

“It’s different this time” – the four most dangerous words in investing

Point of View
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There’s a new hit song out there. The refrain goes “It’s different this time” and the verses drive the message home with catchy phrases like “never before seen,” “first time ever,” “unrecognizable” and “unprecedented.” To us, this sounds like the soundtrack to a horror movie.

The song would set the tone for dark scenes in which one Terrified Investor after the next (read: you? Your friend? Your neighbor?) is coaxed down the one-way Capitulation Alley (read: selling out of the market) in the name of salvation from an Abusive, Bipolar Character (read: extremely volatile markets). Any Well-Intentioned Character (read: your advisor?) trying to warn the Terrified Investors that Capitulation Alley almost certainly dead-ends at Destitution Junction is jeered for being “naïve,” “dogmatic” and “out of touch.” After all, the refrain pounds “It’s different this time.”

Back to reality: **we believe that investors’ nerves have taken a worse beating than their nest eggs have. We believe that markets are currently at the mercy of investor sentiment but will return to being driven by fundamentals (corporate earnings).** Of course, Russell could be wrong and investors need to evaluate their own circumstances to determine what is best for them. But, **investors who have stayed the course in the past have been rewarded and we believe this will continue to be true for some time – though we don’t promise that this perspective will be any easier to accept and live by in the future than it is now.**

A litany of concerns

It’s true, investors are being tested. Markets have been nauseatingly volatile: up violently one day, plummeting the next. Add to that the specter of 9% unemployment, outsize government debt, leaders the world over unable to compromise, clearly communicate and implement much-needed solutions, and the global economy seemingly teetering at the brink of a second recession. It’s no wonder that people are fed up. Nobody has given these concerns better voice than the “Occupy Wall Street” movement, which is gaining traction nationally and garnering international support. To many normal citizens, it feels as if something has fundamentally changed or broken in how political, economic and market systems function. How can so much be in jeopardy all at once – but still be expected to return to “normal?” Clients are by far more pessimistic than their advisors. According to advisors polled in September for Russell’s Financial Professional Outlook survey, their clients are more pessimistic about the capital markets over the next three years than they were last quarter. Advisors reported that only 13% of their clients appear to feel optimistic, while 34%

seem pessimistic (the remaining were characterized as “uncertain”).¹ In short, **it feels different this time. This feeling is driving some investors to reflexively conclude that they would be better off getting out of the markets and second guessing whether advisors who encourage discipline are stuck in a dogma.**

At Russell, these concerns are forefront in our thinking. Taking the situation in Europe as a case in point, in our reading, it is as bad as it looks. Europe remains the dominant issue and the greatest threat to the global economic recovery, as witnessed by the extreme market volatility. It’s a genuinely difficult problem to resolve. We believe a permanent solution there will require a three-legged stool approach:

- Leg One: Core European Monetary Union members will need to write a check to shore up finances of peripheral countries and European banks;
- Leg Two: Lenders to insolvent countries will need to take a haircut;
- Leg Three: Eurozone countries will need to orchestrate, implement and accept greater centralization of fiscal and economic governance.

Progress has been made – notably on clarity around Leg Two – but a comprehensive solution will require all parties to recognize two important things. First, that they’re out of time (the longer they put off resolving the debt problem, the bigger the check will be that they have to write). Second, that what started as a short-term debt crisis has become a long-term conundrum: the mechanics of creating a sustainable fiscal policy among 17 sovereign nations bound by a system that wasn’t designed to address this form of integration. At least until the short-term debt crisis is resolved, we expect ongoing shocks in response to parliamentary votes, rescue talks, new solutions – and, worst of all – speculation and rumor.

As old as dirt

Basically, **we don’t accept the argument that it’s different this time. We challenge investors to distinguish between the *features* and the *structure* of our current economic crisis. We posit that while the features of this particular economic crisis are novel – for instance, its spectacular political brinksmanship and its perniciously global scope – *at bottom, the structure of this economic crisis is not novel at all.***

We believe that the source of investor anxiety today originates from a universal question that lenders (creditors, bondholders, pick your avatar) face all the time: **“Am I gonna get paid or not?”** Today’s particular variations on that central question sound something like this: “Am I gonna get paid what I thought or less?” (think: am I going to have to take a haircut); “Am I gonna get paid on time?” (think: is my repayment going to be rescheduled to a later date?); “Am I gonna get paid reliably?” (think: are existing policy instabilities going to get in the way of the reliability and consistency of my repayment?).

