

The Futility of It All: Predicting Market Reactions in a Crisis

March 15, 2011

As Margaret Thatcher famously said to George H. Bush just before the first Gulf war, "Don't go wobbling on me now George."

At moments like these we are tempted to make serious mistakes. One bad decision made in panic can take a big bite out of the long-term return you need to retire. Discipline in moments like these will save you. It might seem that the world is ending and markets are headed straight down, but that is far from certain. Read on for the details.

Just ten weeks into 2011 and major events (both man-made and natural) are having a substantial impact on the global economy and markets. The annual ritual of reading and discussing the predictions of economists, market strategists, and the financial media for the year ahead was barely completed and already those outlooks have been overtaken by events. The Predictors now acknowledge that the events that actually unfolded were unpredictable. None of them mentioned potential uprisings in places like Egypt, Libya and Bahrain and, of course, none of them could predict a massive earthquake, tsunami, and subsequent radiation leaks in northern Japan. It seems the only difference this year is that the shelf life of the predictions seemed shorter than ever.

As you know by now, our approach is to avoid making or paying attention to forecasts. Predictions and resulting recommendations are wrong more often than not. There is no reason for us to claim that we are any smarter or more clairvoyant than the highly-paid and credentialed Wall Street prognosticators whose annual forecasts look so dated so quickly each year.

The most successful "famous investors" (e.g., Warren Buffett) are the first to declare that they have no idea what the stock market will do in any given year. There is no better proof of that than what happened recently. Buffett's Berkshire Hathaway announced in the morning that it would buy a chemical company called Lubrizol for \$9 billion in cash. With news of the radiation leak in Japan, the stock market there fell 10%, and our markets were down over 2% the following morning (but prices are rising from the opening lows). Buffett has his discipline for seeking out good value and acting accordingly. He has an excellent sense of how to allocate capital based on parameters that are within his control. He also has an excellent sense of what is out of his control and avoids those kinds of speculations. The short-term timing is irrelevant in his view, and in ours.

At the risk of repeating our mantra yet again, we are committed to our discipline of helping our clients develop financial plans that “rehearse” what would happen in the event of falling markets. We acknowledge that could happen at any time; we can’t control that. You and we need to focus on what we can control. Is your asset allocation appropriate? Will you have the discipline to rebalance, i.e. lower your equity allocation in rising markets as your equity weighting rises above your target and then actually add to equities in falling markets if allocations fall below targets?

Maintaining discipline through times of euphoria and through times of heightened concern and even panic is within our control. It is the most critical component of long-term success. It is by no means easy given the headlines and the talking heads on business television. With our help our clients have and will continue to navigate well the ups and down of the markets and not veer off course at critical moments.

The attached charts from Dimensional Fund Advisors illustrate well how short-term crises and catastrophes have ultimately been digested by the markets, as bad markets are frequently followed by good ones. The second chart shows how much long-term return you can lose by missing a few of the market’s best days. Changing one’s investment program in reaction to big events has clearly been bad strategy.

Please do not hesitate to contact your consultant to discuss any questions or concerns. We know this is challenging and we are always here to help. The end of the quarter is just two weeks away, and we will be back in touch in shortly thereafter with our quarterly letter. Meanwhile, while we are all terribly concerned about the tragedies unfolding in the world today, let’s keep cool heads in regard to our financial plans.

