

2011 Review: Economy & Markets

The past year reminded investors that they should hope for the best, prepare for the worst, and be thankful when reality does not match their fears. Investors entered 2011 with hopes that the world economy would continue recovering from a long and painful deleveraging process. Equity markets had posted two straight years of positive performance, central banks remained committed to pro-growth monetary policy, and major developed nations were focused on reducing debt.

By mid-year, however, optimism faded as troubling events around the world dominated headlines. The devastating earthquake and tsunami in Japan, political unrest in the Middle East, rising oil prices, a US credit downgrade, the threat of another global recession, and an escalating debt crisis in Europe weighed heavily on markets. As stock market volatility returned to global financial crisis levels, investors faced a major test to their discipline and staying power.

Although US stocks experienced some of the highest volatility in years, the broad US market delivered flat performance in 2011. Developed markets logged negative returns, and emerging markets had mixed performance, with most countries also underperforming the US. The bright spots were in the fixed income arena, where a flight to quality triggered by the euro debt crisis and US credit downgrade boosted returns on US government securities, inflation-protected securities, and municipal bonds.

US Stock Market Performance

Russell 3000 Index with Selected Headlines and Events from 2011



Source: Russell Investment Group.

In US Dollars. Index is not available for direct investment. Performance does not reflect the expenses associated with management of an actual portfolio. Past performance is not a guarantee of future results.

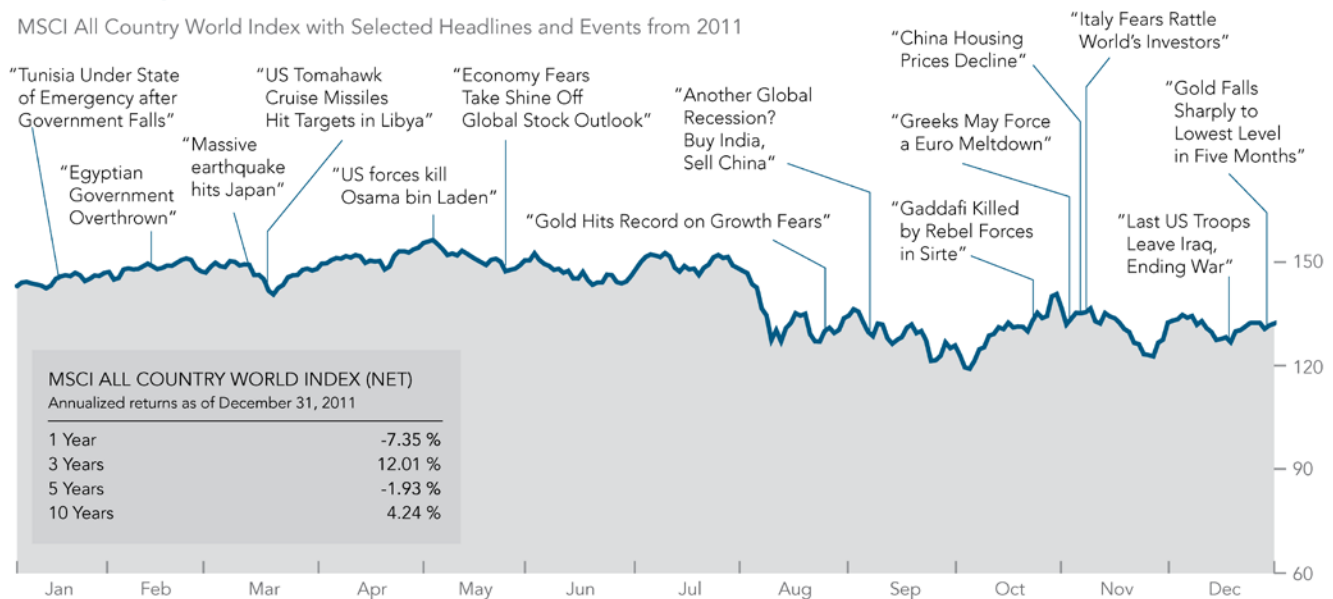
The above headliner graph features some of the year's most highly publicized events in the context of the Russell 3000 Index, a broad indicator of US stock market performance. These events are not offered as an explanation of market performance, but as an

illustration that a volatile news environment can challenge even the most disciplined long-term investors.

The World Stock Market Performance chart below offers a snapshot of global stock market performance, as measured by the MSCI All Country World Index. Actual headlines from publications around the world are featured. Again, these headlines are just a sample of events during the year.

World Stock Market Performance

MSCI All Country World Index with Selected Headlines and Events from 2011



Source: MSCI.

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Throughout the year, investors could find a host of reasons to avoid stocks and wait for more positive news before returning to the market. As these select headlines suggest, determining the right time to invest is a difficult task since the market anticipates news and quickly factors in new information.