The debt crisis in Europe, and our own version of it at home, boils down to this prosaic reality. The features of this particular problem don’t make obsolete the relationship between risk and reward with which we’re all familiar: potentially being rewarded for taking investment risk. Recognizing that the structure of the crisis is basically “as old as dirt” brings some light to the end of the tunnel. It enables you to **dislodge the four most dangerous words in investing: “It’s different this time.”** **Throwing out everything we know about evaluating risk and capital markets can be very risky.** It reminds us that, as investors, it’s

¹ Russell Investments, Financial Professional Outlook, September 2011. Russell’s Financial Professional Outlook survey is a quarterly snapshot of advisor sentiment that’s intended to answer questions like what advisors and investors thinking and have their sentiments changed over time, and give advisors valuable perspective on the views and practices of their peers. For the September 2011 survey Russell collected the opinions of 374 financial advisors working for 142 national, regional and independent advisory firms nationwide.

critical that we focus on facts and analysis (a.k.a. fundamentals) – and not to let ourselves be swayed by market sentiment and political speculation.

Diversification may come in handy for those who can't predict the future

Predicting economies is hard. Predicting market outcomes is even harder. Predicting politics is virtually impossible. So, where does that leave investors today in a market that's driven by sentiment about the uncertainty of how and when political leaders will tackle the real problems? Diversification does not assure a profit and does not protect against loss in declining markets, but it may help long-term investors who are unsure of which direction the markets will go.

For the kinds of professional, active money managers that Russell has been researching for decades, sentiment-driven markets are extremely challenging because they don't trade on fundamental information on which active managers are paid to make decisions. In the past quarter, any type of risky investment, or investment perceived to take risk, was down as investors sought shelter in Treasuries and gold. Case in point, the best performing sector of the U.S. market² in the third quarter was utilities – a sector that active managers typically steer clear of because it's so heavily regulated that it's virtually impossible to derive any information advantage from it. That being said, money managers that participated in Russell's survey aren't getting beaten down – instead, they're feeling fairly optimistic and see buying opportunity in equity markets³ in anticipation of the time when fundamentals will drive markets again. So, active managers are positioning portfolios to benefit from the change when it occurs. Their ability to look beyond the short-term uncertainties and possibilities toward long-term probabilities helps them maintain perspective and see opportunity in exactly the same things that other investors are interpreting as a reason to flee.

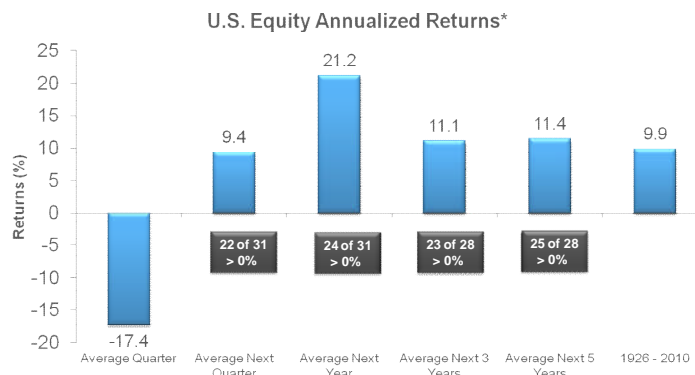
Your options: Hold, Fold, All in.

What about individual investors – especially those working with a financial advisor and who have a credible financial plan that they understand and believe in – what are their options? They have at least three options. To put them into poker terms, the options are: fold your hand, hold your hand, or go all in.

If you fold our hand, you're moving down the risk spectrum and assuming less equity risk – perhaps even fleeing the market altogether. Your rationale might be “it's different this time. This market's not for me. I'll get back in when the market is safe and sound.” If you follow this path, **you have to be prepared to miss out on the potential upswing because timing it is very difficult – both intellectually and emotionally** – but history has shown that it comes and it comes fast. As the chart on the next page shows, of the 31 times since 1926 that the U.S. equity market has produced double digit negative returns in a single quarter (as the quarter ending September 30, 2011 did), returns in following quarters tended to be positive – and have even, on average, outperformed the long-term average.

² Based on Russell 1000® Index.

³ Russell Investments, Investment Manager Outlook, September 2011. Russell's Investment Manager Outlook is an ongoing, quarterly survey intended to generate a meaningful snapshot of investment manager sentiment. For the current installment of the survey, Russell collected the opinions of senior-level investment decision-makers at equity investment management firms, as well as at fixed-income investment management firms. For this iteration, 102 managers participated in the survey.



**Source: Ibbotson U.S. Equity series 1926 – 1978, Russell 3000® Index 1979-2010. Indexes are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.*

Deciding to go all in – that is, using market volatility as an opportunity to buy on the dips or extend your risk exposure – may sound appealing and it has been the genesis of many great fortunes. However, **it requires nerves of steel, significant surpluses and time.** Those may be ingredients some investors have in reserve, ready to put to use right now – but judging by skittish investor sentiment of late, most of us are, at the very least, lacking the nerves of steel.

