The Lost Decade, and How Our Strategy Navigated

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The New York Times ran an interesting, and in my opinion timely, piece on Friday: "The Markets Have Been on a Roll. Is It Time to Hedge Your Bets?" The article states that the S&P 500 is on track for a fourth straight year of double-digit gains, something that has happened only three times since 1928, and the most recent time was the late 1990s.

Then the article mentions a statistic that surprised me, even though I was a professional institutional investor during that period. "You would have been better off with no stock holdings at all from Dec. 31, 1999, until March 9, 2009." The S&P 500 lost 46 percent over that stretch with dividends included.

We think of our system as an Absolute Return strategy: depending on the circumstances, we could be anywhere from fully invested to sitting entirely in cash. That is our 200-day moving average rule. Even so, it is tempting to compare our returns to the well-followed benchmarks, as I do below.

The article's conclusion is that trying to time the market is a losing game.

I ran the decade through our rules. I rounded it out to the full ten years, from the last day of 1999 through the last day of 2009. That is a harder test, because it forces you to get back invested **after** the bottom instead of stopping at it. Please study the table that follows.

Ten years, Dec. 31, 1999 to Dec. 31, 2009	Growth of $10,000	Total return	Worst drop along the way
Our sector strategy	**$13,853**	**+38.5%**	**−21.5%**
The S&P 500	$9,037	−9.6%	−55.2%
A 60/40 balanced fund	$12,978	+29.8%	−35.9%
Cash (Treasury bills)	$12,998	+30.0%	none

The real difference in the investment results shows up in the last column: significantly reduced risk. The market drop cut a portfolio's value roughly in half, and even a balanced fund gave up more than a third. Our worst stretch was a drop of 21.5 percent, and in 2008 itself we were down 10 percent while the market lost 36.8 percent. That is the difference between a bad year you can live through and a bad year that makes you lose sleep at night, or even sell at the bottom.

When I reviewed our results, most of the return advantage in that decade came from weighting the sectors equally, nine of them back then, rather than letting the biggest companies dominate. Equal weighting alone, with no timing signal at all, would have turned the S&P's 9.6 percent loss into a 34.4 percent gain. That is our rule one. The timing signal added the rest. That is rule two, the 200-day timing rule. It is what eliminated the emotional pain of a drastic drawdown. The market fell 55.2 percent during the decade; our portfolio's worst drop was 21.5 percent. **The return came from rule one, spreading the money, and the safety came from rule two, the signal.** That is exactly what we expect from our two-rule system: disciplined rules, no emotion.

Our rules respond to what the market has already done, and they put the portfolio back in the market, sector by sector, when a positive trend is established. We were invested about 59 percent of the days in that decade.

One decade is a short stretch to judge any strategy by, and this one happened to suit our strategy particularly well. I am using it here because it is the decade the article discussed, and because the article speculates we may be headed for something similar again, not because it is the one that flatters us most. But if we do get another 2000 to 2009, I would rather be guided by our system's rules than any analyst's forecast.

The majority of mutual funds, nearly 90 percent of them over most decades, underperform their benchmarks, and still charge a fee of around 1 percent a year, roughly 10 cents on the dollar over a decade. Investment advisors often charge similarly. Even more troubling, hot funds in one decade rarely appear at the top of the list in the next.

Given that, as a self-directed investor putting a portion of your portfolio into this strategy, you can avoid fees and sleep better at night.

John

Total return with dividends reinvested, Dec. 31, 1999 through Dec. 31, 2009. The balanced fund is the Vanguard Balanced Index Fund, and every worst drop in the table is measured day by day. Cash is Treasury bills.