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# Long-Term Investing Trumps Market Timing

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With the senses constantly bombarded by seemingly rational stock market pitches for instant riches or by equally convincing warnings of impending doom, it is not easy to remove emotion from the investment process. But history shows that suppression of emotion can smooth travels on the road to potential long-term investment success.

Indeed, it takes a strong stomach to look beyond the ups and downs, the teeth gnashing and the hand-wringing that mar daily life on Wall Street. We seek shelter from the chaos in an investment philosophy that's built on a firm foundation of selection, diversification and patience.

That last bit—patience—is perhaps most crucial, especially when market winds shift against us. It can help to know that market moves over the long term have been more often favorable than not, a message that for the past three decades has floated Al Frank Asset Management above the market din.



**Al Frank**  
ASSET MANAGEMENT

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We understand that there are always scary things to worry about, but it is helpful to remember the advice of legendary investor Peter Lynch. Mr. Lynch, the former Portfolio Manager of the Fidelity Magellan Fund, had this to say in response to the tragic events of September 11, 2001: “Despite nine recessions, three wars, two Presidents shot (one died and one survived), one President resigned, one impeached, and the Cuban Missile Crisis, stocks have been a great place to be...The United States historically has had a perfect record when it comes to rebounding from the most difficult times. With those nine recessions, we’ve had nine recoveries...Since World War II...corporate earnings are up 63 fold and the stock market is up 71 fold. Corporate profits have grown over 9 percent annually despite the down years.”

“The sign of an intelligent people is their ability to control emotions by the application of reason.”

—Mayra Mannes

Similar words of wisdom from our founder Al Frank, written on October 1, 2001, are as follows: “I cannot live in fear of the next terrorist attack or of the bottom dropping out of the market. My attitude is not a question of being optimistic or indifferent, it is based on history and probability as I see it. There will probably be more terrorist attacks, and although many of them will be thwarted, some will happen. Even so, we will have to adjust and live as normally as possible (albeit a new norm). The stock markets are part of the fabric of our free enterprise system. They will be around and functioning for a long time, I believe.”

If we somehow had advance knowledge of the terrorist attacks, the natural reaction might have been to liquidate our equity portfolios, but our real-world experience illustrates that this may not have been the right move. For example, though the Russell 2000 Index, comprised of small- and mid-cap stocks, was off 8.0 percent in the more than nine months through September 10, 2001, and fell an additional 14.0 percent by September 21 of that year, the index regained all of the ground lost after the attacks and then some. In fact, the index was higher by 11.4 percent at year’s end from the September 10 close, and recorded a 2.5 percent gain for the year.

I am not suggesting that we should simply ignore the threat of terrorism or that stocks will easily shrug off the next attack, but I do not believe that anyone can predict with any certainty the short-term direction of the financial markets. Indeed, in my research on Peter Lynch, I came across a couple of items that illustrate the folly of trying to time the market.

Some say it is a myth, but Mr. Lynch supposedly once said, “When I managed Fidelity’s Magellan Fund more people lost money investing in the fund than made money despite the fund’s exceptional performance. This is because a lot of people would always jump into the fund after a period of high returns and exit after experiencing a significant draw down.”

*Investor returns are calculated by Dalbar as the change in total mutual fund assets after excluding sales, redemptions, and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses, and any other costs.*

Whether or not the Lynch story is true, Dalbar’s annual Quantitative Analysis of Investor Behavior study is sobering. The financial-services research firm examined actual investor returns from and money inflows to and outflows from equity mutual funds in the 20 years ended December 31, 2007. Over those two decades, Dalbar found that the average equity fund investor would have earned an annualized return of just 4.48 percent, versus an average annualized return of 11.81 percent for the S&P 500. Of the data Dalbar concluded,

“Investment return is far more dependent on investor behavior than on fund performance. Mutual fund investors who hold their investments typically earn higher returns over time than those who time the market.”

Interestingly, the media have not been shy in trumpeting the dismal performance of the major market averages since the Tech Bubble burst in 2000, with the inference being that a good market timer would have been out of equities. Of course, some investors understand that a stealth bull market has been underway for the majority of stocks since the beginning of this decade.

