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Portfolio Advisory Services Investment Committee

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Six Reasons Not to Invest

We know the world is a troubled place. Every morning we turn on the news or open the newspaper and see that there are more problems today than there were yesterday. Where is an investor supposed to put money, since every investment option seems to have massive roadblocks to success?

And yet, when you look back over the past 50 or 60 years of tumultuous events, somehow the markets have been able to absorb the bad news and keep going. There are certainly down years; we never try to pretend that markets do not sometimes go down. But time after time, the results demonstrate that strong up years follow down years.

In this article, we are going to refer to some of the unhappiest events of our lifetimes. It is disheartening to read about all these dismal events, one after the other, because it calls actively to mind a list of egregious human failures. Even so, just as history marches on, markets also march on. No matter what disaster strikes, the markets re-open, and, so far, there have always been buyers as well as sellers.

One of the most important lessons you can take away from this exercise is the importance of broad diversification. We often talk about diversification in terms of the fixed-income allocation that helps temper downdrafts in the equity markets. Equally important is the diversification that allocates funds to an asset class that experiences an outsized performance.

The other lessons to observe go to the heart of our investment philosophy: stay invested because you never know when the market is going to reverse; and stay invested for the long-term, do not try to figure out for yourself how to time your entry into and exit from the marketplace, and do not allow short-term volatility to drive you out.

What follows here is a series of statements that read like some of the scariest headlines we see in the newspaper; we hear such things repeated by our clients when they express reluctance to invest. Then we cite a similar, relatively recent example of the same kind of problem, issue, or world disaster, and provide some market statistics that demonstrate how the markets kept going.

The asset classes we have selected demonstrate the performance of the S&P 500 (selected largest U.S. companies), Large Value (large-cap value stocks), Small (small company stocks), Small Value (small-cap value stocks), MSCI EAFE (international companies), REITs (real-estate investment trusts) and One-Year T-Note or Five-Year T-Note (short-term fixed income).

Note: all the tables below contain the percent return for the calendar year for each asset class.

1. Headline: The recent shocking rise in oil and gas prices is disrupting the entire economy and could cause a major recession. It has even started to affect consumer spending.

Clients think: Maybe they ought to be putting their money into CDs.

Reality: What if energy prices quadrupled? When OPEC raised crude oil prices in 1973, prices rose four-fold and the demise of the Western world was widely predicted.

How did the markets react?

Year	S&P 500	Large Value	Small	Small Value	MSCI EAFE	One-Yr T-Note
1973	-14.7	-4.0	-35.1	-32.0	-14.2	6.9
1974	-26.5	-17.1	-28.2	-20.2	-22.1	8.7
1975	37.2	47.6	53.2	66.9	37.1	7.4

The numbers in this table are the percent return for the calendar year for each asset class.

It is true that 1973 and 1974 had some of the worst down markets in recent history, and it took two years for this price shock to work through the markets—but it did work through. Large-cap value stocks were the least affected equity category in 1973 and small-cap value stocks were up most sharply in 1975. We know that energy prices increased everywhere, so it is no surprise that international companies were as affected as U.S. companies. All of this suggests that an appropriate asset allocation strategy would have included large-cap value stocks in 1973 to minimize loss, and small-cap value stocks in 1975 to provide upward movement.

Every year—or every year when the equity markets are up—clients complain about the amount of their portfolio allocated to bonds. This particular series of numbers indicates, once again, how important that asset-class diversification is.

2. Headline: Washington's fiscal and economic mismanagement is so serious that it will soon derail the economy.

Clients think: They are worried that rulings, policies and laws from Congress, the Federal Reserve, and the White House together will cause a recession.

Reality: How do you like wage and price controls as government policy? How many of you can remember the momen

tous day in 1971 when President Nixon instituted wage and price controls? They expired in April 1974.

In 1971, inflation was raging at something like 4.5% and government officials panicked. They slapped on wage and price controls that worked effectively for a while but eventually had a reverse effect, arguably resulting in the inflationary cycle of the 1980s. These controls were implemented domestically and may have had a dampening effect on the markets, because international performance soared in 1971 and 1972. Then OPEC flexed its muscles three years into the wage-and-price-control era, as discussed above.

