Bell Investment Advisors, Inc.

TheOpeningBell

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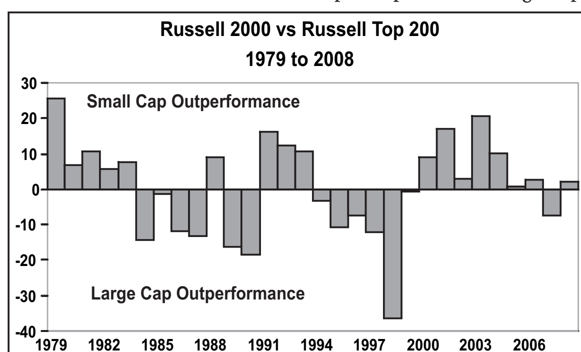
A Winning Disposition

Last month we produced a webinar that explained how our momentum-based strategy, ACTIVE PORTFOLIO ENHANCEMENT®, works. Along with a step-by-step demonstration of the methodology, we also illustrated why our strategy has been so successful since its inception in 1991. The presentation included the adjacent graph, which shows the degree of out-performance of small-caps (Russell 2000) versus large-caps (Russell Top 200) in every calendar year from 1979 to 2008. When the bar is above the zero line, small caps outperformed large-caps in that year; conversely, when the bar is below the zero line, large-caps outperformed small-caps. The height (or depth) of the line represents the degree of outperformance. As you can see, the bars tend to bunch together, meaning that the prevailing trend of small-cap or large-cap outperformance often lasts years at a time. The same is true for investment styles, sectors, and geographic regions. This is one reason why momentum-based investment strategies like ours work—winning investments tend to keep winning for extended periods of time. (To view a recorded version of the webinar, please visit bellinvest.com/webvideo.html.)



Because we like to keep our webinars to a pithy 30 minutes, we did not have time to explore the reasons behind the reason for the success of momentum-based investment strategies. Why does the market move in trends? And why do winning investments continue to win?

Certainly there are many reasons. In fact, there is a plethora of academic research available that attempts to explain the phenomenon we refer to as momentum. Unfortunately, this article does not afford us enough space to uncover every possible explanation, but we will use our remaining words to share one reason that we believe is a significant factor in producing the market's inherent momentum.

In 1985, two pioneers in the nascent field of behavioral finance, Meir Statman and Hersh Shefrin, hypothesized that investors have the tendency to sell winning investments too soon and hold losing investments too long. They based their belief on the emotional feelings caused by selling a stock at a gain versus at a loss—selling a stock at a gain results in positive feelings while selling a stock at a loss causes negative feelings. Because we humans want to feel good about ourselves, Statman and Shefrin theorized that investors would be quick to sell a winning investment to lock in the gain (and perhaps more importantly the accompanying feeling of success), and at the same time, they would be hesitant to sell a stock at a loss to avoid a feeling of failure *and* in the hope that the stock would recover its losses and become an eventual winner. They coined the term "disposition effect" to explain this behavior.

What Statman and Shefrin knew theoretically in 1985 was proven empirically 13 years later by Terrence Odean, a finance professor at U.C. Berkeley. Odean studied the trading patterns in 10,000 retail brokerage accounts and found that investors were, on average, 50% more likely to sell a winning investment than a losing investment.

In an efficient market, investors should quickly recognize the top-performing companies (the winners) and buy them; at the same time, they should recognize the poor-performing companies (the losers) and sell them. But because of the disposition effect, this recognition process does not occur in a timely or efficient manner. In fact, the tendency of investors to sell winners and hold losers creates, in effect, a headwind that delays a stock from reaching its intrinsic value.

Take for example a company that announces surprisingly strong earnings. In response to the good news, the stock goes up. As a result of the stock going up, many investors sell to lock in their gain and a feeling of success. The selling pressure pushes the stock back down and creates a deviation between the market price and the stock's intrinsic value based on the company's higher level of earnings. Because the stock is undervalued relative to the company's improved prospects, it is set up to outperform going forward.

At the other end of the spectrum, consider a company that announces surprisingly bad earnings. In response to the news, the stock goes down, but there are many investors who refuse to sell their stock despite the bad news because they don't want to realize a loss and live with the negative feelings that accompany it. As a result, there is inadequate selling pressure to bring the stock price in line with its new intrinsic value given the company's deteriorating performance. The stock remains overvalued and is set up for a period of underperformance.