In fact, the Russell Midcap Index and the Russell 2000 Index both set all-time highs in July 2007, illustrating our oft-stated admonition that it is a market of stocks and not a stock market. One should not overlook the fact that in the supposedly difficult year of 2001, when the Nasdaq Composite Index was off 21 percent and the NYSE Composite Index dropped 10 percent, more stocks advanced than declined. Incredibly, on the New York Stock Exchange, 2,370 stocks rose in 2001 while only 1,569 fell.

While most investors understand that equities have outperformed other investment classes such as bonds and government securities over the long term, few have bothered to actually study market history. Having investigated the data, we know that, historically, downturns always have been followed by market recoveries.

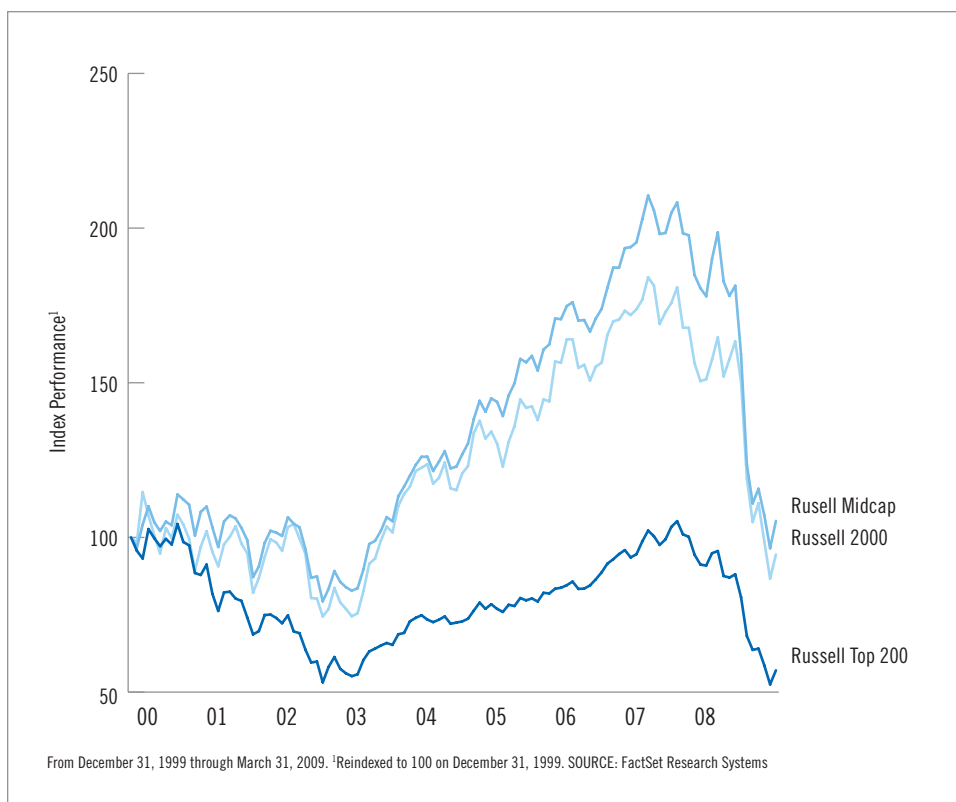


Figure 1:  
Small-stock performance

Since the turn of the century, smaller stocks have performed quite well, despite many suggesting investors avoid the equity markets.

A wonderful book called *Stocks, Bonds, Bills and Inflation* put out by research firm Morningstar should be on the desk of anyone who participates in the financial markets. It is a hefty investment, but it is chock full of facts and figures that support the case for long-term investing in undervalued equities.

Our review of the historical evidence begins with the effect of a hypothetical \$1 invested in 1925. As Figure 2 dramatically illustrates, a heck of a lot more money would have accumulated over the past 83 years in equities than in fixed income, with small-cap stocks outperforming large-caps. Of course, the appreciation on large-cap stocks is not exactly chopped liver! Figure 7 provides information on the construction of Morningstar’s data series.

Another way to view the long-term data is on an annualized return basis. In Figure 2, again, we see that equities, both large and small, have outperformed bonds and inflation over the long haul.

