

Also inside:

- › *Your brain on investing*
- › *Have a conversation*

# Investor

Winter Q1 2012



During times of market uncertainty, investing can feel like a frustrating and frightening game of *“one step forward, two steps back.”*



It can be tempting to turn your back on your long-term investment plan, go down the risk spectrum and perhaps even flee the market altogether.

But if you follow this path, you could miss out on the potential market upswing because timing it is very difficult—and history has shown that when turnarounds come, they have happened fast.

**Patient, disciplined investors tracking progress toward their long-term goals one step at a time have been rewarded in the past. At Russell, we believe it's no different this time.**

Every year, there are events that could lure investors into giving up—on the markets, on their plan, on their goals. 2011 was no exception. Imagine if someone had made the following predictions on New Year's Eve in 2010:

- › Three months into the year, one of the largest economies of the world will shut down because of an earthquake, a tsunami and a nuclear reactor disaster;
- › In the spring, conflicts in the Middle East will result in oil supply shocks, price spikes and further instability in the region;
- › In the summer, the U.S., still suffering from slow economic growth, high unemployment and a weak housing market, will be within 24 hours of defaulting on its

debt and will gratefully settle for a debt downgrade by one of the most influential rating agencies;

- › Europe will be even more uncertain than it was in 2010, several heads of state will lose their posts and several countries will be on the brink of default;
- › Over the summer, market volatility, as measured by the VIX, will increase to ranges recalling the fall of 2008<sup>1</sup>.

You might have expected that such an epic journey could have only one destination: financial meltdown.

You might be surprised, then, to learn that the plot has a twist: **Market volatility has made things feel worse than they've actually been.** The U.S. equity market<sup>2</sup> hasn't declined as much as you might have thought it would. What's more, a hypothetical diversified index portfolio held up better than you might have assumed it would and did so with less volatility than the overall U.S. equity market.

Indeed, if you had invested \$100,000 in a hypothetical balanced index portfolio<sup>3</sup> on New Year's Eve of 2010, your portfolio would have been worth \$100,346 by the end of November 2011. Admittedly, your portfolio would have gained only 0.4% in that 11-month period. But, the broad U.S. market<sup>4</sup> returned only 0.2%, the broad global market<sup>5</sup> lost -12.9% and the fixed income market<sup>6</sup> gained 6.7%. So, the combination of U.S. equity, international equity and fixed income would have helped to soften the extreme market movements.

With this context, you might be lamenting, "But if only I'd had more fixed income, I would have done better." Let's remember, though, that fixed income didn't look attractive to many investors at the start of the year because of low interest rates and the municipal bond doomsday stories that were all over the financial news<sup>7</sup>.

**For those of us who don't have a crystal ball to predict the future, a diversified portfolio can help provide a sensible way forward<sup>8</sup>. ■**

<sup>1</sup>The CBOE VIX (Chicago Board Options Exchange Volatility Index) measures annualized implied volatility as conveyed by S&P 500 stock index option prices.

<sup>2</sup>Represented by Russell 3000<sup>®</sup> Index.

<sup>3</sup>Represented by 40% Russell 3000 Index (proxy for U.S. equities), 20% Russell Global ex-U.S. Index (proxy for international equities) and 40% Barclays Capital U.S. Aggregate Bond Index (proxy for fixed income). Please see disclosures for index definitions. Indexes are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance and are not indicative of any specific investment.

<sup>4</sup>Represented by Russell 3000 Index.

<sup>5</sup>Represented by Russell Global ex-U.S. Index.

<sup>6</sup>Represented by Barclays Capital U.S. Aggregate Bond Index.

<sup>7</sup>Abelson, Max and Michael McDonald, "Whitney Municipal-Bond Apocalypse Short on Specifics," Bloomberg, February 1, 2011.

<sup>8</sup>Diversification and strategic asset allocation do not assure profit or protect against loss in declining markets.

# Your brain on investing.

## Your instincts can be a powerful force for survival. But when it comes to managing money, intuition isn't always on your side.

Why is that? Because your intuition is driven by one of the most complex biological structures known to man: the brain. Unfortunately, human brains are hardwired in ways that can make it hard for us to make good—as in logical, consistent—financial decisions. For instance, our brains are hardwired to:

- › flee danger<sup>9</sup>—we do more of what appears to improve our odds for survival and avoid what feels risky;
- › remember highs and lows rather than the total experience<sup>10</sup>. Think about the past year. You most likely remember the happiest and saddest moments, but you probably don't recall each day of the year;
- › strongly prefer avoiding losses compared to acquiring gains<sup>11</sup>—we feel the pain of losing money twice as much as we feel the joy of gaining the same amount of money.