The Year in Review

In 2011, global diversification proved as important as ever. Although diversification may not have prevented losses, investors with broadly diversified portfolios were better equipped to endure the uncertainty. Major themes during the year included:

European Debt Problems

The sovereign debt crisis intensified as European authorities struggled to avert a Greek debt default and alleviate fiscal pressures in Italy and France. But these restructuring attempts fell short of market expectations, which spooked investors and raised concerns of additional sovereign debt downgrades and a possible breakup of the Eurozone. The crisis also hurt European banks holding large positions in sovereign debt. To avoid losses, leading institutions reduced lending and dumped assets, which depressed asset values.



Higher borrowing costs in the most indebted countries, combined with reduced government spending and revenues, raised more concerns that the Eurozone was entering a recession in late 2011.

Economic Uncertainty

Since the global financial crisis in 2008, central banks and governments have taken bold measures to fuel business activity and stabilize financial markets—and investors have eagerly awaited signs that economic recovery has taken hold. The economic signals continued to be mixed in 2011. Favorable US news included strong corporate profits and dividends, substantial levels of cash on corporate balance sheets, low interest rates and inflation, a booming domestic energy sector, continuing strength in auto sales, record-high share prices for some multinationals, and improved fourth-quarter numbers in manufacturing, exports, consumer confidence, and employment. Pessimists could point to the longstanding jobless trend, slumping home prices, tepid growth in retail sales, worrisome levels of government debt, and political gridlock at both the national and state levels.

Although emerging economies showed resilience, investors were concerned that another recession in Europe would impact its trading partners in emerging economies—and particularly in China, where high inflation and a manufacturing slowdown threatened to send its previously fast-growing economy into recession.

Rising Volatility

Investors in US equities had to endure a heavy dose of uncertainty for their moderate gains. The S&P 500 Index reflected this volatility by closing up or down over 2% on thirty-five days in 2011, compared to twenty-two days in 2010. By contrast, before the global financial crisis, the index did not have a single day with a 2% or more movement in 2005, and only two days in 2006.

Market observers also documented higher correlations among individual stocks and between asset classes. In 2011, there were sixty-nine days in which 90% of the S&P 500 stocks moved in the same direction, which is more than the combined total for 2008 and 2009. Higher correlations are common during periods of uncertainty, as macroeconomic forces overshadow the impact of a company's business fundamentals on its stock price.

Falling Commodity Prices

In early 2011, commodities soared with expectations of improving economic growth around the world. Copper, cotton, and corn hit all-time highs in the first half of the year. Crude oil experienced double-digit returns in response to anticipated higher demand and threats of supply disruptions tied to political unrest in the Middle East. The Dow Jones-UBS Commodity Index peaked in April, and then fell 20% as the global economic outlook faded. The index returned -13% for the year—its first negative return since 2008. The most notable exception was gold, which set more records in 2011 and peaked at \$1,888.70 per ounce in August before declining in the fourth quarter to return about 10% for the year.

Investor Risk Aversion

The fragile world economy made markets particularly vulnerable to shifting investor sentiment. During the year, investors reacted to uncertainty by moving to asset classes they deemed more stable, including large cap stocks and government bonds. Despite the Standard & Poor's downgrade of the US credit rating in early August, investors fled to US government securities as concerns mounted over the sovereign debt crisis in Europe and political stalemate over the US debt ceiling.

2011 Investment Overview

Most global equity investors experienced negative returns in 2011. After a strong first-quarter start, developed equity markets grew more volatile in response to discouraging news on the economy and sovereign debt crisis. Despite a brief rebound in July and during the fourth quarter, most equity markets logged negative performance for the year.

The US stock market was one of the few developed markets to experience positive returns. The S&P 500 logged a 2.11% gain (dividends reinvested), and the Russell 3000 returned 1.03% for the year. Despite strong returns in the fourth quarter, developed and emerging markets logged negative returns, with forty of the forty-five countries that MSCI tracks posting losses. The MSCI World ex USA Index returned -12.2% and the MSCI Emerging Markets Index returned -18.4% for the year. Ireland and New Zealand were the only developed markets besides the US to end the year in positive territory, and Greece was by far the worst performer. Indonesia and Malaysia were the only emerging markets that ended the year with positive returns, and Egypt was the worst performer.