While it is obvious that stocks have offered the best returns, the natural question is which types of equities have enjoyed the greatest performance. Morningstar provides historical answers for that as well, which we detail in Figure 3. Using the ratio of book value to share price (higher = value and lower = growth) as the distinguishing factor, we see that common sense prevails, as fundamentally less expensive stocks have performed better. As Figure 3 shows, this phenomenon holds regardless of market capitalization, with large-value stocks actually outperforming small-growth companies.

Figure 2:  
Long-term performance

Over the past 82 years, small-cap stocks have greatly outperformed large-cap stocks, and their returns have vastly exceeded those of fixed-income investments. Figure 7 details the indices represented in this chart.

*This chart illustrates the performance of a hypothetical \$1 investment made in the indices noted on December 31, 1925. It assumes the reinvestment of dividends and capital gains. This chart does not imply any future performance.*



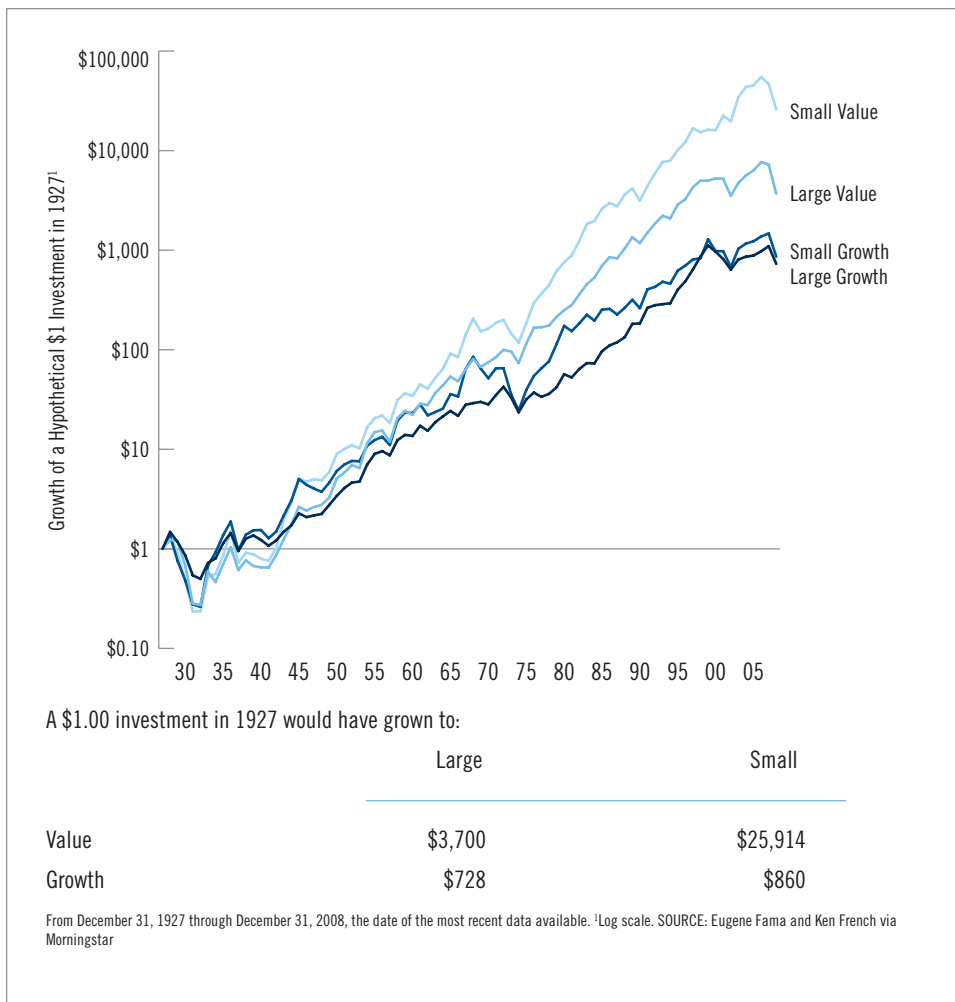


Figure 3:  
Value versus growth

Contrary to what the naming convention suggests, value stocks have outperformed growth stocks since 1927. Figure 7 details the indices used in the Fama-French study.

