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# White Paper

DiMeo Schneider & Associates, L.L.C

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► JULY 2009

## A Practical Guide for Stunned Investment Committees

*Effective Investment Oversight in Difficult Times*

### Summary

Any institution seeking even moderate investment growth has suffered serious portfolio losses, and investment committee members feel stunned. Should I have seen this coming? Can we meet our budget commitments? Will recent market rallies hold?

Back in 2007, after five years of market advances, some committees operated on autopilot. But things changed in a hurry for all investors, especially those acting as fiduciaries or stewards serving on investment committees.

- **Volatility ran wild** with an eruption in the number of trading days when the S&P 500 increased/decreased by 5% or more:
  - ✓ *Twenty-one in the past twelve months ending June 30, 2009.*
  - ✓ *Nineteen over the previous fifty-eight years!*
- The **10 calendar years through 2008 were the worst for stocks** in U.S. History (*worse than the great Depression through 1939*).
- The **broad markets declined steeply** to begin 2009 then rallied in March, generating the rare occurrence of both a Bear Market and a Bull Market all in the same quarter.

These are challenging times for investment committee members, many who unselfishly volunteer their time and treasure. This Guide can help balance the fear associated with short-term losses with the need for committee members to make long-term decisions that help the organization survive and thrive.

### Challenging questions for investment committees:

- *What budget commitments are in jeopardy?*
- *Are we still capable of meeting our most basic obligations?*
- *Is there a better way to diversify...is diversification dead?*
- *Could we have seen this coming and done something differently?*
- *How can we prevent losses of this magnitude in the future?*
- *How much risk can we afford to take in the future?*
- *Can we meet our objectives with a lower investment return hurdle?*
- *Is the recent market rally real?*

**You bet it's tough and here's why.**

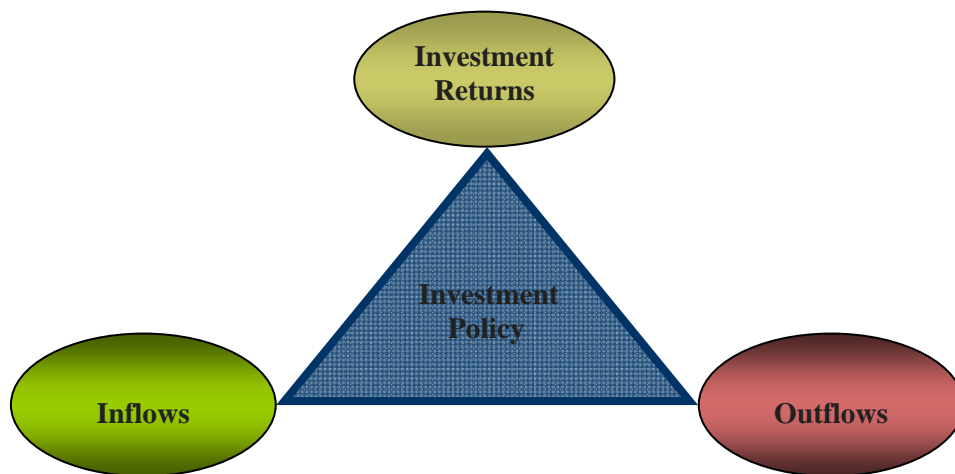
Unlike many previous Bear Markets, the recent downturn was swift and universal. Many overlook that in the last Bear Market (2000-2002), the S&P 500 lost nearly 50% compared to “just” a 37% decline in 2008. The speed of a decline certainly affects our perception but even more so, the breadth of the decline matters. Other asset classes, like real estate, performed extremely well in the previous downturn. This Bear mauled nearly all investments with the exception of Treasuries. Science helps explain why losses are so tough on us. A new field called “neurofinance” adds biology to the mix of economics and psychology to understand investor feelings and decisions. Using tools like MRI scanners, scientists now understand that humans use the “reflex” portion of their brain for investment decisions. This part of the brain loves rewards, dislikes uncertainty and hates risk. Brain scans show that losing money, or even the belief of losing money, can trigger fear reactions similar to swerving your car to avoid an accident. Moreover, the emotional response to losing money is quite strong; three-times more intense than the pleasure associated with making money. <sup>1</sup>

*In light of the way humans are “wired”,  
Investment Committee Members must guard  
against dangerously reactive decisions.*

A final thought on why this Bear Market feels so bad is that investors tend to extrapolate the recent past. The Bear that roared earlier this decade seems tame now, but think back to the state of fear that once prevailed. After September 11, people were fearful of hometown terrorist attacks and some U.S. citizens became first time gun owners. It always has and always will feel worst when uncertainty exists and the solution is yet unknown.

