

# 2011 Capital Markets Review

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## Ebb & Flow

Investors were overwhelmed with headline events during 2011. A devastating tsunami in a leading global economy; a European debt crisis/solution/crisis/solution...; a polarized U.S. government; and a downgrade in the credit rating on U.S. debt all contributed to heightened volatility during the year. These macro headwinds diminished the value of fundamental security analysis as correlations **within** asset classes reached new highs. According to the Leuthold Group, the average correlation of the individual companies within the S&P 500 and the index itself hit 86% during October (and remained

over 80% at year-end). This means 86% of a stock's price movement can be explained by the overall stock market rising or falling, while only 14% is attributed to the company's specific fundamental characteristics. This spike in correlations is unprecedented, reaching a level not seen during the Great Depression, the market crash in 1987 or the financial crisis of 2008.

To understand the historical impact of the market's correlation, Arbor Research states, *"In the entire history of the S&P 500, there has never been a day in which all 500 stocks in the index go up or all 500 go down. There have been 11 days in which 490+ stocks all move in the same direction on a given day. Of those*

*11 instances, 6 have occurred since July 2011."* This "risk on" / "risk off" trading market was not limited to the U.S., influencing nearly all risk-based assets during 2011 (especially the second half of the year), resulting in sharply higher correlations **between** the S&P 500 and foreign markets, currencies, commodities and interest rates.

## Global Equity Markets

In 2011, the primary investment quality that mattered was patience with global stock markets providing many opportunities to buy high and sell low! Within the U.S., despite all the rallies and sell offs, the price level of the S&P 500 ended the year almost exactly where it began. The Index's price

S&P YTD PRICE RETURN



Source: Yahoo Finance

|                                     |          |
|-------------------------------------|----------|
| S&P 500 Opening Price (12/31/10):   | 1,257.64 |
| S&P 500 Closing Price (12/31/11):   | 1,257.60 |
| S&P 500 2011 Price Return:          | 0.00%    |
| S&P 500 2011 Dividend Reinvestment: | 2.11%    |
| S&P 500 2011 Total Return:          | 2.11%    |



change for 2011 was the smallest absolute (0.04) and percentage (0.003%) change since Standard & Poor's expanded to 500 companies in 1957.

As a result, the entire return for the S&P for the year came from dividends, resulting in a 2.1% total return for 2011.

This modestly positive annual return would not have been possible without a dramatic broad-based rally during the fourth quarter which erased the severe declines posted during earlier periods. For the quarter, the S&P 500 gained 11.8% with seven out of ten sectors generating double digit gains.

From a style and capitalization standpoint, small and mid cap companies outpaced large cap companies during the fourth quarter, while value returned to favor over growth across the capitalization spectrum.

Outside the U.S., the year-end equity rally was significantly less robust with emerging markets gaining 4.5% (MSCI Emerging Market Index) and developed markets climbing only 3.4% (MSCI EAFE Index). These gains failed to offset

earlier losses resulting in sizeable declines for most markets for the year.

### Fixed Income Markets

Within fixed income markets, risk appetites increased during the fourth quarter with investors favoring higher yielding sectors over higher quality sectors. According to Barclays Capital, below investment grade corporate bonds generated the best results, gaining 6.5% for the quarter followed by emerging market debt which increased 4.9%. As quality increased, returns decreased, resulting in the Treasury sector turning in the worst results for the period, gaining 0.9%. Despite the relatively weak quarter, Treasuries had a remarkable year, gaining 9.8% as anxiety and Operation Twist drove yields down and Treasury prices up.

### Global Multi-Strategy/Diversifiers

Given the "Risk on" market environment during much of the quarter, most of the flexible mandates were unable to keep pace with global equity market gains. However, for the year, many of these strategies added both excess return and dampened portfolio volatility. Unfortunately, not all

## Global Equity Returns (\$) 2011

|                |         |
|----------------|---------|
| Ireland        | 14.3%   |
| New Zealand    | 6.4%    |
| USA (S&P 500)  | 2.1%    |
| United Kingdom | (2.5%)  |
| Australia      | (10.8%) |
| Spain          | (11.2%) |
| Canada         | (12.2%) |
| Japan          | (14.2%) |
| France         | (16.0%) |
| Hong Kong      | (16.0%) |
| Germany        | (17.5%) |
| China          | (18.2%) |
| Russia         | (19.3%) |
| Brazil         | (21.6%) |
| Italy          | (22.3%) |
| India          | (37.2%) |
| Greece         | (62.7%) |

strategies worked, especially those that maintained overweight exposures to emerging markets which experienced significant declines during the year. Overall, the diversification benefits have been muted as correlations have climbed, but we believe strong fundamentals and sound capital allocation decisions will ultimately be rewarded.



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