*This chart illustrates the performance of a hypothetical \$1 investment made in the indices noted on December 31, 1927. It assumes the reinvestment of dividends and capital gains. This chart does not imply any future performance.*

Believe it or not, some investors might actually be disappointed with 9 percent, 10 percent or even 12 percent per annum, as many enter the equity markets with a ‘get rich quick’ mentality. If you fall into this camp, we implore you to consider the miracle of compounding.

In 2004, Pablo Picasso’s ‘Boy with a Pipe’ fetched a record \$104 million at auction at Sotheby’s. Actually, the painting sold for \$93 million, but the auction house charged a commission of \$11 million. And you think your brokerage commissions are high! The painting was previously bought by John Hay and Betsey Whitney in 1950 for \$30,000. This fact caused breathless news anchors to shake their heads in amazement at the couple’s fantastic return on investment. While we recognize that very few have ever been able to parlay \$30,000 into \$93 million, the annualized compounded rate of return on ‘Boy with a Pipe’ over those 54 years was only 16.1 percent.

Figure 4 illustrates the wonders the passage of time can do for a nest-egg if the money is allowed to compound. At the 11.7 percent return that Morningstar estimated for large-cap stocks from December 31, 1950 through December 31, 2004, money would double every 6.2 years, allowing the potential to slowly grow wealth. Compare that to the 313 years ( $72 \div 0.55$ ) the ‘Rule of 72’ tells us that it’s going to take for money to double earning a money-market yield of 0.23 percent, a figure from iMoneyNet, Inc. reported by *The Wall Street Journal* as the average seven-day compound yield for taxable money-market funds on April 2, 2009.

Figure 4:  
Miracle of compounding

Investors shouldn't scoff at returns in the 10 percent to 12 percent annual range, as it doesn't take long to generate sizable sums at those rates. Figure 7 details the indices represented in this chart.

*This table illustrates the performance of a hypothetical \$30,000 investment made in the asset classes noted on December 31, 1950. It assumes the reinvestment of dividends and capital gains. This chart does not imply any future performance.*

	Inflation	LT <sup>1</sup> Corporate Bonds	Large Company Stocks	Small Company Stocks	Boy with a Pipe
Growth	3.8%	6.5%	11.7%	14.5%	16.1%
Dec. 31, 1950	\$30,000	\$30,000	\$30,000	\$30,000	\$30,000
Dec. 31, 1955	\$36,202	\$41,043	\$52,225	\$59,028	\$63,153
Dec. 31, 1960	\$43,686	\$56,151	\$90,916	\$116,144	\$132,944
Dec. 31, 1965	\$52,717	\$76,820	\$158,271	\$228,524	\$279,862
Dec. 31, 1970	\$63,615	\$105,098	\$275,526	\$449,644	\$589,140
Dec. 31, 1975	\$76,766	\$143,784	\$479,649	\$884,721	\$1,240,202
Dec. 31, 1980	\$92,636	\$196,711	\$834,995	\$1,740,777	\$2,610,758
Dec. 31, 1985	\$111,787	\$269,121	\$1,453,599	\$3,425,154	\$5,495,926
Dec. 31, 2004	\$228,301	\$885,516	\$11,949,075	\$44,837,418	\$93,000,000

<sup>1</sup>Long-term. SOURCE: Al Frank using data from Morningstar

At Al Frank we hold our stocks for the long term, a focus that starts with our individual stock valuations, which look out over 3-to-5-year time frames. While we are confident that the lengthy holding period enhances our long-term returns, we also believe that it reduces our risk. Figure 5 supports the merits of long-term investing. We reviewed data provided by Morningstar regarding the performance of large company stocks from December 31, 1925 through December 31, 2007 and found that the risk of losing money in any one year has been 29 percent. The risk of loss dropped to 14 percent if stocks were held for 5 years, 4 percent if they were held for 10 years and 0 percent if held for 20 years or more. Small company stocks have shown the same trend over the long haul, with an even slightly better batting average over 5-year periods, after a slightly weaker 1-year performance average.

Figure 5:  
Risk reduction

These data suggest that historically the risk of losing money investing in stocks has decreased over time. Figure 7 details the indices represented in this chart.