So, the rest of us mere mortal investors are left in the position of holding our hand – which doesn't mean doing nothing. It means talking to your financial advisor about potentially capitalizing on the uncertain markets by diversifying, sticking to your long-term plan, and rebalancing to the strategic allocations you and your advisor originally laid out. It simply means admitting that we can't forecast the future – and that diversification may help.

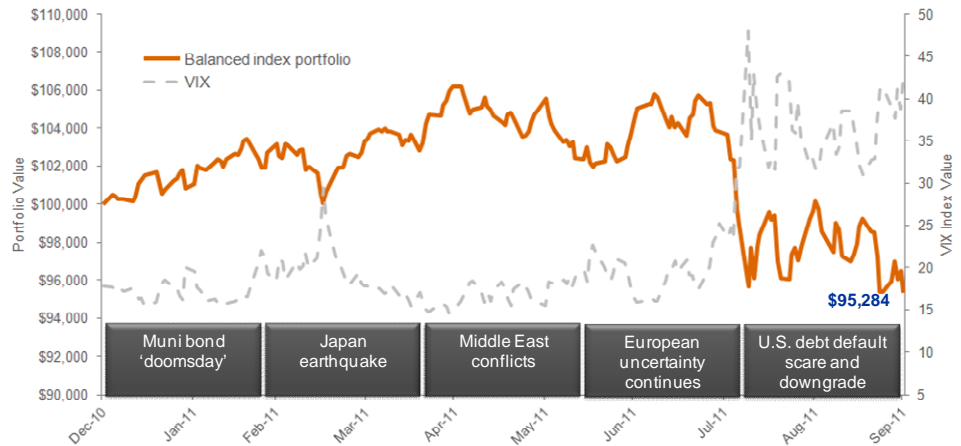
We believe investors' nerves have taken a worse beating than their nest eggs

If you consider all the events that have rattled markets and investors this year (municipal bond “doomsday”, the Japan earthquake, the Arab spring, Europe’s debt crisis, U.S. debt default scare and downgrade to name but a few) and then look at how markets have actually held up, you realize that **market volatility has made things feel worse** than they have actually been in the first nine months of this year. **Year to date (as of September 30, 2011), a hypothetical balanced index portfolio⁴ lost -4.7% while the broad U.S. market⁵ lost -11% and the broad global market⁶ lost -17.4%.**

⁴ Represented by 40% Russell 3000® Index, 20% Russell Global ex-U.S. Index and 40% Barclays Capital Aggregate Bond Index. Please see disclosures at the end of this letter for index definitions.

⁵ Represented by Russell 3000® Index. Please see disclosures at the end of this letter for index definitions.

⁶ Represented by Russell Global ex-U.S. Index. Please see disclosures at the end of this letter for index definitions.



Diversification and strategic asset allocation do not assure profit or protect against loss in declining markets. Balanced index portfolio represented by: 40% Russell 3000® Index, 20% Russell Global ex-U.S. Index, and 40% Barclays Capital Aggregate Bond Index. Indexes are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment. The CBOE VIX (Chicago Board Options Exchange Volatility Index) measures annualized implied volatility as conveyed by S&P 500 stock index option prices. Other time periods will produce different and perhaps less favorable results.

Investing = belief in the future

Investors have hardly caught a break lately. Not quite sure what to believe and what to trust anymore, 53% of us are uncertain about what the capital markets may bring over the next three years.⁷ But, **investing is an activity fundamentally rooted in belief in the future.** Belief that the world will NOT fall apart; belief that fundamentals WILL again drive markets; belief that global economic growth IS possible. Of course, that doesn't mean dogmatically clinging to your beliefs even when the facts have changed and have shown you wrong. Instead, it means a firm commitment to discipline: systematic and continuous reviews of your beliefs as new information becomes available. Sometimes these reviews will result in changes to your beliefs; other times the reassessments will reconfirm your beliefs. This is exactly what our strategist team and portfolio managers are doing at Russell on our clients' behalf. We believe that infecting those around you with disciplined optimism – instead of engaging in the partisan political ugliness and falling prey to arguments about the futility of markets – is critical to helping avoid terrible mistakes.

In the meantime, remember that markets come and go in waves. On days when markets sink, steel your nerves and stretch your perspective so you don't become pessimistic. On days when markets surge, remind yourself that a day does not a trend make. The patient accumulation of wealth has always faced this challenge and **it's no different this time around.**

All the best,

Your Capital Markets Insights Team – Timothy Noonan, Sophie Gilbert, Johann Schneider

⁷ Russell Investments Financial Professional Outlook, September 2011.

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