

# The Week

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## Defending Against Large Losses is One Sound Way to Potentially Build Wealth through Investing

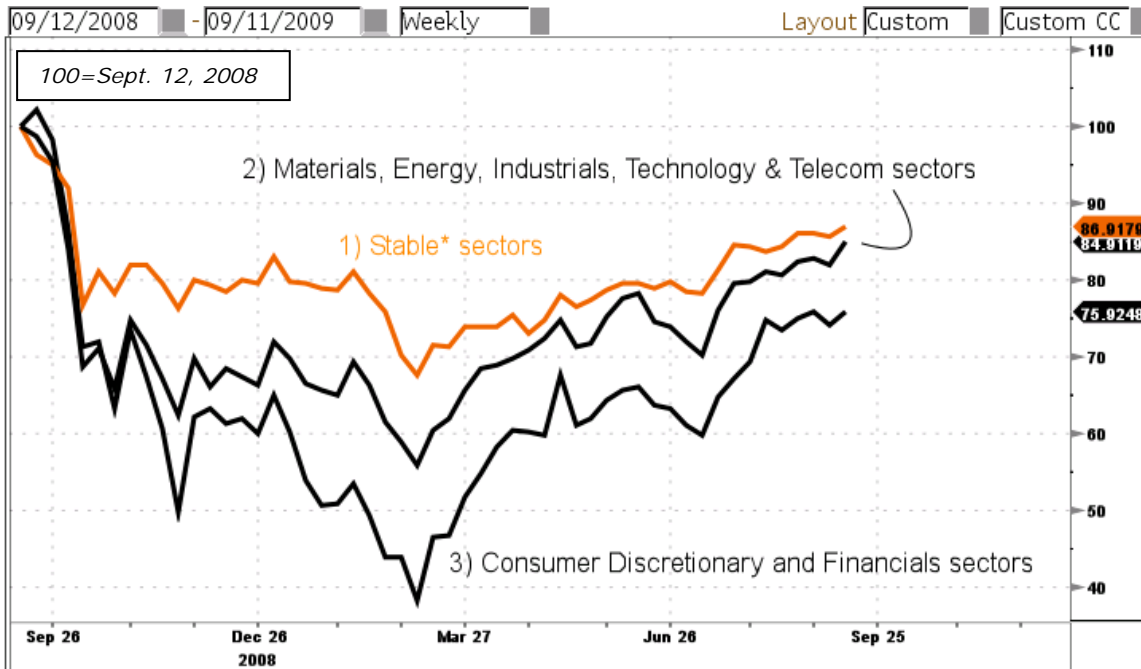
- Competing for attention among last week's remembrances — the first anniversary of the convulsive bankruptcy of Lehman Brothers and the eighth anniversary of 9/11 among them — is difficult enough. For those content to look forward and celebrate the athletic pursuits of our agile young people, September brings the onset of football season, the exciting final stretch of the baseball regular season, and of course the US Open Tennis tournament.
- Somewhere buried among all of these events was the coverage of an obscure golf tournament first held in 1922. Every two years, amateur golfers from the US pair off with their counterparts from Great Britain & Ireland to battle for the Walker Cup. This year, the tournament was held at Merion GC, a venue where one of the legends of the game made an extraordinary shot under great pressure to tie — and eventually win — a major tournament nearly 60 years ago<sup>1</sup>. This moment was memorialized by what may be one of the most famous photographs of the sport.
- Despite being remembered for his approach to the 18<sup>th</sup> green on the last hole of regular play, Ben Hogan made 286 other shots to tie two others for the ultimate lead, and victory was his after a special playoff the following day. In his book about the fundamentals of golf, Hogan observed that — even when he was playing at his best — in a typical 18-hole round, only one or two shots would turn out exactly as he intended. Like golf, investing is a game of mistakes ... and like golf, investment success is about minimizing those mistakes ... making fewer mistakes with less severe consequences.
- The Standard & Poor's 500 index has provided a negative return of -1%/yr. over the past 10 years, including reinvested dividends, but disregarding expenses and inflation. Of course, dividends can be reduced or eliminated without warning at any time, as investors in financial stocks have learned only too well in the past year or two. But investors might well have fared better if they had avoided the "big mistakes" of participating in the technology and telecom bubble of 1998-99, or the housing bubble of 2004-06. *An index is not managed and is unavailable for direct investment.*
- Even though most popular stock averages show that equity investors have done poorly over the past decade, the average company has performed significantly better, as we have pointed out in "The Week" (*July 28, 2009 issue*). The returns attendant to investing in good business franchises that are well-positioned to participate in a so-called "new normal" economy (i.e. a slower-growing economy — and one less dependent on the extravagant urges of an overleveraged US consumer — than the one we became accustomed to from 1980 to 2006) should continue to meet or exceed reasonable expectations, in our view.
- Another approach is to carefully examine your financial situation in a holistic way, ensuring that your allocation among various "risk buckets" is appropriate for your situation. Your financial advisor should be able to help you with this. Make sure you are not devoting too much of your wealth to assets that rely on an extraordinary outcome like Hogan's famous shot at Merion in 1950. Reduce spending to boost investment assets, and make sure you have enough allocated to areas that will protect principal and let it grow at a reliable pace.

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<sup>1</sup> [http://www.golf.com/golf/tours\\_news/article/0,28136,1852010,00.html](http://www.golf.com/golf/tours_news/article/0,28136,1852010,00.html)

## Despite Stronger Gains from the Lows, "Lending & Spending Beneficiaries" Are Struggling to Recover Losses Incurred Over the Past Year

(Sector Performance of the S&P 500 Has Shown Remarkable Divergences Since 2006)



Note: Each stock in the S&P 500 is assigned to one of ten economic sectors, and each of the 10 sectors is combined into one of the three indexes shown above. \* 1) Stable sectors include: Consumer Staples, Health Care and Utilities. Performance does not include dividends. Past performance is not a guarantee of future results. An index is not managed and is unavailable for direct investment. Source: Bloomberg, Standard & Poor's.

Our chart shows the remarkable sector divergences within the Standard & Poor's 500 index have become less severe as the financial crisis has given way to broadening hope and optimism for recovery. From September through February, investors worried that extraordinary measures taken by policy makers could not avert a severe, multi-year recession, and they punished shares dependent on "lending and spending" (chart, index #3), which fell over -60%. The stable sectors (chart, index #1) dropped less than half as far — because they were perceived as the least vulnerable — while those sectors most exposed to global growth (chart, index #2) were hurt somewhat more.

More recently, the largest declines have turned into the biggest advances — as measured from the March lows. But over the past year, the defensive sectors are still ahead, retaining 87% of their year-ago value. The "global growth beneficiaries" are only a little behind, while the "lending and spending" groups — despite their strong recovery — have rebounded to only 76% of their year-ago value.

It is important to remember that the financial crisis did not begin with the Lehman bankruptcy. In the prior 18 months (not shown on chart), the "lending and spending beneficiaries" fell -33%, while the other two groups actually rose modestly, as investors reacted to increasingly negative developments in the housing and credit markets.

Some portfolio managers — like Warren Buffett of Berkshire Hathaway — had enough foresight to position their portfolios defensively ahead of the crisis, and were facile enough to boost their exposure to strong business franchises during the worst of the tempest. Like Ben Hogan did, Buffett consistently shows us that the key to long term success is avoiding the big mistakes.

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