In both examples, it takes time for the market to overcome the disposition effect so that the stock price can catch up with the company's changed fundamentals. This is why, in part, momentum can often last years at a time.

The disposition effect is simply one theory for why momentum investing works. It may be the main reason; it may not be. And surely there are other factors. Momentum has suffered from a lack of acceptance in the investment industry because it is not totally clear, despite numerous studies, why it exists. It is often dismissed as an anomaly. However studies have shown momentum's presence in asset markets as early as the 1800s—not surprising considering that although markets were quite different back then, humans, with all of their idiosyncrasies, were still doing the investing. Just because momentum's existence can't be precisely explained doesn't mean we should avoid using it for our benefit. ■

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Account Performance Report through September 30, 2009

Since 1999 we have calculated the average and median returns of our clients' accounts. These performance figures are derived from actual accounts managed by Bell Investment Advisors. Here is a quick look at the latest results:

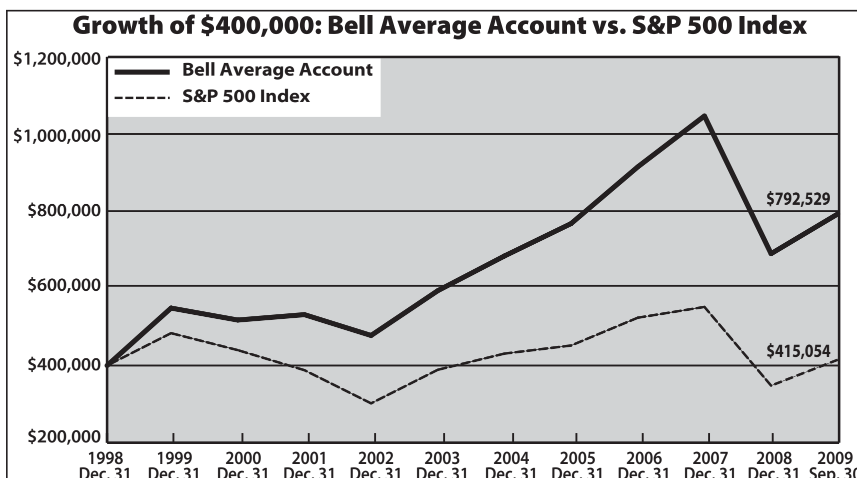
Matthew P. King, CFA

	2009	January 1999 to September 2009	
Index	**Year-to-Date**	**Total Return**	**Annualized Return**
Bell Average Account (1)	14.9%	98.1%	6.6%
Bell Median Account (1)	15.3%	96.7%	6.5%
Dow Jones Industrial Average (2)	13.5%	33.9%	2.8%
S&P 500 Index (2)	19.3%	3.8%	0.3%
Nasdaq Composite (2)	34.6%	–3.2%	–0.3%
Russell 2000 Small Cap Index (2)	22.4%	64.9%	4.8%
MSCI EAFE Index (2)	29.6%	45.7%	3.6%

This table compares our average and median account performance compared to five of the major market indices. While you cannot invest directly in any of the indices listed above, it is interesting to note that the most popular index, the S&P 500—with almost $1 trillion indexed to it—gained just 3.8% since the start of 1999.

Meanwhile, our Active Portfolio Enhancement® methodology has nearly doubled our clients assets since 1999. Our advantage lies in our proactive, momentum-based approach versus the passive strategy of tracking a particular market index.

When you compare performance results, it is important to make note of what is, and is not, included in the stated returns. Our returns are reported net of all management fees, mutual fund expenses, and trading costs. Here, the bottom line is the bottom line.



You have seen our performance in terms of percentage return. Here is how our average account performance since 1999 compares to the S&P 500 Index in dollars and cents. The graph above shows the growth of a hypothetical $400,000 investment made in January 1999. ■

Notes: (1) These accounts include the effects of Bell's management fee, mutual fund expenses, Schwab transaction fees, short-term redemption fees, and cash holdings. (2) These returns do not include the effects of the items described in Note 1.