**Principle #1: If you can achieve your investment goals by investing in T-bills, you should.**

This simple but crucial concept leads to a discussion of the **Three Levers** that affect all institutional investors. Our work with clients extends well beyond portfolio structure and it is common for us to engage with staff, committee and board members to establish Investment Policy in concert with the **Three Levers**:



Unique circumstances might lead an institution to recognize that one of the levers is distinctly over or under weighted. It is impulsive and perhaps impossible to construct a portfolio without clear appreciation of each lever and its respective impact on the organization.

Imagine a Pension Committee making Policy decisions for a Plan where total assets and liabilities represent insignificant amounts relative to the organization's overall balance sheet. The Plan's performance may have very modest impact. On the other hand, consider a university where portfolio earnings account for 50% of annual spending. Investment results may determine whether the institution survives.

There is an inherent challenge to Principle #1, which states that you should invest in T-bills if doing so can achieve your financial goals. The simple fact is that most institutions cannot come anywhere close to achieving their goals with such low returns. Actually, the return **hurdle rate** for the typical institution is a lot closer to 8% (e.g. – a pension plan with an 8% actuarial earnings assumption or an endowment that seeks their 5% spending rate plus inflation of 3%). Moreover, returns of 8% are no walk in the park. The risk and volatility associated with an 8% hurdle rate are much higher than committee members typically want to accept. As reference, our forecast return for Large-cap US stocks is an average of 8.3% over the next ten years.

It is immaterial whether you are responsible for a pension plan, an endowment, a board designated fund or any other pool of assets with a long-term time horizon; the relative weight of the **Three Levers** specific to your organization plays a vital role when making Asset Allocation and Investment Policy decisions.

**A Conundrum for most Long-term Investors:**

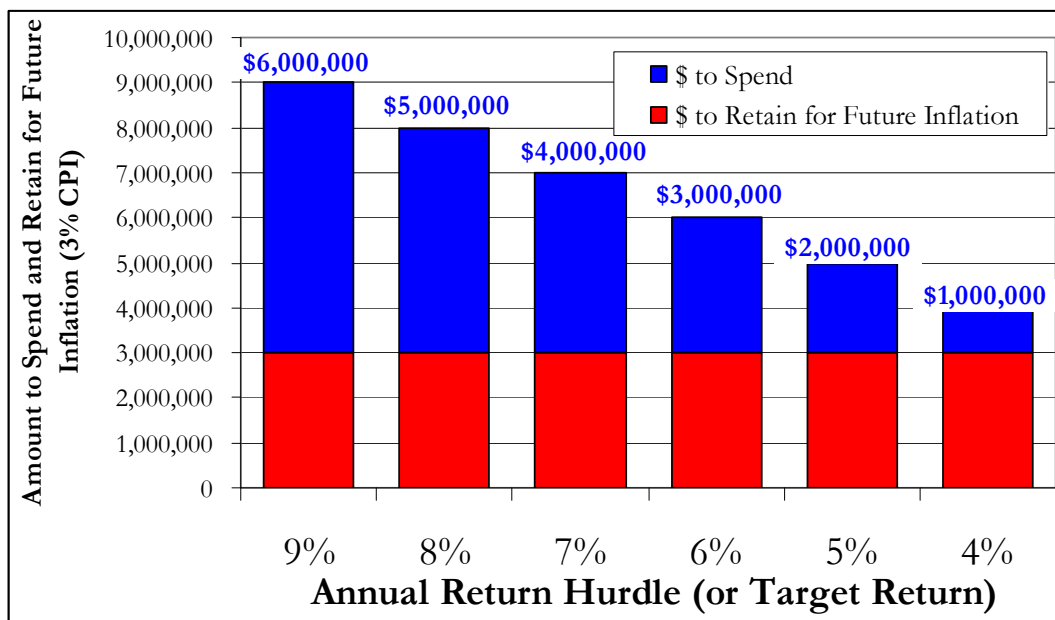
1. Invest in T-bills and guarantee falling short of the targeted hurdle rate.
2. Invest 100% in Large-cap U.S. stocks or another single asset class with a high-expected return.
3. Invest in a thoughtful, diversified portfolio.
4. Slash the budget.