Holding Period	Number of Periods	Times Positive	Percent Positive	Historical Risk of Loss
<b>Large Company Stocks</b>				
1-Year Returns	83	59	71 percent	29 percent
5-Year Rolling Returns	79	68	86 percent	14 percent
10-Year Rolling Returns	74	71	96 percent	4 percent
20-Year Rolling Returns	64	64	100 percent	0 percent
<b>Small Company Stocks</b>				
1-Year Returns	83	57	69 percent	31 percent
5-Year Rolling Returns	79	69	87 percent	13 percent
10-Year Rolling Returns	74	72	97 percent	3 percent
20-Year Rolling Returns	64	64	100 percent	0 percent

From December 31, 1925 through December 31, 2008. Table is representative of the Standard & Poor's 500 Stock Composite Index. SOURCE: Morningstar

Don't think you've got 15 years to tend to your investments? Well, government actuaries might disagree as the latest numbers (it being the government, 2006 figures are the most recent) from the National Center for Health Statistics, shown in Figure 6, say that the average 65-year old American has another 19.0 years to live.

	All Races			White			Black		
	Both	Male	Female	Both	Male	Female	Both	Male	Female
At birth	78.1	75.4	80.7	78.5	76.0	81.0	73.6	70.0	76.9
At 65	19.0	17.4	20.3	19.0	17.5	20.3	17.6	15.5	19.1
At 75	12.2	10.9	13.0	12.1	10.9	13.0	11.7	10.2	12.6

SOURCE: From National Vital Statistics Reports. Expectation of life by age, race, and sex: United States, 2006. SOURCE: National Center for Health Statistics

Figure 6:  
Life expectancy

Living longer is great, but it also means our nest-eggs will have to support us for a longer time.

Let's close the loop by putting those nearly two decades into perspective. Historical data would suggest that the chances of losing money are low over those 19.0 years. Thinking more optimistically, and using basic math skills, \$10,000 invested today at an annualized compound rate of 9.6 percent, Morningstar's estimate of the long-term average return of large company stocks from December 31, 1925 through December 31, 2008, would grow to \$57,069 in 19.0 years. At 11.7 percent per year, Morningstar's estimate of the long-term average return of small company stocks from December 31, 1925 through December 31, 2008, the initial \$10,000 investment would soar to \$81,848 over that same time frame.

*This paragraph illustrates the performance of a hypothetical \$10,000 investment made in large company or small company stocks today. The rate assumes the reinvestment of dividends and capital gains. This paragraph does not imply any future performance.*

We know that no matter what the historical evidence supports, many investors will shun equities due to worries over the budget deficit, the weak U.S. dollar, high oil prices, slowing corporate profit growth, geopolitical uncertainty and/or the threat of rising interest rates. These are certainly serious concerns but they are no worse than what we have faced in the recent past. Reason tells us that equity investing is the way to go and that our value strategy works, therefore we won't be deflected by emotional headlines.

We survived Black Monday, Iraq I, the collapse of Long Term Capital Management, the Asian Contagion, Presidential Impeachment, The Tech Bubble, September 11, Accounting Scandals and Iraq II. Yes, we have not had to endure a 1973-74 Bear Market, but some view the 2000-02 period as something comparable.

Even more, our long-term track record is not the result of frenetic adaptation to constantly changing investment fads and fashions. Through the years, we have remained steadfast in our commitment to what we view as undervalued and out of favor stocks, and our holdings, on average, have consistently sported high market value-to-price ratios while also being smaller in terms of market capitalization. Indeed, relying on what has worked historically is the foundation of everything we do. Still, we must have learned a thing or two about stock selection over the years as well.

Figure 7:  
Morningstar asset class data series

Morningstar provides a long history of return data for a broad range of asset classes. Professors Eugene Fama and Ken French have calculated long-term returns for stocks by market capitalization and relative valuation.

### ASSET CLASS SERIES

Series	Definition
Large Company Stocks	The Standard & Poor's 500 Stock Composite Index.
Small Company Stocks	A portfolio of stocks representing the fifth capitalization quintile of stocks on the NYSE for 1926-1981. For January 1982 to March 2001, the series is represented by the Dimensional Fund Advisors (DFA) U.S. 9-10 Small Company Portfolio and the DFA U.S. Micro Cap Portfolio thereafter.
Long-Term Corporate Bonds	Citigroup long-term high-grade corporate bond total return index.
Long-Term Government Bonds	A one bond portfolio with a maturity near 20 years.
U.S. Treasury Bills	A one bond portfolio containing, at the beginning of each month, the bill having the shortest maturity not less than one month.

