WEEKLY MARKET COMMENTARY October 22th, 2012

The Markets

Twenty-five years later, are there any lasting lessons from the October 1987 stock market crash?

You may recall that on October 19, 1987, the Dow Jones Industrial Average plummeted 22.6 percent. This drop was far steeper than the 12.8 percent decline on October 28, 1929, the day many consider the start of the Great Depression and it "immediately raised fears of an international economic crisis and a recession in the United States," according to the *Los Angeles Times.*

Although the crash was mind-boggling and is firmly etched in investment lore, on a long-term performance chart, it shows up as just a blip. In fact, in the first eight months of 1987, the Dow rose more than 40 percent, and, despite the crash, the Dow – *amazingly* – finished the year with a gain.

With the benefit of 25 years, here are a few investment lessons to remember:

1. ***Don't panic.*** The crash was painful, but the market was back to breakeven just two years later.
2. ***Valuation matters.*** Traditional valuation metrics such as price earnings ratios and dividend yields were flashing red back in 1987 which suggested the market was ripe for a fall – so pay attention to valuation.
3. ***Stay diversified.*** Even though correlation among asset classes tends to rise during times of market stress, it's still important to own a variety of asset classes as over time, it may help balance your portfolio.
4. ***Invest responsibly.*** People who borrowed money to invest in the stock market or made high-risk bets got burned when the market crashed. Always invest within your risk tolerance so a repeat of 1987 won't put you out of business.
   Sources: *Los Angeles Times*; The Motley Fool; *Forbes*

When asked what the stock market will do, the great banker J.P. Morgan replied, "It will fluctuate." Indeed, as October 1987 shows, stocks do fluctuate – sometimes dramatically.

Knowing that and remembering the four lessons above could help make you a better investor.

Data as of 10/19/12	1-Week	Y-T-D	1-Year	3-Year	5-Year	10-Year
Standard & Poor's 500 (Domestic Stocks)	0.3%	14.0%	18.5%	9.3%	-0.9%	4.8%
DJ Global ex US (Foreign Stocks)	1.9	9.8	6.6	0.0	-6.4	7.4
10-year Treasury Note (Yield Only)	1.8	N/A	2.2	3.4	4.4	4.2
Gold (per ounce)	-1.7	10.3	5.1	18.3	17.9	18.7
DJ-UBS Commodity Index	-0.4	4.1	1.0	2.3	-4.0	3.3
DJ Equity All REIT TR Index	1.5	17.4	29.5	20.6	3.2	12.2

Notes: S&P 500, DJ Global ex US, Gold, DJ-UBS Commodity Index returns exclude reinvested dividends (gold does not pay a dividend) and the three-, five-, and 10-year returns are annualized; the DJ Equity All REIT TR Index does include reinvested dividends and the three-, five-, and 10-year returns are annualized; and the 10-year Treasury Note is simply the yield at the close of the day on each of the historical time periods. Sources: Yahoo! Finance, Barron's, djindexes.com, London Bullion Market Association. Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly. N/A means not applicable.

HOW GOOD ARE YOU at predicting the future? Well, despite a bazillion bits of information at our fingertips and unbelievable computing power, humans are still pretty bad at it.

Let's use an example that gets to the heart of the financial crisis. As described in Nate Silver's book, *The Signal and the Noise*, back in 2007 Standard & Poor's Corporation (S&P) gave investment ratings to a particularly complex type of security called collateralized debt obligation (CDO). For CDO's that were rated AAA – the highest rating possible – S&P said the likelihood that a piece of debt within those CDO's would default within five years was a miniscule 0.12 percent. That's about one chance in 850.

Now, you probably know where this is going. Guess what the actual default rate was? According to S&P, it was around 28 percent. Simple math says the actual default rate was more than *200 times higher than S&P predicted* and, as Silver wrote, "This is just about as complete a failure as it is possible to make in a prediction."

It's easy to poke fun at bad predictions; however, there is a larger point here. First, we can't predict the future so we always need a plan B. And, second, we need to differentiate between risk and uncertainty.

Economist Frank Knight said risk involves situations where we can calculate the probability of a particular outcome. For example, actuaries can calculate the probability of a 60-year old male dying within 10 years because they have historical mortality statistics that don't change much from year to year.

By contrast, uncertainty has no historical data to use as a solid basis for making a prediction. For example, predicting the outcome of war in Syria is not knowable because there's no set of historical data or probability distribution on which to base the prediction.

It's just our luck that the financial markets seem to contain elements of risk and uncertainty. However, we can try to use that to our benefit by being cognizant when the risk/reward seems to be in our favor while at the same time, having plan B in case uncertainty tries to spoil the party.

Weekly Focus – Think About It…

"It is a truth very certain that when it is not in our power to determine what is true we ought to follow what is most probable."

--*Descartes, French philosopher, mathematician, writer*

Financial Factoid: The USA has only 314.6 million citizens in a worldwide population of 7.05 billion people, i.e., 95.5% of the worlds potential consumers for US businesses are not Americas (source: Census Bureau)

Irish Wit & Wisdom: It is better to be young in your failures than old in your successes.

-- Flannery O'Connor

Have a great week!

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Securities offered through LPL Financial, Member FINRA/SIPC.

* The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.
* The DJ Global ex US is an unmanaged group of non-U.S. securities designed to reflect the performance of the global equity securities that have readily available prices.
* The 10-year Treasury note represents debt owed by the United States Treasury to the public. Since the U.S. Government is seen as a risk-free borrower, investors use the 10-year Treasury Note as a benchmark for the long-term bond market
* Gold represents the London afternoon gold price fix as reported by the London Bullion Market Association.

* The DJ Commodity Index is designed to be a highly liquid and diversified benchmark for the commodity futures market. The Index is composed of futures contracts on 19 physical commodities and was launched on July 14, 1998.
* The DJ Equity All REIT TR Index measures the total return performance of the equity subcategory of the Real Estate Investment Trust (REIT) industry as calculated by Dow Jones.
* Yahoo! Finance is the source for any reference to the performance of an index between two specific periods
* Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.
* Past performance does not guarantee future results.
* You cannot invest directly in an index.
* Consult your financial professional before making any investment decision