



# FINDING YOUR DIRECTION

Comprehensive financial planning services

Michael Freeman & Rick Edwards offer securities through Sammons Securities Company, LLC - Member FINRA/SIPC

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## Ready For Some Football

"The Compass" gets a piece of the action surrounding the Super Bowl by discussing the Super Bowl Indicator (SBI). We do not recommend using the SBI as an investment guideline but it does provide a good example of the dangers of confusing correlation with causation.

The premise of the SBI is that following victories by original NFL teams the stock market goes up, however, it goes down after original AFL team victories. Ed Dyl, a finance professor, calculated as of 1989 that the stock market went up by 2.9% in the four weeks following the Super Bowl when an NFL team won versus a 4.6% loss when AFL teams won. By 2010, he discovered the trend continued, although a bit weaker, showing 1.1% market gains on NFL victories and -0.1% drops after AFL wins.\*

Many phenomena that have absolutely nothing to do with the stock market happen to be highly correlated with it. One economist cited butter production in

Bangladesh as having a correlation with the S&P 500. He also reported that the number of discoveries of buried treasures in England is seemingly synchronized with the Dow Jones Industrial Average. Another study showed a connection between ice cream production in the U.S. with stock market fluctuations.\*\* For more about correlation, check out the next article in this issue, "Destination Correlation."

Leonard Koppett, who is attributed with creating the SBI, once commented, "It's a joke. I meant the whole thing as a satire on the fallibility of human reasoning."\* Obviously, it is not just football statistics that should be taken with a grain of salt.

\*(2011, January 28). Super Bowl Indicator: The Secret History. Available from WSJ.com. \*\*Hulbert, M. (2011, February 4). Don't Bet on Super Bowl Indicator. Available from SmartMoney.com.

### Advisor Corner



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The content of The Compass is not intended to make investment recommendations nor is it product specific. We encourage all of our clients to call or send us an e-mail message to address questions about their specific portfolio needs.

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## Destination Correlation

"Correlation" and "correlated assets" are mainstay expressions in the jargon of investors and financial professionals, and while the concept of correlation can be confusing to novice investors, a quick explanation can clarify why correlation is a key factor in portfolio construction.

Let's say you or your financial advisor are trying to choose two investments in the construction of a portfolio. Would you prefer investments that are similar (move in the same direction) or investments that are dissimilar? Think about it this way: If you are going on vacation to an unknown island, what type of clothes will you put in your suitcase? If you only take summer clothes and the island nights turn out to be cold, or if you only bring winter clothes and the climate is tropical, your vacation will probably end in tears. It's the same with investing: You're better off diversifying than putting all your money in similar investments.

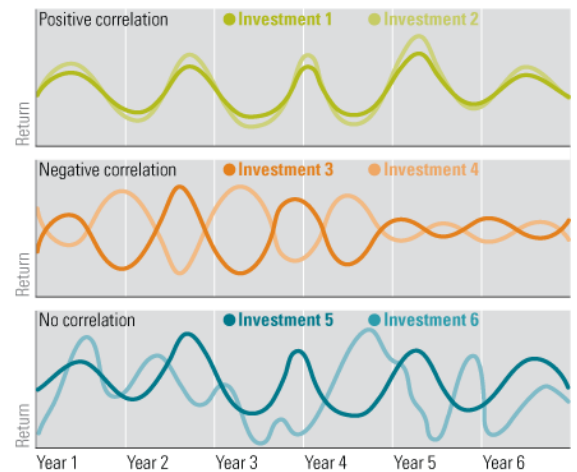
In order to create a truly diversified portfolio, the investments in the portfolio have to compensate for each other's shortcomings. If investment A declines in value, ideally you would want investment B to increase in value, or at least decline less than investment A. In order to achieve this, you need two investments that behave differently, meaning they have a low correlation.

Correlation is a statistical measure designed to quantify the interrelationship of two investments (again, investment A and investment B). By taking into account the characteristics of the two investments, a mathematical formula calculates a number between  $-1.00$  and  $+1.00$ . This number is called the correlation coefficient. If this coefficient is negative (for example,  $-0.81$ ), we say the two asset classes are negatively correlated. This simply means they tend to move in different directions: if asset class A declines in value, asset class B is likely to increase in value, and vice versa. If the correlation coefficient is positive (for example,  $+0.34$ ), the two asset classes tend to move in the same direction: they are positively correlated. A correlation coefficient of zero means

the asset classes are completely uncorrelated; their movements in relation to one another are random.

