate</b>	27.61%	5.85%

Vanguard Group and DFA, Inc.

The second quarter of the year was simply a continuation of the apparent bull market that started on March 10th. By April 1st, most equity asset classes were already up 20% from their bottoms. During the next three months, they continued in that direction. Value, small and small value, and real estate equity asset classes outperformed their large cap and growth counterparts in the U.S., foreign and emerging market countries. Interestingly, the asset classes that experienced the largest losses during the downturn have experienced the largest gains in the rebound. Those investors that may have fled those bear market victims were

precluded from experiencing their generous upside at what appears to be the beginning of the new bull. Fixed income had small positive increases, as bond market volatility decreased dramatically.

The quarter's large equity returns transformed the year-to-date performance into respectable positive returns. The remaining quarters of 2009 will most likely not repeat these remarkable double digit returns. Continued equity asset class rewards will most likely hinge on the economy bottoming and a measurable improvement in corporate earnings.

Stay cool, use sunscreen, and enjoy the remainder of your summer.

Sincerely,

**Dixon Hughes Wealth Advisors**