*Committee members must be realists. It is impossible to have a long-term time horizon, a high hurdle rate, invest in cash and still avoid cutting the budget.*

**Principle #2: Assume only the risk you must.**

Committee members do not roll out of bed eager to own risky assets like emerging market stocks, commodities or hedge funds. Yet in this market downturn, the most challenged committees are those that cannot clearly articulate their hurdle rate or why they own risky assets. It's great if your investment pool is large enough to avoid taking risk, but this strategy requires careful consideration. Large sums of money can produce rather small amounts of income when invested too conservatively. The following chart shows how funds available for Spending shrink dramatically with lower earnings.

## Available Spending for a \$100 million endowment as Returns Decline



How much risk a committee should assume is a complex question and signing up for “too little risk” can greatly affect an organization. Think of the public company that perpetually reduces earnings per share because they desire less volatility in their pension plan. Also, consider the hospital with less beds or the school with fewer scholarships all because the committee wants less risk. Are these tradeoffs wrong? Not at all, unless the risk decisions are made in a vacuum.

If you do not have a hurdle rate, you invest in risky assets, and you “can’t sleep at night”, the question is why? If you do not require high returns and sleep is important, scale back and own low risk investments.

### **Principle #3: Beware of seductive myths**

The solution is often unknown as financial storms rage. But when it comes to the US economy and stock markets, a solution has always surfaced. It becomes easy to question investment fundamentals during stressful periods, so let’s present and dispel a few myths that seem to be gaining momentum.

#### **Myth #1: Lousy economic times necessarily go hand in hand with lousy investment performance.**

Fact – As soup lines surged and unemployment exceeded 20% in the mid-1930s, the S&P 500 gained 514%. While this is a dramatic example, it is common for the stock market to lead an economic recovery by six months or more.

#### **Myth #2: Market timing can be an effective long-term strategy**

Fact – Market timing strategies can be seductive, especially during severe bear markets. Unfortunately, seductive does not mean effective. Anecdotes abound during volatile markets; we hear the tale about the institution or individual investor who “got out” or “got in” at exactly the right time. Upon deeper investigation, many of the stories prove fallacious. The empirical evidence is overwhelming that systematic market timing does not work, and almost always leads to lower long-term returns. The efficacy of market timing strategies grows weaker as the observation period grows longer.

Would you really want to bet your organization's future on whether you could make two correct guesses (both when to sell and when to buy back)?

**Myth #3 – Diversification is dead.**

Fact – While it is true that diversification did not prevent losses during the huge selloff last fall, diversification certainly added value and continues to do so. Unlike earlier in this decade and previous Bear Markets when diversification substantially buffered losses, the current Bear attack was broad and deep. Nonetheless, diversification is far from dead.

The following chart shows how various asset classes performed during the 2000-2002 and 2007-2009 bear markets. It also shows the performance of a plain-vanilla **70/30 mix\*** and a **Broadly Diversified Mix\*\*** with the same return objectives. The **Broadly Diversified Mix\*\*** allocates to all of the asset classes below.

**2000-2002 versus 2007-2009 Bear Markets**

Bear Market	S&P 500 Index	70/30 Mix*	Broadly Diversified Mix**	Cash	TIPS	US Bonds	Foreign Bonds	High Yield Bonds	Large US Equity	Mid US Equity	Small US Equity	REITs	Foreign Equity	Emerging Markets	Commodity Futures (+ TIPS)	Hedge Funds	MLPs
2000-2002 Bear: 8/31/00 - 9/30/02	-45%	-29%	3%	8%	30%	23%	16%	-6%	-45%	-30%	-31%	21%	-42%	-34%	28%	0%	54%
2007-2009 Bear: 10/31/07 - 2/28/09	-51%	-38%	-27%	2%	1%	6%	6%	-26%	-51%	-54%	-52%	-67%	-56%	-61%	-44%	-22%	-33%