Disclosures:

Past performance is no guarantee of future results. Future returns may differ significantly due to materially different economic and market conditions. Returns assume the reinvestment of dividends and capital gain distributions. These investments involve risk and the possibility of loss—including principal. Mention of a security in this newsletter should not be taken as advice to buy or sell that security.

In regard to the Bell Average Account, the term "average" is defined as a simple average—not a weighted average. Only fee-paying clients who fully employ our Active Portfolio Enhancement strategy are included in the return calculation. Client accounts that hold individual securities or funds not recommended by Bell; employ fixed income, hedging, cash reserve, market timing, socially responsible, or any other strategy not representative of Active Portfolio Enhancement; or maintain cash allocations greater than ten percent of the portfolio are not included in the calculation. We believe that removing these accounts improves the stated results as Active Portfolio Enhancement has traditionally been our most successful strategy. Additionally, only client accounts that were managed for the full calendar year are included in that year's return calculation. Accounts opened mid-year are not included in that specific year's reported results. We do not believe this policy has any material effect on the stated results.

The "Growth of $400,000" graph represents a hypothetical investment of $400,000 made at the end of trading on December 31, 1998, and is based on the returns produced by the average Bell account and the S&P 500 Index, neither of which can be invested in directly.

The S&P 500 Index is an unmanaged, market-cap weighted index of large-cap stocks commonly used to represent the U.S. stock market. More information can be found at www.standardandpoors.com. The Dow Jones Industrial Average is an unmanaged, price-weighted index of 30 large-cap stocks. More information can be found at www.dowjones.com. The Nasdaq Composite is an unmanaged, market-cap weighted index of all-cap stocks listed on the Nasdaq Stock Market. More information can be found at www.nasdaq.com. The Russell 2000 Index is an unmanaged, market-cap weighted index of small-cap stocks. More information can be found at www.russell.com. The MSCI EAFE Index is an unmanaged, unhedged, market-cap weighted index of foreign stocks commonly used to represent developed stock markets outside the United States. More information can be found at www.mscibarra.com. None of these indices can be invested in directly. The composition and volatility of Bell's client accounts vary and may significantly deviate from these indices over time. ■

MAKING A GOOD LIFE HAPPEN℠

Are You on Track? by Bonnie Bell, MA, M.Div., Career & Life Coach

Change is definitely in the air—and I don't just mean the colder nights and crispy leaves. As our part of the earth turns toward winter, people seem to be coming to life. It's as if the gloom of the post-market collapse is beginning to lift.

Whatever your mood or situation is, Fall is the perfect time to reflect, assess, and develop a plan of action for the new year. It is possible to get back on track or possibly get on track for the first time—with your career, your finances and your life.

How to begin? Here are some important questions to consider. As you reflect on each question, take notes on what comes to mind. Capture your thinking in brief bullet points, like on a resume. When you're all done, see what your own reflection tells you about how to move forward.

1) What's working? You know what is working in your life, but you may not be paying attention. Divide the various areas of your life into categories such as friends, family, finances, career, etc. You want to always keep and expand what's already working.

2) What's not working? You know what's not working in your life, as well, but you might not be doing anything about it. There is always something you can do: get rid of it, modify it, get help with it, overcome it.

3) What's missing? This can range from the specific, e.g., wanting more contact with a particular friend, to the grand, e.g., music, meaning, or purpose. What's missing tells you what to add to your plan of action.

4) What now? This is the situational question that locates you in time and dictates to some degree what is possible. What is possible *now that I have a baby . . . now that the kids are in school . . . now that I'm 50 and thinking more seriously about retirement.*

5) What else? This is about the rest of who you are: what you love to do, what you are good at, what your gifts and talents are, what you care about, and—most importantly—what you want in your life now and in the future.

Once you have reflected on and captured your thinking in response to these questions, let them tell you what to do. Develop a written, sequential plan of action and get moving. Being in action that moves you closer to your goals is almost as satisfying as getting there.

You cannot sit on the sidelines and hope it will all work out. You can reflect, plan, and take effective action to make a good life happen.

Call me or email me if you hit any snags; or if you 'd like to learn more about career coaching, life planning, or the Making a Good Life Happen package.

Bonnie Bell, MA, M.Div.

The Ultimate Retirement Question: How Much is Enough? by Jim Bell, CFP®

People often ask us: "How much do I need to be able to retire?" Of course the answer is very personal and depends on the person asking.