This market mini-cycle ended with the fabulous markets of 1975. Clients who stayed in the market, committed to the long term, would have benefited greatly. That would have been difficult to predict in 1974.

Year	S&P 500	Large Value	Small	Small Value	MSCI EAFE	One-Yr T-Note
1971	14.3	19.4	20.9	15.9	31.2	5.6
1972	19.0	19.4	5.0	5.0	37.6	4.2
1973	-14.7	-4.0	-35.1	-32.0	-14.2	6.9
1974	-26.5	-17.1	-28.2	-20.2	-22.1	8.7
1975	37.2	47.6	53.2	66.9	37.1	7.4

The numbers in this table are the percent return for the calendar year for each asset class.

3. Headline: The Fed's misguided policy of interest-rate increases is causing the U.S. housing market to collapse, and will result in a wave of foreclosures and bankruptcies for overextended consumers.

Clients think: Do not buy anything now.

Reality: Consider the situation in October 1981, when the long bond yield hit 15%.

Year	S&P 500	Large Value	Small	Small Value	MSCI EAFE	REITs	One-Yr T-Note
1981	-4.9	16.5	2.5	16.6	-1.0	17.9	14.5
1982	21.4	20.6	28.1	37.8	-0.9	20.9	17.3

The numbers in this table are the percent return for the calendar year for each asset class.

Mortgage rates touched 18% in 1981. The housing market was slow—maybe deathly slow—but it did not disappear. Interestingly enough, REITs showed a double-digit return during this period of record inflation. Why? We are not sure, but an investor who held this asset class during this time would have been happy for the diversification. Nominal returns for the one-year Treasury note were incredible, although real returns (subtracting the elevated inflation rate) were significantly lower. The Fed policy of interest-rate increases not only did not cause the equity and bond markets to collapse, it brought confidence that inflation could be brought under control. The result was the markets of 1982, which must be one of the few years in the history of the U.S. economy where six major domestic asset classes had double-digit returns (the miracle is seeing nominal U.S. fixed-income returns in double digits; international performance was down slightly).

4. Headline: There will be major terrorist attacks on U.S. soil that will cause so much loss of life and property that the economy will slide into a major recession.

Client thinks: Maybe this is a bad time to invest in anything.

Reality: There was such a terrorist attack: 9/11. It caused billions of dollars of property damage and major loss of life in the heart of the financial center of the United States. The events of 9/11 happened late in the year 2001, did not cause an instant major market crash, and probably had a subdued effect on full-year returns. Note the high returns for small value.

Year	S&P 500	Large Value	Small	Small Value	MSCI EAFE	REITs	One-Yr T-Note
2001	-11.9	-2.7	18.0	40.6	-21.2	12.4	7.3
2002	-22.1	-30.3	-19.9	-11.7	-15.7	3.6	3.4
2003	28.7	36.4	57.8	74.5	39.2	36.2	1.5

The numbers in this table are the percent return for the calendar year for each asset class.

The after effects of 2001 then percolated through the economy—the market disruption, the loss of property and life, major relocations for businesses and people. There is no question that 2002 was a grim year in the marketplace, with all major categories of the equity markets down. Once again, an appropriate allocation to bonds would have muted the effect of the losses in other markets. Remaining fully invested through all of it would have been helpful as 2003 swung into action, with major upswings across the board.

5. Headline: There are those who argue that U.S. military intervention will anger allies, enrage enemies, and result in recession or depression. This is what an investor might be thinking about the current U.S. situation in Iraq.

Client thinks: Pull out of the market and wait for better times.

Reality: Have we really forgotten the U.S. experience in Vietnam? How many of you remember the fall of Saigon in 1975, ending some 25 years of more-or-less direct military intervention, including some years of a hot, shooting war?

Year	S&P 500	Large Value	Small	Small Value	MSCI EAFE	One-Yr T-Note
1975	37.2	47.6	53.2	66.9	37.1	7.4
1967-75*	4.9	10.5	4.5	8.1	NA	6.8

The numbers in this table are the percent return for the calendar year for each asset class.