\* 70% Large US Equity (S&P 500 Index) & 30% US Bonds (Bardays US Aggregate Bond Index)  
 \*\*Broadly diversified Frontier Engineer™ mix designed to match the expected long-term annualized return (7.3%) of the 70/30 mix.  
 \*\*\*The allocation of the broadly diversified mix is proprietary information. If interested, please contact Bob DiMeo at [bdimeo@dimoschneider.com](mailto:bdimeo@dimoschneider.com) for a summary of the allocation.  
 Note: A summary of the indexes used for this analysis are in the footnotes & disclaimers section of this paper.  
 Note: Past performance is no guarantee of future returns. Summary for illustrative purposes only.

Diversification is once again paying dividends as evidenced by year-to-date results. The capital markets, as they typically do, are selectively rewarding or punishing risk rather than indiscriminately punishing all risk.

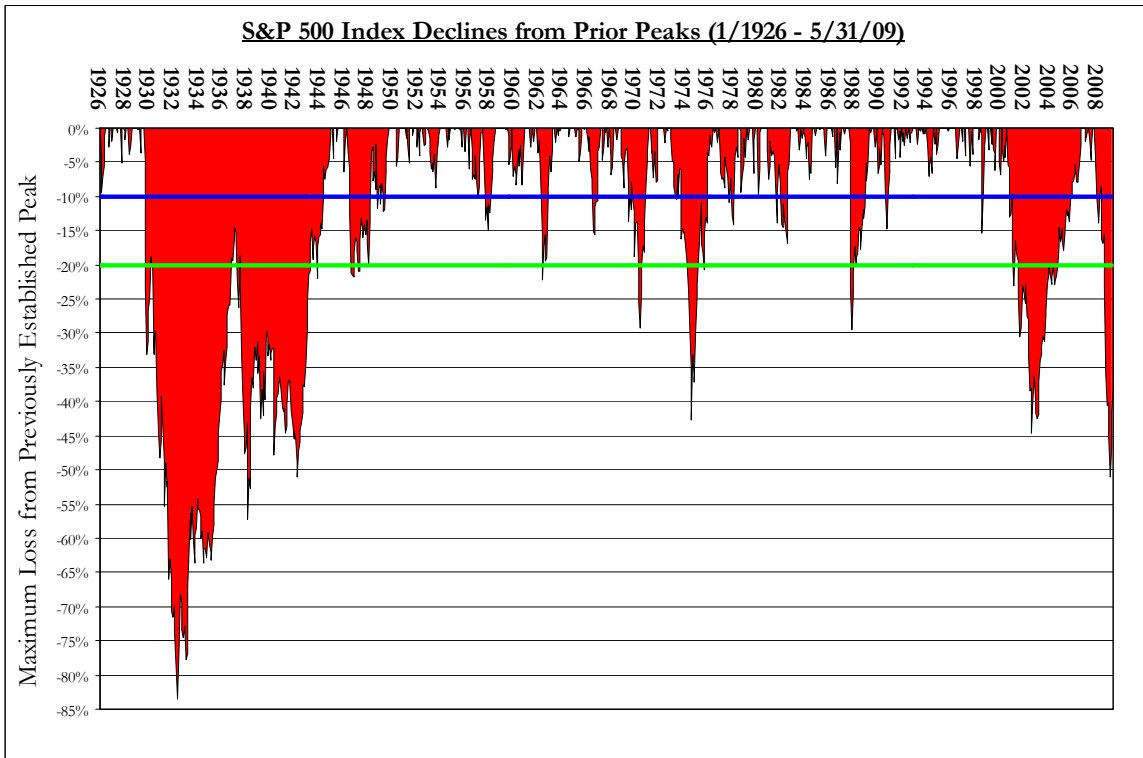
**2009 YTD Returns (5/31/09)**

<b>Asset Classes</b>	<b>2009 YTD Returns (5/31/09)</b>
Cash	0.1%
TIPS	4%
US Bonds	1%
Foreign Bonds	-1%
High Yield Bonds	25%
Large US Equity	3%
Mid US Equity	10%
Small US Equity	1%
REITs	-10%
Foreign Equity	9%
Emerging Markets	38%
Commodity Futures(+TIPS)	11%
Hedge Funds	7%
MLPs	35%

