



Investment Perspective

After a year that was alternately sedate and scary, stocks ended the year almost exactly where they began, leaving many investors with little except perhaps exhaustion. Indeed, the S&P 500 closed 2011 at 1257.60, 0.003% lower than its starting price of 1257.64. Volatility reigned supreme, and the Volatility Index or VIX spent much of the 2nd half of the year in elevated territory, at times spiking to extreme levels not seen since 2008. The toxic mix of a European debt crisis, a struggling U.S. economy, slowing emerging market economies, and U.S. political machinations conspired to buffet financial markets.

That 2011 ended flat is fitting, as it marked the end of a frustrating five-year period where the S&P 500 returned -0.25%. This “all pain, no gain” performance has caused many investors to simply give up on stocks. We see this in dramatically lower trading volumes, dismal investor surveys, and perhaps most notably, equity mutual fund outflows. Equity mutual fund withdrawals exceeded contributions by more than *\$250 billion* in 2011. Over the past five years, the net exodus was almost *\$600 billion*.

Aside from disappointing returns, investors have other reasons to be concerned, and the desire for return of capital supersedes a need for return on capital, particularly for those in retirement. For individuals that lack the fortitude or time to endure volatility or losses, principal protection understandably becomes paramount. As a result, much of the money leaving equity mutual funds has found its way into bond funds. Investors should note, however, that bonds are not without risk, and a plug-and-play approach to investing, regardless of the asset class, is ill advised in today’s environment.

A recent Wall Street Journal headline seemed to offer further confirmation of the gloomy mood on Wall Street: “*Bridgewater Takes Grim 2012 View.*” Bridgewater commands attention, if not for its \$125 billion in assets, then because it has an incredible track record, particularly in volatile markets. Bridgewater’s Chief Investment Officer elaborated on the firm’s outlook: “we are in a secular deleveraging that will take 15 to 20 years to work through, and we’re just four years in.” Ironically, all this cynicism is good news for the long-term equity investor. Indeed, in the same article Bridgewater goes on to say that a “moribund economic outlook is pretty priced in right now” and “chances are equities are a pretty good bet...” Essentially, Bridgewater is espousing the view that expectations for equities are very low, and thus their risk-reward profile is attractive.

The mutual fund flow data noted above also suggests this is the case. Historically, when investors have poured money into mutual funds, this has been a reliable sign of a market *top* (as in the late ‘90s when investors pumped a net \$800 billion into stock funds until the tech bubble burst and stocks crashed in 2000). Conversely, when equities seem universally despised and investors are withdrawing funds (as they are now), it is often a sign of market *bottom*. To be sure, there are other factors that influence mutual fund flows, but as a broad measure of investor sentiment, the data unequivocally show that investors remain fearful. Fear inevitably gives way to greed, and greed is a powerful motivator that can wrest even the most skeptical pessimist off the sideline. For instance, some see substantial value in a U.S. market that declined slightly amid earnings growth of 16%, and others are attracted to international equities that, after a gut wrenching plunge in 2011, now trade at just 9x expected earnings.

While equities are attractively valued by certain measures, markets are forward-looking, and 2011’s flat performance reflects investors’ collective lack of confidence about the future. This lack of confidence stems from concerns over “structural” problems, namely that most of the world’s developed economies, with the exception of Canada and Australia, are suffocating under massive, unsustainable debt. Servicing or restructuring this debt threatens to choke off economic activity, and uncertainty surrounding the resolution of this issue will continue to cast a pall over markets. This uncertainty, coupled with a fragile economy, portends more volatility next year. Still, mutual fund flows, valuations, and recent economic data are encouraging, and suggest markets could move higher in 2012, even if the ride is a bumpy one.