Sincerely,

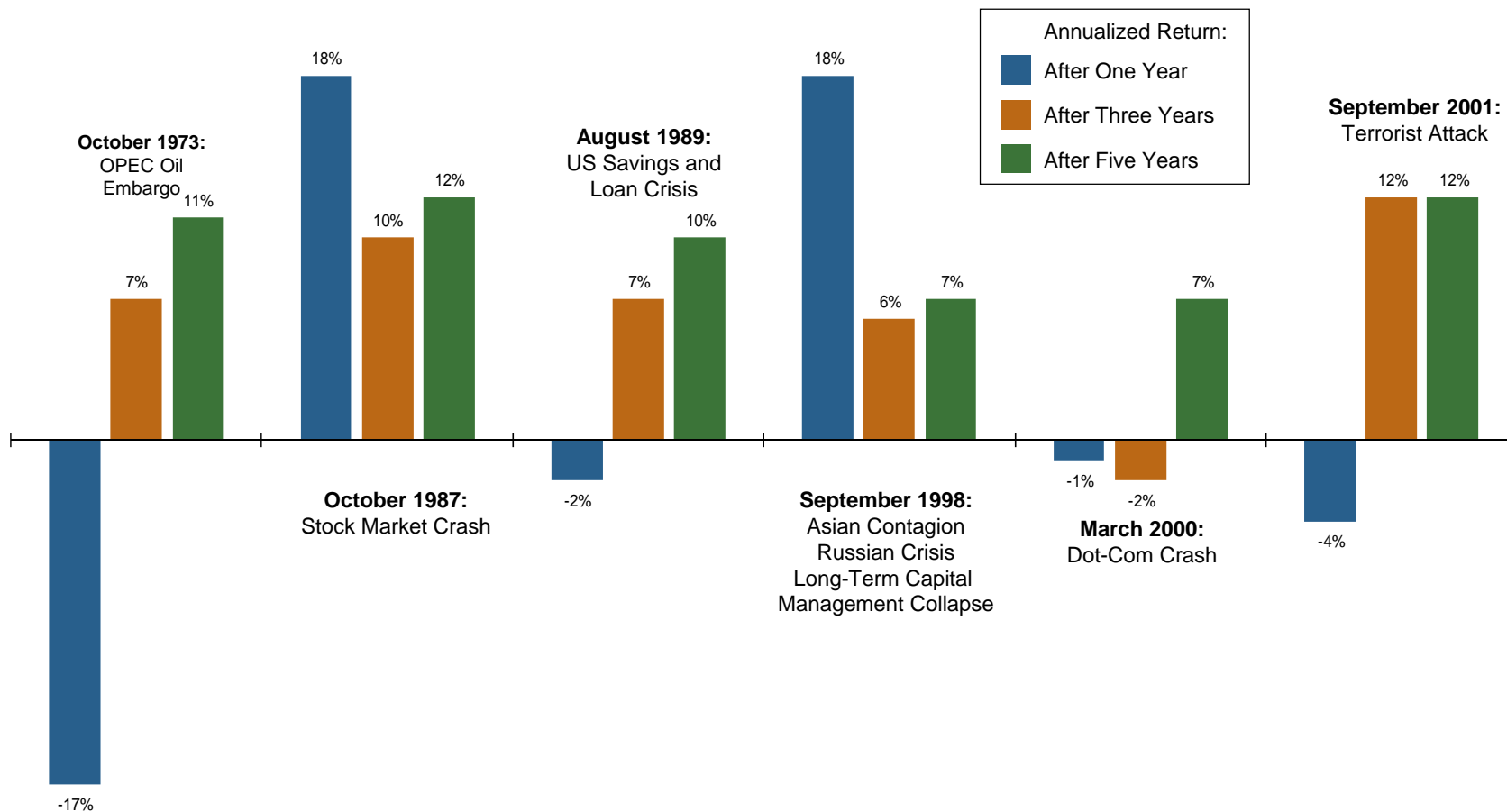


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The Market's Response to Crisis

Performance of a Normal Balanced Strategy: 60% Stocks, 40% Bonds



Normal Balanced Strategy: 42% US equity indexes, 18% non-US equity indexes, 40% fixed income indexes.

The S&P data are provided by Standard & Poor's Index Services Group. Fama/French data provided by Fama/French. Dow Jones Wilshire data provided by Dow Jones Indexes. MSCI data copyright MSCI 2010, all rights reserved. International Small Cap Index and International Small Cap Value Index compiled by Dimensional from StyleResearch securities data; includes securities of MSCI EAFE countries in the bottom 10% of market capitalization, excluding the bottom 1%; market-cap weighted; each country capped at 50%; value includes the upper 30% book-to-market range; rebalanced semiannually. The Merrill Lynch Indices are used with permission; copyright 2010 Merrill Lynch, Pierce, Fenner & Smith Incorporated; all rights reserved. Barclays Capital data, formerly Lehman Brothers, provided by Barclays Bank PLC. Citigroup bond indexes copyright 2010 by Citigroup. Indexes are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Not to be construed as investment advice. Returns of model portfolios are based on back-tested model allocation mixes designed with the benefit of hindsight and do not represent actual investment performance.