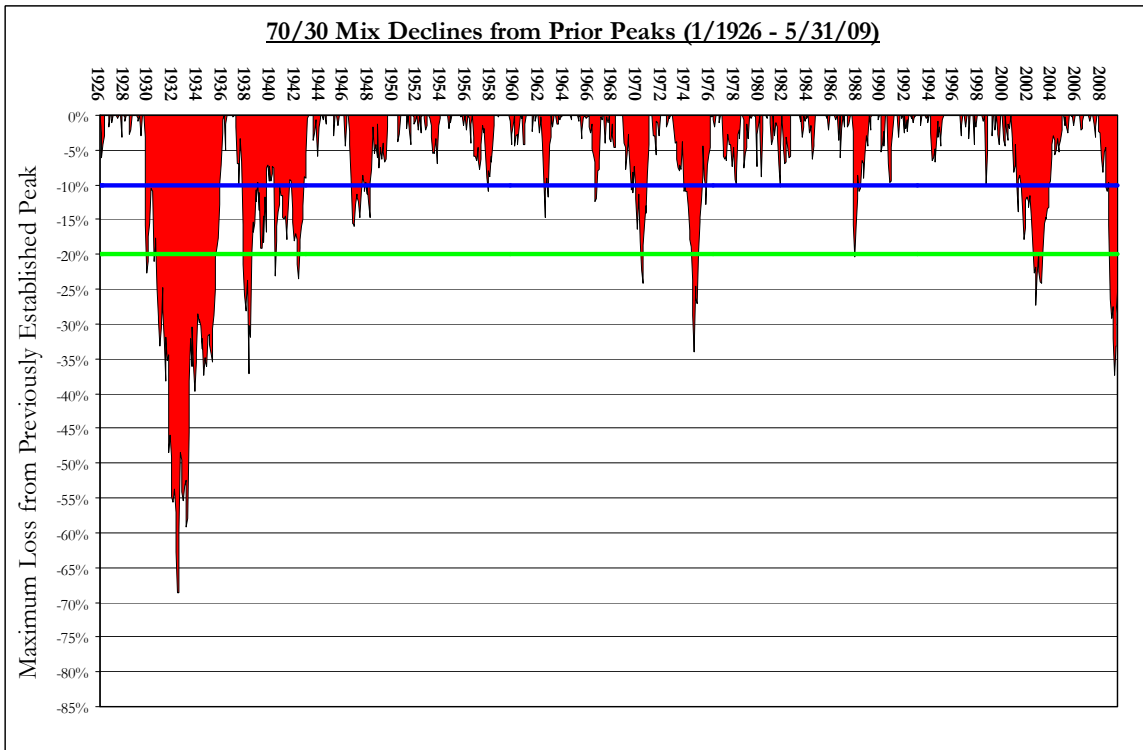
*Note: A summary of the indexes used for this analysis are in the footnotes & disclaimers section of this paper.*

The following graphs compare the peak-to-trough losses for the **S&P 500 Index** and the **70/30 Mix** from 1926 through May 2009.