### FAMA-FRENCH SERIES

Inflation	The Consumer Price Index, not seasonally adjusted, prior to January 1978, after which the Consumer Price Index for All Urban Consumers was used.
FF Large Growth Stocks	A portfolio of stocks constructed by setting a book-to-market value ratio cutoff at the bottom 30 percent of NYSE stocks and a market capitalization cutoff at the median of NYSE stocks and selecting all NYSE, AMEX and Nasdaq stocks with a book-to-market value ratio lower than the book-to-market value cutoff and a market capitalization greater than the market capitalization cutoff.
FF Large Value Stocks	A portfolio of stocks constructed by setting a book-to-market value ratio cutoff at the top 30 percent of NYSE stocks and a market capitalization cutoff at the median of NYSE stocks and selecting all NYSE, AMEX and Nasdaq stocks with a book-to-market value ratio higher than the book-to-market value cutoff and a market capitalization greater than the market capitalization cutoff.
FF Small Growth Stocks	A portfolio of stocks constructed by setting a book-to-market value ratio cutoff at the bottom 30 percent of NYSE stocks and a market capitalization cutoff at the median of NYSE stocks and selecting all NYSE, AMEX and Nasdaq stocks with a book-to-market value ratio lower than the book-to-market value cutoff and a market capitalization smaller than the market capitalization cutoff.
FF Small Value Stocks	A portfolio of stocks constructed by setting a book-to-market value ratio cutoff at the top 30 percent of NYSE stocks and a market capitalization cutoff at the median of NYSE stocks and selecting all NYSE, AMEX and Nasdaq stocks with a book-to-market value ratio higher than the book-to-market value cutoff and a market capitalization smaller than the market capitalization cutoff.

SOURCE: Asset Class series from Morningstar; Fama-French series from Professors Eugene Fama and Ken French via Morningstar

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## Important Information

The Standard & Poor's 500 Stock Index is an unmanaged index generally representative of the U.S. Stock Market, without regard to company size. The Russell Top 200 Index is an unmanaged index generally representative of the largest 200 stocks in the Russell 1000 Index as ranked by total market capitalization. The Russell Mid-cap Index is an unmanaged index generally representative of the smallest 800 stocks in the Russell 1000 Index as ranked by total market capitalization. The Russell 2000 Index is an unmanaged index generally representative of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index.

Nasdaq Composite Index is a market-capitalization weighted index of the more than 3,000 common equities listed on the Nasdaq stock exchange. The types of securities in the index include American depositary receipts, common stocks, real estate investment trusts (REITs) and tracking stocks. The index includes all Nasdaq listed stocks that are not derivatives, preferred shares, funds, exchange-traded funds (ETFs) or debentures.

NYSE Composite Index measures all common stocks listed on the New York Stock Exchange and four subgroup indexes: industrial, transportation, utility and finance. The index tracks the change in the market value of NYSE common stocks, and is adjusted to eliminate the effects of new listings and delistings. The market value of each stock is calculated by multiplying its price per share by the number of shares listed.

Citigroup Long-Term High-Grade Corporate Bond Index (also known as Citigroup High-Grade Corporate Bond Index) is the corporate component of the Credit Index. It includes those issues from the Credit Index that have at least 10 years to maturity (long term) but excludes asset-backed securities and non-U.S. sovereign/provincial issues.

Indices are unmanaged and not available for direct investment.

Book-to-market value ratio—A ratio used to compare a stock's book value to its market value to its. It is calculated by dividing the stock by the latest quarter's book value per share by the current closing price.

*Al Frank Asset Management is committed to assisting our clients build wealth. We are a leading resource for value-based investor information in the financial community, where we combine our simple philosophy of buying securities that we believe are undervalued for their long-term capital appreciation. We use our experience, hard work and intensive research to give you actionable investment information that can be used by individual investors.*

*For information regarding managed accounts,  
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