Dimensional

OUTSIDE THE FLAGS

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Many Happy Returns

The holiday season and start of a new year encourage media retrospectives about financial markets. It's fun to match these up with what people were saying a year before.

In December 2011, *Barron's* told investors to "buckle up." The consensus prediction of its panel of 10 stock market strategists and investment managers was for the S&P 500 to end 2012 some 11.5% higher, at about 1,360.[1]

"That sounds like a big gain, but a lot of things have to go right for the market to make such impressive headway," the writer said. "Even the most bullish of these Street seers fears stocks could be more wobbly in the next six months than in the six months past."

There was so much for forecasters to get right—the negotiation of the euro zone crisis, uncertainties over the growth of earnings, the roadblock of the US presidential election, and the challenge for emerging economies to sustain high economic growth rates.

More than 12 months later, markets are still grappling with many of the same issues, though from different angles. Much of Europe is either in recession or growing only modestly, unemployment is high, and a number of countries that use the euro are unable to pay their debts. The US presidential election gave way to worries over the "fiscal cliff," while Chinese exports have been hit by the slowdown elsewhere.

In the meantime, however, there have been solid gains in many equity markets, including parts of Europe and Asia, as well as North America. That *Barron's* panel forecast of the S&P 500 reaching 1,360, which the magazine said was ambitious, turned out to be conservative. The index ended the year 13% higher, at 1,426. What's more, some of the strongest performances have been in emerging and frontier markets.

1. Vito J. Racanelli, "Buckle Up," *Barron's*, December 19, 2011.

The table below shows performances for 2012 (through December 31) and annualized returns for the past three years for 20 developed and 20 emerging markets, using MSCI country indices. Returns are ranked on a year-to-date basis and expressed in US dollars.

Among developed markets, three members of the 17-nation euro zone—Belgium, Germany, and Austria—were among the top 10 best-performing equity markets this year. Leading the way among emerging markets was Turkey, which regained its investment-grade ranking from agency Fitch in November.

While not one of the top performers, the US market still delivered positive returns in what many observers judged as a highly uncertain economic and political climate.

And while much of the media focus has been on the so-called BRIC emerging economies of Brazil, Russia, India, and China, the real stars in the emerging market space the past three years have been the Southeast Asian markets of the Philippines, Thailand, and Indonesia.

TOP PERFORMERS IN 2012

DEVELOPED MARKETS (USD)		
COUNTRY	YTD	3YR
Belgium	39.6%	7.5%
Denmark	31.3%	13.0%
Singapore	31.0%	9.5%
Germany	30.9%	5.2%
New Zealand	29.3%	13.9%
Hong Kong	28.3%	9.9%
Austria	25.9%	-4.2%
Australia	22.1%	7.6%
Sweden	22.0%	11.1%
France	21.3%	-1.1%
Netherlands	20.6%	2.5%
Switzerland	20.4%	7.8%
Norway	18.7%	5.8%
United States	15.3%	10.3%
United Kingdom	15.3%	6.9%
Finland	14.6%	-4.9%
Italy	12.5%	-9.8%
Canada	9.1%	4.7%
Japan	8.2%	2.3%
Greece	4.5%	-40.1%

EMERGING MARKETS (USD)		
COUNTRY	YTD	3YR
Turkey	64.2%	8.6%
Egypt	47.1%	-4.2%
Philippines	46.4%	24.8%
Poland	39.2%	3.9%
Colombia	35.9%	22.8%
Thailand	34.5%	26.8%
Pakistan	32.5%	14.1%
Mexico	29.1%	13.1%
India	26.0%	-1.4%
Hungary	22.8%	-9.7%
China	22.7%	1.6%
Korea	21.2%	10.6%
Peru	20.2%	13.2%
South Africa	18.7%	10.9%
Taiwan	16.7%	4.0%
Malaysia	14.3%	16.2%
Russia	13.7%	2.9%
Chile	7.8%	7.3%
Indonesia	4.6%	14.1%
Jordan	-0.6%	-8.5%

Source: MSCI country indices through December 31, 2012.

There are a few lessons here. First, while the ongoing news headlines can be worrying for many people, it's important to remember that markets are forward-looking and absorb information very quickly. By the time you read about it in the newspaper, the markets have usually gone on to worrying about something else.

Second, the economy and the market are different things. Bad or good economic news is important to stock prices only if it is different from the information that the market has already priced in.

Third, if you are going to invest via forecasts, you need to realize that it is not just about predicting what will happen around the globe, but it is also about predicting correctly how markets will react to those events. That's a tough challenge for the best of us.

Fourth, you can see there is variation in the market performance of different countries. That's not surprising given the differences in each market in sectoral composition, economic influences, and market dynamics. That variation provides the rationale for diversification—spreading your risk to smooth the performance of your portfolio.

So it's fine to take an interest in what is happening in the world. But care needs to be taken in extrapolating the headlines into your investment choices. It's far better to let the market do the worrying for you and diversify around risks you are willing to take.

In the meantime, many happy returns!

"Outside the Flags" began as a weekly web column on Dimensional Fund Advisors' website in 2006. The articles are designed to help fee-only advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying, and focusing on elements within the investor's control—including portfolio structure, fees, taxes, and discipline. Jim's flags metaphor has been taken up and recognized by Australia's corporate regulator in its own investor education program.