## S&P 500 Index



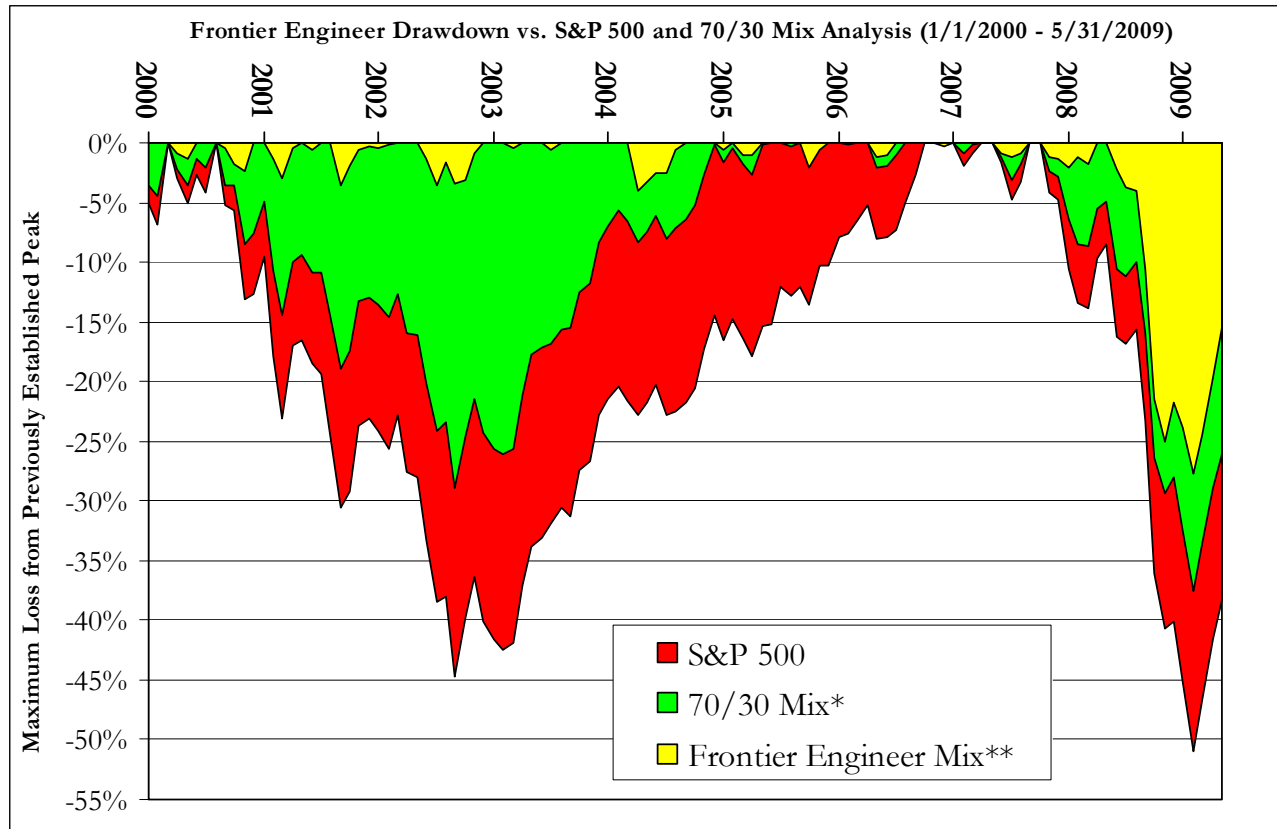
## 70% Stocks & 30% Bonds



The following graph compares the peak-to-trough losses for the **S&P 500**, the **70/30 Mix\*** and a **Broadly Diversified Mix\*\*** during the first 9.5 years of this tumultuous decade.

### Broadly Diversified Mix\*\*

Note: The **Broadly Diversified Mix\*\*** is designed to meet same return objective of the **70/30 Mix\***



We experienced two bear markets this decade that combined to create the worst 10-year stock market performance in U.S. history. S&P 500 losses surpassed even the worst 10-year decline during the Great Depression (1999-2008 loss of -1.4% annually compared to 1929 -1938 loss -0.9%).

From January 2000 to May 2009, the **S&P 500 Index** lost 26% of its total value. The **70/30 Mix\*** did better for the decade, but still lost 1% of its value. However, the **Broadly Diversified Mix\*\*** (the Frontier Engineer™ Mix) managed to gain 75.2% (or a +6.1% annualized return). While no portfolio is perfect, the **Broadly Diversified Mix\*\*** mitigated losses in both bear markets and generated positive returns (+6.1% annualized) during the first 9.5 years of this otherwise dreadful decade. As the following graph shows, the **Broadly Diversified Mix\*\*** would have mitigated losses between November 2007 and May 2009 as compared to the **S&P 500 Index** and the **70/30 Mix\***.