As a result, faced with extremely volatile markets (*the highs and lows*), many investors make quick decisions to move their money out of the markets (*flee danger*) or stop contributing to their retirement plans (*avoid further loss*). We aren't being irrational. We're just being human.

But, these human reactions can have a long-term impact on our portfolio: they risk jeopardizing our ability to reach our financial goals. It's precisely the stock market's inherent risk that offers the possibility of financial rewards, including the potential for higher returns compared to other major asset classes, such as bonds and cash. Without that risk, there can be no reward: they're two sides of a coin.

So, what matters most is not how we *feel* about investing, but rather how we can make use of the markets, in both volatile times and calmer times, to accomplish one of our most important goals of all: not outliving our nest egg. Intuition has its place. But when it comes to our portfolios, intuition should be secondary to facts and fundamentals. ■

## Have a conversation.

*For many of us, investing is not necessarily something we like to do. It's a means to an end, a long-term program designed to increase the chances of outpacing inflation and enjoying the quality of life we dream of when we retire. It can be a frustrating journey—but you don't need to go it alone. Talk to your advisor about your concerns. As you think about your investment portfolio, consider asking your financial advisor:*

- › *Are my investments positioned to support the standard of living I'm envisioning in retirement?*
- › *Does my portfolio need to be rebalanced to my optimal asset allocation mix?*
- › *Should I be worried about outliving my money?* ■

<sup>9</sup>Shefrin, Hersch. *Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing*, (Harvard Business School Press: Boston, MA, 1999).

<sup>10</sup>Kahneman, Daniel and Tversky, Amos, eds. *Choices, Values, and Frames*. (Cambridge University Press and the Russell Sage Foundation: New York, 2000), chapter 38.

<sup>11</sup>Kahneman and Tversky, Amos. "Prospect Theory: An Analysis of Decision under Risk", (*Econometrica*, Volume 47, Number 2), March 1979.



# Investor

---

**INVESTOR** is published quarterly by Russell Investments.

Please direct your comments or questions to your plan sponsor or financial professional.

[www.russell.com](http://www.russell.com)

## › About Russell

Russell Investments is known for its sophisticated research, rigorous analysis and unwavering focus on the long term. We've been in business since 1936 and help guide the investments of some of the world's largest companies, foundations and pension plans. We can do the same for you.

---

No investment strategy can guarantee a profit or protect against a loss.

These views are subject to change at any time based upon market or other conditions and are current as of the date at the top of the cover page.

The information, analysis and opinions expressed herein are for general information only. Nothing contained in these materials is intended to constitute legal, tax, securities, or investment advice, nor an opinion regarding the appropriateness of an investment, nor a solicitation of any type.

The general information contained in this publication should not be acted upon without obtaining specific legal, tax, and investment advice from a licensed professional.

The Russell logo is a trademark and service mark of Russell Investments. This material is proprietary and may not be reproduced, transferred, or distributed in any form without prior written permission from Russell Investments. It is delivered on an "as is" basis without warranty.

The Russell Global ex-U.S. Index measures the performance of the global equity market based on all investable equity securities, excluding companies assigned to the United States. The Russell Global ex-U.S. Index is constructed to provide a comprehensive and unbiased barometer for the global segment and is completely reconstituted annually to accurately reflect the changes in the market over time.

The Russell 3000<sup>®</sup> Index measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market. The Russell 3000<sup>®</sup> Index is constructed to provide a comprehensive, unbiased, and stable barometer of the broad market and is completely reconstituted annually to ensure new and growing equities are reflected.

The Barclays Capital U.S. Aggregate Index is an index with income reinvested, generally representative of intermediate-term government bonds, investment grade corporate debt securities, and mortgage-backed securities. (Specifically: Barclays Capital Government/Corporate Bond Index, the Asset-Backed Securities Index, and the Mortgage-Backed Securities Index.)

Russell Investment Group is a Washington, USA corporation, which operates through subsidiaries worldwide, including Russell Investments, and is a subsidiary of The Northwestern Mutual Life Insurance Company.

Copyright© Russell Investments 2011. All rights reserved.

**Russell Financial Services, Inc., member FINRA, part of Russell Investments.**

First used January 2012.

RFS-7106

01-01-166 (1 01/12)