Adding investments with low correlation to a portfolio can soften the impact of market swings because the investments do not all react to economic and market conditions in the same manner. For example, building a portfolio with large, small and international stocks would probably not be such a good idea because stocks are generally highly correlated to one another—if large stocks go down, the other stock categories will probably go down, too. The same logic applies to a portfolio with only bonds. However, combining stocks and bonds in a portfolio could provide a significant diversification benefit because these two types of investments do not tend to move together (they have a low correlation).

### Various Levels of Correlation



Past performance is no guarantee of future results. Diversification does not eliminate the risk of investment losses. Investment returns shown and correlation numbers mentioned in the text are based on hypothetical data. Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than bonds.

## What Is Up with Gold?

With the runup on gold during the past few years, many investors have been enamored with its short-term performance and are aching to jump into it. Never mind that gold itself has almost no intrinsic value or that the price is largely determined by what other buyers are willing to pay. The past decade, with market crashes and uncertainty, has caused many investors to flee to the safety of gold, but looking longer term, gold might not be as attractive as it appears. An investment of \$100 in stocks beginning in 1980 would have grown to \$2,838 by November 2011. That \$100 invested in bonds over the same time period would now be \$2,186. And if one had invested that \$100 in gold in 1980, it would be a measly \$333 today.

History has shown that given the volatility of the price of gold, both stocks and bonds outperformed gold in the long run over the past 30 years by providing higher average returns. Stocks and bonds also outperformed gold over a 20-year time period. A starting point of 1980 was chosen because, not unlike today, the price of gold was then at all time highs. With gold fervor rampant, a speculative investment in gold, then, would have resulted in not-so-stellar results today, even with gold's recent performance.

Gold is not without its merits. It has traditionally been considered a good hedge against rising inflation rates, given its ability to preserve purchase power. Gold is also commonly considered a safe haven in times of political and currency crises. As fears of a double-dip recession mount, gold may be considered a tool for diversification, because it generally does not react identically to the same economic or market stimuli as stocks and bonds. A well diversified portfolio of stocks, bonds, and gold has the potential to produce a more appealing risk-and-return trade-off over various time periods.

### Compound Annual Returns

	1 yr	3 yrs	5 yrs	10 yrs	20 yrs	30 yrs
Stocks	7.8	14.1	-0.2	2.9	8.3	10.8
Bonds	19.4	8.5	9.5	8.4	9.0	10.6
Gold	26.2	28.9	22.0	20.3	8.1	4.9
60/40 portfolio	12.9	13.2	5.3	6.2	9.4	11.4
50/40/10 portfolio	14.7	14.6	7.4	7.9	9.5	10.9
50/30/20 portfolio	15.3	16.5	8.5	9.0	9.4	10.4

Diversification does not eliminate the risk of experiencing investment losses. Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Gold, like any other coin or bullion, is subject to investment risks like perceived scarcity, its quality, current demand, market sentiment, and economic factors. There are material differences between investing in gold versus investing in stocks and bonds. Such differences may include investment objectives, costs and expenses, liquidity, safety, fluctuation of principal or return, insurance, tax features, and any other investment characteristics.

Source: Data as of November 30, 2011. Stocks in this example are represented by the S&P 500® index, which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. Bonds are represented by the 20-year U.S. government bond. Gold is represented by the Federal Reserve (2nd London fix) from 1980-1987 and the Wall Street Journal London P.M. closing price thereafter. Portfolios are rebalanced every 12 months.

## The Rest of the Story

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Dr. Pemberton lived in an era right after the Civil War when the corner druggist knew as much about medicines as the national drug manufacturers. Sometime after peddling such products as "Mr. Pemberton's Triplex Liver Pills" and "Dr. Pemberton's Indian Queen Hair Dye," the pharmacist started working on a concoction to relieve headaches.

In those days most patented medications contained alcohol but John Pemberton would have none of that. He experimented with the extracts of fruits, nuts and leaves, but they were mainly for taste. A headache cure would need a stimulant, perhaps caffeine. It would also need an analgesic, such as cocaine.

John's next mission was to sell his product. So, in 1886 he took a jug of his reddish-brown syrup to Jacobs Pharmacy, one of the most reputable in Atlanta. John told the manager that the ingredients were secret but that he should try some.

All he had to do was mix it with water and drink it.

The story goes that sales of the potion were slow until one day a customer came in with a hangover. The clerk remembered Pemberton's syrup and went to mix up a batch for him. He was new on the job and not quite acquainted with the procedure and used carbonated water by mistake. His mistake is still in the recipe. In fact, most of the ingredients, except for cocaine, are basically the same.

Sadly Dr. Pemberton, the master of cures, could not cure himself. His health failed soon after the last discovery. His little business could have been bought for \$2,000 when he died. The country druggist died before his product became sold around the world. The product? Coca Cola!

Source: Aurandt, P. (1977). Paul Harvey's The Rest of the Story. New York: Doubleday & Company, Inc.

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