## Losses Since November 1, 2007

Returns from November 1, 2007 to May 31, 2009	S&P 500 Index	70/30 Mix*	Broadly Diversified Mix**
<i>Loss from peak (11/1/07 - 5/31/09)</i>	-38.3%	-26.1%	-14.8%
<i>Required Gain to Return to 10/31/07 Level</i>	62.0%	35.2%	17.4%

\* 70% Large US Equity (S&P 500 Index) & 30% US Bonds (Barclays US Aggregate Bond Index)

\*\*Broadly diversified Frontier Engineer™ mix designed to match the expected long-term annualized return (7.3%) of the 70/30 mix.

\*\*The allocation of the Broadly Diversified Mix is proprietary information. If interested, please contact Bob DiMeo at [bdimeo@dimeoschneider.com](mailto:bdimeo@dimeoschneider.com) for a summary of the allocation.

Note: A summary of the indexes used for this analysis are in the footnotes & disclaimers section of this paper.

Note: Past performance is no guarantee of future returns. Summary for illustrative purposes only.

### **Principle #4: Committee members must work especially hard to avoid dangerously reactive decisions in challenging times.**

As a committee member, you oversee the institution's portfolio but you likely have personal investments. Emotional lines between the two may easily blur during turbulent times. An effective committee member will set personal fears and concerns aside and approach decisions exclusively with the organization's goals in mind. Does this mean committee members should not be conservative? Not at all; however, decisions should be made in an eyes-wide-open manner with an understanding of how each relates to the overall mission.

Committee members must also diligently avoid scams. A "financial expert" recently boasted on a Chicago radio station that his clients did not lose one cent during this market downturn. Wow! The worst 10 years for stocks in U.S. history and their clients were unscathed. The pundit went on to explain that his firm offered a product, ideal for both retirement plans and wealthy individuals, that not only guaranteed a high rate of return but also included a 10% CASH BONUS on money transferred in. "\$200,000 becomes \$220,000; \$500,000 becomes \$550,000... and that's before you start earning high guaranteed rates!"

The claims made are curious at best since it is likely that every investor positioned for long-term capital gains suffered at least some loss during the devastating downturn that began in late 2007. These extremely challenging times can cause otherwise rational individuals to contemplate dramatically altering their investment programs (how else could a firm that promises 10% cash bonuses on guaranteed investments be in business?). Tried and true investment principles are under attack and in need of defense.

By now, you are probably thinking there is no way you would fall for Ponzi schemes or commission-laden insurance products sold with storybook illustrations. And you probably wouldn't. However, the dangers lie in more subtle myths that tempt investors to abandon long-term principles.

Your peril might be the investment committee member who attempts to convince the group that diversification is dead (it's not, as previously demonstrated). Or perhaps you start to believe in the merits of market timing (also a challenge for any portfolio with a long-term time horizon since success requires not one but two correct guesses).

It is fully understandable how these hard-hitting times might shake the confidence of any investor, especially an investment committee member. However, emotionally driven decisions rarely align with the long-term goals of an institution. Good stewardship is not always easy. Yet it is more important than ever to clearly understand your organization's objectives and time horizon and to avoid dangerously reactive decisions.

### **Investment Committee Checklist:**

#### **Ten Timely Suggestions for All Investment Committees**

Regardless of the near-term direction for capital markets, these timely suggestions can help maximize your committee's long-term success.

##### **1. Carefully craft your Investment Policy and document your actions.**

Committees should appreciate their *Three Levers* (i.e., Inflows, Outflows, and Investment Returns) as they establish Spending and Investment Policies. The Investment Policy must factor in spending needs, liquidity needs, time horizon(s), risk tolerance, and return objectives. Without documentation of decisions, future committee members may be quick to question the past investment strategy.

##### **2. Understand that even your best investment managers will periodically underperform.**

"Patient or passive" was the conclusion of our comprehensive 2007 study, called "*The Next Chapter in the Active Versus Passive Debate*". We made the following observations when examining top quartile managers over a 10-year period (1997 – 2006):

- About 90% of the top-quartile managers (over the 10 years) suffered at least one three-year stretch where they were below median.
- More than 50% of top-quartile managers (over the 10 years) spent at least one five-year period in the bottom half compared to peers.

##### **3. Expect a lot from vendors.**

Are you receiving proactive and beneficial services from your investment consultant, attorney, accountant and custodian? Replace providers that are not prudently progressive or not placing your interests first.