What are your goals for retirement income?

This is a difficult question for most people because they do not know how to think about it and work through it. I start by asking them about the quality of their lives, not the quantity. What are the most important qualities you want to produce in retirement? Is it time with the grandchildren? Travel? Living in a specific location? And, in the context of this world wide asset devaluation, the appropriate question has become: "What is an acceptable retirement?" Is one trip per year acceptable instead of two? Is the second home, the vacation home, an absolute priority, or is one home enough? Is it acceptable to work until age 66 instead of retiring at 60?

The rule of 20 times

If your pre-tax retirement income goal is $200,000 per year, 20 times $200,000 is $4 million, which is what you will need at a minimum to sustain $200,000 in annual income. The rule of 20 times is based on the rule of 5%, which is the maximum annual withdrawal rate that we say is prudent and sustainable from an actively-managed, growth-oriented portfolio using a momentum strategy. Prudent and sustainable indicate that your money will last longer than you will. We cannot and do not promise or guarantee that a 5% annual withdrawal is prudent and sustainable; we assert from our years of experience that it is *probable* that it will be.

What about Social Security?

If you are eligible for Social Security or other pension income, then you can use it to adjust the 20 times calculation. If a married couple were to receive $50,000 per year in full Social Security benefits, then this would take care of 25% of their $200,000 annual retirement income goal. Now the $200,000 can be adjusted to $150,000 times 20 equals $3 million, which is the answer to how much is enough, at a minimum, for this couple to retire.

Many people are extremely skeptical about the reliability of Social Security income. We believe the system could be repaired by notifying workers under 40 years old that the age at which benefits begin will be increased. Currently early retirement benefits start at age 62, and the full retirement benefits start at age 66 or 67; we think eventually full retirement Social Security benefits will begin at age 70, and this makes perfect sense. Your probability of living beyond age 90 increases every day. Many people are living more years in retirement than they worked in their careers, and some of our clients report that they would have worked longer had they known they would live so long.

How much is enough for cash reserves?

This is a fundamental financial planning question, and like

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everything else, the current thinking about it has been influenced by the global economic reset of 2008/2009. Before the market downturn last year, financial planners used a rule of thumb that everyone should have six months of living expenses in safe and liquid cash reserves. Safe, in this context, means cash reserves in an FDIC-insured checking/savings account or in a money market fund, which is not FDIC-insured but very safe. Liquid means that the money can be easily accessed at any time with no fees or penalties.

James F. Bell, CFP®

Job insecurity

Now that job insecurity is on the rise, six months' living expenses may not be enough for some folks, meaning that these people should look to accumulate a year or more of cash reserves. Before the real estate collapse, many people thought of their home equity line of credit (HELOC) as their emergency fund. With the disappearance of so much home equity and with much higher standards for home equity loans, this strategy has been compromised. Many banks have taken the customer unfriendly move of cutting or eliminating HELOC agreements without notice. Some investors with brokerage accounts also thought of the margin borrowing power in their brokerage accounts as another source of emergency cash reserves, but stock market declines in excess of 40% proved this strategy as flawed.

Cash is king.

Cash is king because the holders of cash are in control of their situation—unlike borrowers who do not control their bank loan officers and investors who do not control stock market values. In 2008 we learned that two years of living expenses is ideal for retired clients who no longer earn income from work and who depend mostly on their investment portfolios for income. When the market began dropping, investors who had significant cash reserves did not have to worry about their financial needs. Their reserve funds helped them to stick with their investment strategy so they were not forced to sell into a declining market and could fully benefit from the stock market recovery that began on March 10, 2009.

What is the answer?

Individual financial situations vary, so we offer professional and fiduciary planning to design a customized retirement plan and cash reserves strategy that is right for you. We have observed that those with solid plans and adequate cash reserves have greater success as investors because the security they provide helps these investors resist appointing their emotions as their investment manager.

In this issue of the Opening Bell, we have addressed important issues relating to your quality of life: investment management, financial planning, and career and life planning, our primary areas of professional expertise. We believe they can all work together to enrich your life now and create the momentum you will need to produce a good life in the future. Please feel free to contact us to begin or continue the conversation about what we do and how we do it. ■

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