Source: Dimensional Fund Advisors

Missing the Best Days

Performance of the S&P 500 Index

Daily: January 1, 1970-December 31, 2010

The best single day was October 13, 2008.

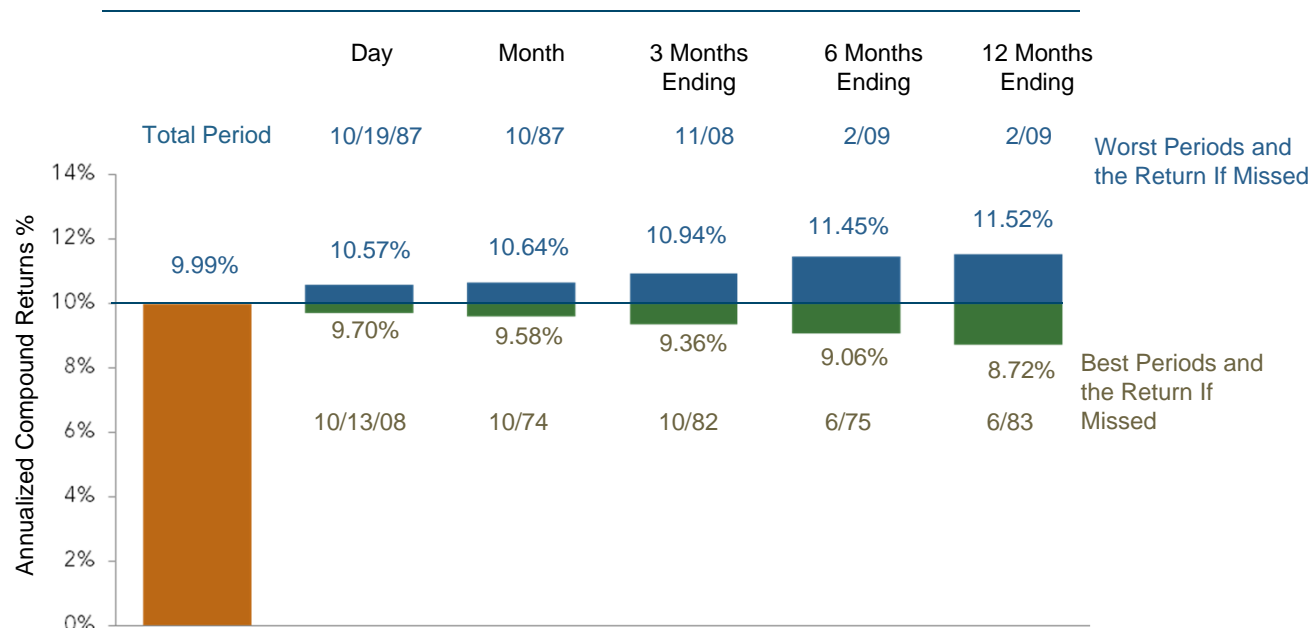
The best one-month return, October 1974, happened immediately after the second-worst one-year period.

The occurrence of strongly positive returns has been especially unpredictable. Investors attempting to wait out an apparent downturn ran a high risk of missing these best periods.

Nine of the top 25 days occurred between September 2008 and February 2009, during which time the S&P dropped 41.8%

Five of the Top 10 days occurred between October 2008 and November 2008, during which time, the S&P 500 dropped 22.8%.

Best/Worst Missed Period



Time periods greater than one month are based on monthly rolling periods, and dates indicated are end of period.

The S&P data are provided by Standard & Poor's Index Services Group.

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Source: Dimensional Fund Advisors