*Annualized compound rate of return

While we could spend all day debating the cultural, social, and political effects of this war on life in the United States, the fact remains that it does not appear to have had a lasting deleterious effect on the performance of the markets. We thought that looking at market performance both for 1975, the year Saigon fell, and for the nine-year period ending in 1975, should reveal the effects of the war on the markets. As noted above, 1975 was one of those years investors dream about, and the nine-year period ending in 1975 was also good, taken as a whole, although we know from some of the discussions, above, that 1973 and 1974 were dismal in themselves.

Reality: If we are worried about wars, then we should also definitely look at the markets during World War II, which involved 80 countries on all continents, with the U.S. economy changed over to a war economy. This war, as all of you certainly know, brought the U.S. economy out of the Great Depression. In fact, the war was such a good thing for the economy that there was a relatively minor recession the year after it ended. This happened as the war economy converted to a civilian economy and as millions of returning servicemen and women had to be absorbed into the civilian marketplace. Please note that 1945 was another one of those banner years for the small-cap value asset class.

Year	S&P 500	Large Value	Small	Small Value	Five-Yr T-Note
1941-45*	17.0	31.3	35.5	48.0	1.8
1945	36.4	44.3	65.7	73.0	2.2
1946	-8.1	-7.8	-10.6	-11.7	1.0

The numbers in this table are the percent return for the calendar year for each asset class.

*Annualized compound rate of return

6. Headline: The U.S. is in major conflict with the entire rest of the world; our government in Washington is a joke; global warming and bird flu are going to wipe out life on earth, and the breakdown of civilization is so advanced that there is little hope for mankind. **Client thinks:** I'm going to put my money in a mattress and climb in under it.

Reality: How many of you remember the Cuban Missile Crisis in 1962? Some of us remember participating in drills that required us to climb under our desks at school (this was supposed to shield us somehow from imminent nuclear attack); we believed that the nuclear war was going to bring the end of the world with it. The sirens needed to announce nuclear attack were sounded on a regular schedule, so they would be in working condition when we needed them to alert us to a nuclear missile attack.

Year	S&P 500	Large Value	Small	Small Value	Five-Yr T-Note
1962	-8.7	-1.3	-14.4	-9.0	5.6
1963	22.8	29.9	18.6	29.6	1.6

The numbers in this table are the percent return for the calendar year for each asset class.

The Cuban Missile Crisis occurred in October 1962, so it is unlikely that the market downdrafts of that year were attributable to that event alone, although such a major event could have caused a major sell off—but did not. Once again, an appropriate allocation to bonds would have significantly dampened the effects of down markets in the other major asset classes. Then one only had to wait for 1963.

In Conclusion

This article tells a story. Bonds play an essential, crucial role in any investor's asset-allocation strategy. Returns in general are random and unpredictable. Even if you were to go to cash at the first sign of a bear market, how would you choose the day on which to re-enter the market? How would you be able to decide which asset classes to sell and which to invest in? Even if there are two years of down markets, how do you predict when to sell and when to buy?

We advise our clients to invest when they can and to stay invested for the long term. There is always something disadvantageous going on in the world and if you looked for the perfect time to invest, you might wait your entire life. Meanwhile the markets continue to exist and make money for those who follow our simple rules of investment:

1. Choose a reasonable asset allocation, customized for your own particular risk tolerance and time horizon.
2. Do not focus on returns, on beating the market, or any particular index; focus instead on getting a reasonable return on your broadly diversified portfolio.
3. Stay the course, focus on the long term, and do not be alarmed at short-term market fluctuations.

*The opinions in this article are not intended as individual investment advice by Genworth Financial Advisers Corporation and Stanley J. Nieminski. Investment advisory service is offered through Genworth Financial Advisers Corp., an SEC Registered Investment Adviser, with its home office at 200 N. Martingale Road, Schaumburg, IL 60173; 888 528.2987. For more information and a copy of a Genworth Advisers Corp. Form ADV Part II, please contact Stanley J. Nieminski at 773-775-0033 or Stanley.nieminski@genworthrr.com.