The US dollar fluctuated but finished about 3% above where it started against most developed-market currencies. It sharply appreciated against the main emerging market currencies, especially against the Indian rupee and the

Major World Indices

US Equity Returns

As of December 31, 2011	Return (%)		
	Fourth Quarter	One Year	Three Years*
Index			
Russell 3000	12.12	1.03	14.88
Russell 2500	14.52	-2.51	18.41
Russell 2000	15.47	-4.18	15.63
Russell 2000 Value	15.97	-5.50	12.36
Russell 2000 Growth	14.99	-2.91	19.00
Russell 1000	11.84	1.50	14.81
Russell 1000 Value	13.11	0.39	11.55
Russell 1000 Growth	10.61	2.64	18.02
S&P 500	11.82	2.11	14.11

Non-US Equity Returns

As of December 31, 2011	Return (%)		
	Fourth Quarter	One Year	Three Years*
Index			
MSCI EAFE Small Cap	-0.56	-15.94	14.62
MSCI World ex USA Small Cap	0.69	-15.81	16.50
MSCI EAFE	3.33	-12.14	7.65
MSCI World ex USA	3.51	-12.21	8.53
MSCI EAFE Value	2.74	-12.17	6.77
MSCI EAFE Growth	3.92	-12.11	8.47
MSCI Emerging Markets	4.42	-18.42	20.07
MSCI Emerging Markets Small	-0.66	-27.18	25.57

Fixed Income Returns

As of December 31, 2011	Return (%)		
	Fourth Quarter	One Year	Three Years*
BofA Merrill Lynch Three-Month US T-Bill	0.00	0.10	0.14
BofA Merrill Lynch One-Year US Treasury Note	0.09	0.57	0.73
Citigroup World Government Bond 1-3 Years (hedged)	0.34	1.43	1.61
Barclays Capital US Government Bond	0.84	9.02	4.01
BofA Merrill Lynch 1-5 Year US Treasury and Agency	0.40	3.19	2.52
Citigroup World Government Bond 1-5 Years (hedged)	0.42	2.31	2.20
Barclays Capital US TIPS	2.69	13.56	10.38

Real Estate Returns

As of December 31, 2011	Return (%)		
	Fourth Quarter	One Year	Three Years*
Dow Jones US Select REIT	15.36	9.37	21.63
S&P Global ex US REIT	1.14	-8.61	13.86

*Annualized

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Brazilian real. This relative strength negatively impacted dollar-denominated returns of emerging market equities. The euro remained stable during the year even as analysts began predicting the dissolution of the currency zone, and the Japanese yen and the Australian dollar both gained against the US dollar.

Along the size dimension, large caps outperformed small caps in the US, non-US developed, and emerging markets. Value stocks underperformed growth stocks in the US, but mostly outperformed growth among emerging markets and had mixed results in developed markets.

In the fixed income arena, US intermediate-term government securities and TIPS performed exceptionally well, returning over 9.4% and 13.5%, respectively. Real estate securities in the US had strong positive returns and excellent performance relative to other US asset classes; in other developed markets, REITs had sharply negative returns but still managed to have good performance relative to other asset classes.

Embracing Imperfection

New Year's resolutions often involve making promises to ourselves we can never keep. But instead of tilting at windmills, we can often generate better results by merely resolving to be less dumb in certain areas. And money is a good place to start.

One human tendency is to judge the effectiveness of our retirement savings strategies by looking at performances on one-, two-, or three-year horizons. We do this because we are wired to be more sensitive to short-term losses than to long-term gains.

This is why much of the financial services industry and media encourage a short-term focus for an audience with a long-term horizon. This is akin to looking through the wrong end of a telescope. The thing you should be focusing on looks even farther away.

The result of this short-term mindset is that investors end up following the herd and seeking safety when opportunities are plentiful and seeking risk when opportunities are few. The less dumb thing is to maintain a level of discipline amid the noise.

Another human tendency—and one allied to our built-in loss aversion—is to be suckers for the supposedly "free" or discounted offer. Like Homer Simpson, a zero price tag makes us fall for pitches selling us stuff that is neither necessary nor good for us.

In the world of investment, it's this tendency that makes people gravitate to strategies that headline high returns without mentioning the risk, or that conveniently bury fees, commissions, and other costs. Regret lies on the other side of those decisions.

A less dumb thing is to focus on return *and* risk. They're related. Focusing exclusively on return can lead to rude awakenings when risk shows up. Focusing exclusively on risk can lead to disappointment when returns are delivered.



A third tendency among humans is to succumb to what behavioral scientists call "hindsight bias." Essentially, this is our habit of viewing events as more predictable than they really were. Call it the "I saw it coming" syndrome.

There is a fair bit of this around at the moment, with plenty of "experts" saying the sovereign risk crisis was completely predictable. This is strange because the overwhelming consensus among institutional investors a year ago was that fixed income would underperform in 2011. The crisis may have been predictable, but the market reaction wasn't.

The consequence of hindsight bias for investors is they tend to be forever rewriting history and forever seeking to interpret performance based on what they know *now* rather than what they knew a year or more before.

A less dumb thing is to accept there will always be a level of uncertainty. The future is unknowable. And all we can do as investors is to ensure the risks we take are related to an expected return, that we diversify around those risks as much as possible, and that we exercise a level of discipline amid the noise.

It's a way of embracing your imperfection, and it's a New Year's resolution you have a chance of sticking to.

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