##### **4. Be aggressive about fees.**

Examine all fees. Your vendors need to make money, but their fees should be reasonable and no conflicts should exist.

##### **5. Stay actively engaged.**

If you are a fiduciary of an ERISA plan, your role carries personal exposure. For stewards of nonprofit funds, your active engagement is more important than ever.

##### **6. Have appropriate indemnification and insurance in place.**

Regardless of how you ended up on the committee, explore having your company or organization indemnify you for good faith efforts. When appropriate, make certain that Fiduciary or Directors' & Officers' insurance is in place to protect you.

**7. Reflation could be your next challenge.**

Thoughtful action today might meaningfully affect your fund for years to come. The U.S. Government has set its sights on economic recovery with aggressive policies that may spark inflation down the road. Consider several asset classes that have a fighting chance against inflation, such as inflation protected bonds and commodity futures.

**8. Be prudently progressive.**

This could be an excellent time for committees to consider new strategies or asset classes.

**9. Ensure that your mission remains front & center.**

Avoid getting too hung up on this month's losses (or gains). Remain focused on the organization's long-term mission.

**10. Use conflict-free advisors.**

Use an advisor that places your interests first and demand disclosure of all sources of revenue. Committee members have enough to worry about without questioning their advisor's interests.

**Conclusion**

We are in challenging times for all investors and the pressure for investment committee members is especially daunting. You are tasked with making tough decisions in times of great uncertainty, and the results of your actions can be vital to the success or survival of your organization. Use the suggestions presented here to help guide your decisions. With time, effort and the appropriate help, you can do this!



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**Observations & Considerations Analysis:** Contact any of the professionals at the firm to receive a complimentary Analysis of your investment strategy and fiduciary/stewardship practices. [www.dimeoschneider.com](http://www.dimeoschneider.com)

1. Jason Zweig – *Your Money and Your Brain*

Historical returns and risks were calculated using index benchmarks for various asset classes. It is impossible to invest directly in any index. Historical returns were calculated for various hypothetical portfolios using weighted average monthly market index returns (rebalanced monthly) and are not intended to predict performance of any investment or asset allocation strategy. Past performance is no guarantee of future performance. No diversification strategy can guarantee against loss.

The following indexes were used in reference to asset class returns throughout this paper:

<b>Asset Class</b>	<b>Index</b>
Cash	Citigroup 3-mo. T-bills
TIPS	Citigroup TIPS
*US Bonds	Barclays US Aggregate Bonds
Foreign Bond	50-50 Citi Currency-Hedged Non-US \$ WGBI & Citi Non-US \$ WGBI
High Yield Bonds	ML HL Master
Large US Equity	S&P 500
Mid Cap US	Russell Midcap
Small US Equity	Russell 2000
REITs	DJ Wilshire RESI
Foreign Equity	MSCI EAFE Index
Emerging Markets	MSCI EMF
Commodity Futures (+ TIPS)	DJ AIG Commodity + TIPS - T-Bill
Hedge Funds	HFRI Fund of Funds Index
MLPs	Alerian MLP Index

\*For U.S. investment grade bond returns prior to the inception of the Barclay's US Aggregate Bond Index, Investment Grade U.S. Bond Market Returns were calculated by blending a long-term government and long-term corporate bond data set (source: Dimensional Fund Advisors).

**Notes:**

The **Broadly Diversified Mix** is a mix generated by DiMeo Schneider & Associates, LLC's proprietary Frontier Engineer™ asset allocation model. This portfolio was selected for reference because, mathematically, it is the lowest expected risk portfolio with a forecasted 7.3% expected 10-year return (between 2009 and 2018), which matches our 10-year forecast return for a 70% Large Cap U.S. Equity and 30% U.S. Investment Grade Fixed Income mix. This allocation is not being offered as a recommendation for any reader, as we do not have knowledge of unique facts or circumstances. The allocation of this **Broadly Diversified Mix** is available by request. DiMeo Schneider & Associates, L.L.C.'s 10-year capital markets assumptions paper is also available upon request. We reserve the right to withhold any information in order to protect our intellectual capital. Our 10-year forecasts represent the median case for each asset class.