The US market rally extended in the second quarter, clocking in a 4.9% gain. Large stocks lead the way (+5.2%), and Small Growth brought up the rear (+1.7%). Once again US REIT's made big moves, up 7.2% for the quarter.

International developed markets had a similar quarter to the US with Large stocks leading Small stocks (4.6% vs 3.2%). Country specific leaders were Canada (+10.3%), Hong Kong (+7.2%), and Norway (+7.2%). Laggards were Ireland (-8.7%), Portugal (-5.2%), and Italy (-1.8%).

After being down a bit in Q1, emerging markets came back nicely, ticking off a 6.6% gain overall, with Value over Growth (7.0% vs. 6.2%) and Large companies over Small (6.6% vs 5.3%). Country specific winners were Turkey (+15.0%) and India (+14.8%). Losers for the quarter were Greece (-10.4%) and the UAE (-7.3%).

Q2

Quarterly Market Review

Second Quarter 2014

Market Summary

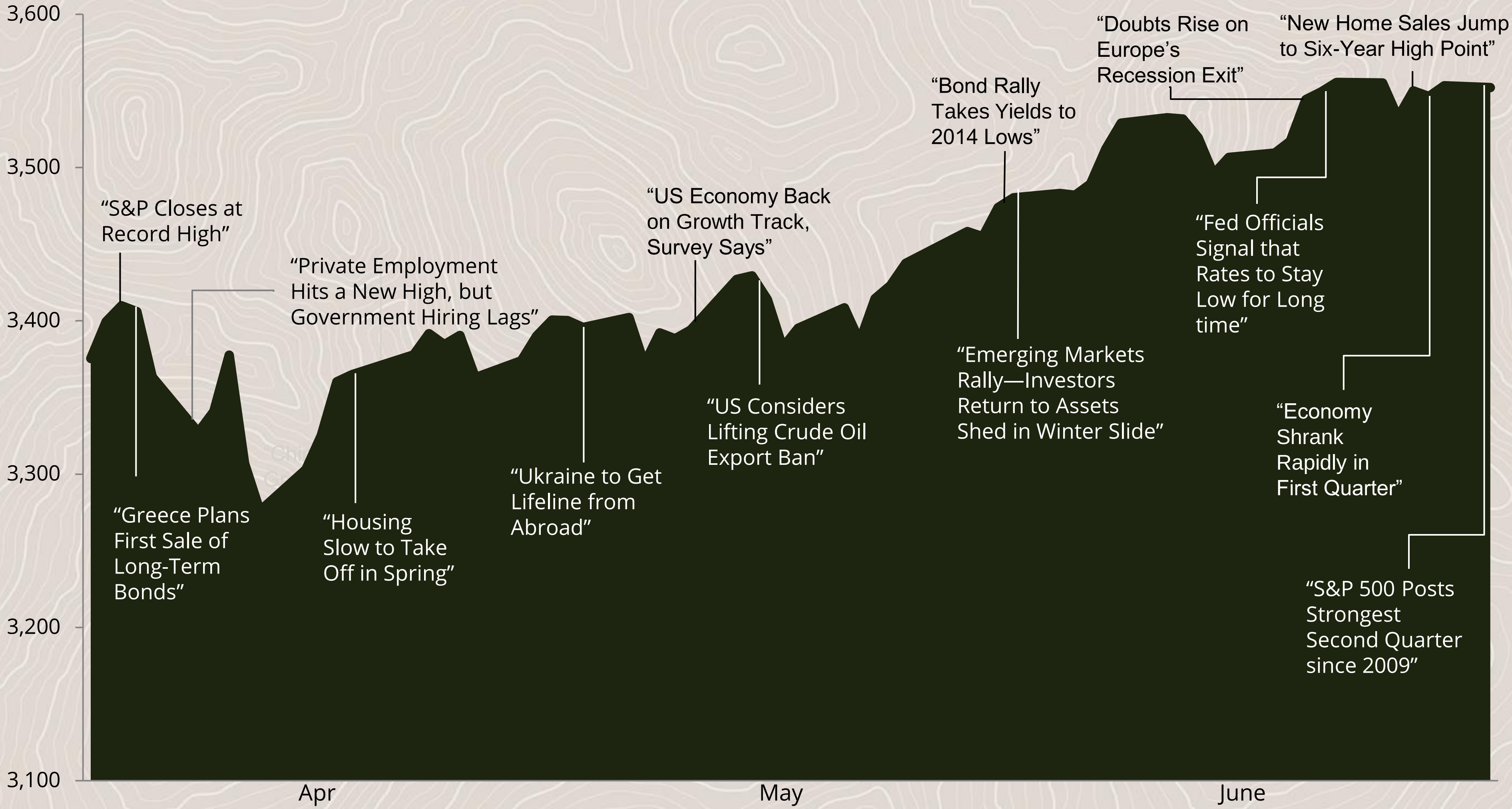
Second Quarter 2014

STOCKS				BONDS	
US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
+4.87%	+4.62%	+6.60%	+7.93%	+2.04%	+2.01%

Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net div.]), Emerging Markets (MSCI Emerging Markets Index [net div.]), Global Real Estate (S&P Global REIT Index), US Bond Market (Barclays US Aggregate Bond Index), and Global Bond ex US Market (Citigroup WGBI ex USA 1−30 Years [Hedged to USD]). The S&P data are provided by Standard & Poor's Index Services Group. Russell data © Russell Investment Group 1995–2013, all rights reserved. MSCI data © MSCI 2013, all rights reserved. Barclays data provided by Barclays Bank PLC. Citigroup bond indices © 2013 by Citigroup. US long-term bonds, bills, and inflation data © Stocks, Bonds, Bills, and Inflation Yearbook™, Ibbotson Associates, Chicago (annually updated work by Roger G. Ibbotson and Rex A. Sinquefield).

US Stock Market Performance

Second Quarter 2014



These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a longer-term perspective and avoid making investment decisions based solely on the news.

Graph Source: MSCI ACWI Index. MSCI data © MSCI 2014, all rights reserved.
It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. Past performance is not a guarantee of future results.

Connecting the Dots

Second Quarter 2014

Human beings love stories. But this innate tendency can lead us to imagine connections between events where none really exist. For financial journalists, this is a virtual job requirement. For investors, it can be a disaster.

“The Australian dollar rose today after Westpac Bank dropped its forecast of further central bank interest rate cuts this year,” read a recent lead story on Bloomberg.

Needing to create order from chaos, journalists often stick the word “after” between two events to imply causation. In this case, the implication is the currency rose because a bank had changed its forecast for official interest rates.

Perhaps it did. Or perhaps the currency was boosted by a large order from an exporter converting US dollar receipts to Australia or by an adjustment from speculators covering short positions. Markets can move for many reasons.

For individual investors, financial news can be distracting. All this linking of news events to very short-term stock price movements can lead us to think that if we study the news closely enough we can work out which way the market will move.

But the jamming of often-unconnected events into a story can lead us to mix up causes and effects and focus on all the wrong things. The writer and academic Nassim Taleb came up with a name for this story-telling imperative: the narrative fallacy.[1]

The narrative fallacy, which is linked to another behavior called confirmation bias, refers to our tendency to seize on vaguely coherent explanations for complex events and then to interpret every development in that light.

These self-deceptions can make us construct flimsy, if superficially logical, stories around what has happened in the markets and project it into the future.

The financial media does this because it has to. Journalists are professionally inclined to extrapolate the incidental and specific to the systematic and general. They will often derive universal patterns from what are really just random events.

Building neat and tidy stories out of short-term price changes might be a good way to win ratings and readership, but it is not a good way to approach investment.

Of course, this is not to deny that markets can be noisy and imperfect. But trying to second-guess these changes by constructing stories around them is a haphazard affair and can incur significant cost. Essentially, you are counting on finding a mistake before anyone else. And in highly competitive markets with millions of participants, that’s a tall order.

There is a saner approach, one that doesn’t require you spending half your life watching CNBC and checking Bloomberg. This approach is methodical and research-based, a world away from the financial news circus.

The alternative consists of looking at data over long time periods and across different countries and multiple markets. The aim is to find factors that explain differences in returns. These return “dimensions” must be persistent and pervasive. Most of all, they must be cost-effective to capture in real-world portfolios.

Admittedly, this isn’t a story that’s going to grab headlines. Using the research-based method and imposing a very high burden of proof, this approach resists generalization, simplification, and using one-off events to jump to conclusions.

But for most investors, it’s the right story.

1. Nassim Nicholas Taleb, The Black Swan: The Impact of the Highly Improbable, Penguin, 2008.