

DOWN TO THE WIRE

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Betting against the House

For those seeking to outperform the market through stock selection, underweighting the market's biggest winners can be just as painful as overweighting the biggest losers.

It's New Year's Day 2012. In addition to overdosing on televised college football, you're spending part of the holiday working on the family finances. Armed with a laptop and various online financial tools, you're on the hunt for appealing stock market opportunities. To prune the list of candidates to a manageable size, you decide to focus on firms that are leaders in their respective industries and exhibit above-average scores on various measures of financial strength. As you work your way through the alphabet, you come to the "P" stocks, and another candidate appears. It's a prominent player in a major industry (good), but operates in a notoriously cyclical industry (not so good), is currently losing money (definitely not good), pays no dividend, and has a junk-bond credit rating of BB-minus. Next! You push the "delete" key and move on.

Congratulations. You just passed up the best-performing stock in the entire S&P 500 Index for 2012.

Shares of PulteGroup Inc., a Michigan-based homebuilder with a 60-year history, jumped 187.8% last year amid strong performance for the entire industry. For the year

ending December 31, 2012, all 13 homebuilding firms listed on the New York Stock Exchange outperformed the S&P 500 Index by a wide margin, with total returns ranging from 34.1% for NVR, Inc. to 382.8% for Hovnanian Enterprises, Inc. The Standard & Poor's SuperComposite Homebuilding Sub-Index rose 84.1% in 2012 compared to 13.4% for the S&P 500 Index.

The point? For those seeking to outperform the market through stock selection, underweighting the market's biggest winners can be just as painful as overweighting the biggest losers. Investors are often caught flat-footed by stocks that do much better or much worse than the broad market, and the problem is not limited to individuals. Not one of the 10 seasoned professionals participating in Barron's annual Roundtable stock-picking panel in early January 2012 mentioned homebuilding stocks or any housing-related firms.

The recent surge in housing shares also serves as a reminder that stock prices are forward-looking and tend to rise or fall well in advance of clear changes in company fundamentals.

Investors who insist on waiting for evidence of healthy profits before investing are often frustrated to find that a firm's stock price has appreciated dramatically by the time the firm begins to report cheery financial results. Shares of Hovnanian Enterprises, for example, rose 580% between October 7, 2011, and December 31, 2012, even though it continued to report losses. Similarly, it is not unusual for a firm's stock price to decline long before signs of trouble become obvious.

The behavior of the S&P Homebuilding Sub-Index in recent years illustrates the challenge of relying on industry characteristics to provide a reliable guide to the direction of stock prices. (Note: Index inception was December 31, 1994, at 100.)

DATE	S&P HOMEBUILDING SUB-INDEX
JULY 28, 2005	1063.19
Index sets a record high, up more than tenfold from its year-end 1994 level of 100.0.	
OCTOBER 9, 2007	368.13
Index closes 65% below its peak on the same day the S&P 500 sets a record high.	
MARCH 6, 2009	150.21
Index slumps to its low for 2009, and the S&P 500 Index follows suit on March 9.	
JULY 27, 2010	239.18
<p>“Sales of new homes are near 47-year lows. ... Homebuilders, which began buying up land late last year in anticipation of an economic and housing rebound, are stuck with thousands of acres that are prone to lose value as the market struggles.”</p> <p>Robbie Whelan, “Supply of Homes Set to Grow,” <i>Wall Street Journal</i>, July 27, 2010.</p>	
AUGUST 25, 2010	225.23
<p>“Price declines could lead to more delinquencies and foreclosures, and additional subsequent price drops. ... ‘You end up in a home-price-depreciation death spiral. It’s not clear there’s enough demand to handle this overhang without another round of price declines.’ ”</p> <p>Quotation attributed to Laurie Goodman, Amherst Securities. Sudeep Reddy and Nick Timiraos, “Plunge in Home Sales Stokes Economy Fears,” <i>Wall Street Journal</i>, August 25, 2010.</p>	

DATE	S&P HOMEBUILDING SUB-INDEX
JULY 11, 2011	250.23
<p>“The housing decline will be a long, multiyear process, and the multiplier effect across the economy will be enormous.”</p> <p>Quotation attributed to Doug Ramsay, Leuthold Group. Roben Farzad, “The Housing Horror Show Is Worse Than You Think,” <i>Bloomberg Businessweek</i>, July 11, 2011.</p>	
NOVEMBER 10, 2011	220.41
<p>“It will take ‘years rather than months for a proper recovery to get going,’ said Mr. Dales, who predicts home prices nationally won’t mount a sustained recovery until 2014.”</p> <p>Quotation attributed to Paul Dales, Capital Economics. Alan Zibel, “Home Prices Keep Dropping,” <i>Wall Street Journal</i>, November 10, 2011.</p>	
DECEMBER 23, 2011	236.80
<p>“Simply put, Hovnanian [Enterprises] may soon become hard-pressed to make payments on its groaning load of debt—\$1.6 billion, all in the form of bonds ... and it has no bank credit lines to fall back on.”</p> <p>Robin Goldwyn Blumenthal, “Hammered and Nailed,” <i>Barron’s</i>, December 24, 2011.</p>	
MARCH 2, 2012	277.95
<p>“Home prices in most parts of the country appeared to bottom out in the summer of 2009 and to begin a slow recovery. But now they have fallen below 2009 levels in most markets, according to the Standard & Poor’s/Case Shiller index released this week.”</p> <p>Floyd Norris, “Home Prices Declined to New Lows in 2011,” <i>New York Times</i>, March 3, 2012.</p>	
MAY 14, 2012	326.18
<p>“Excess inventories “are the mortal enemy of prices, and we’ve calculated an excess of 2 million units, over and above normal working levels of inventories of new and existing homes.”</p> <p>A. Gary Shilling, “Is Now the Time to Buy Your First House? No: The Fall Isn’t Over,” <i>Wall Street Journal</i>, May 14, 2012.</p>	

DATE	S&P HOMEBUILDING SUB-INDEX
MAY 24, 2012	330.55
<p>“Even as a tentative housing recovery ... appears under way, a big stumbling block remains: the vast number of underwater homeowners.”</p> <p>Alejandro Lazo, “Negative Equity Remains a Drag on Housing Market,” <i>Los Angeles Times</i>, May 24, 2012.</p>	
JULY 26, 2012	362.79
<p>“The broad dynamics are still quite scary. We think housing is still a short.”</p> <p>Quotation attributed to Michael Feder, CEO, Radar Logic. Peter Coy and Roben Farzad, “Housing: A Long Way from Normal,” <i>Bloomberg Businessweek</i>, July 26, 2012.</p>	
SEPTEMBER 26, 2012	417.42
<p>“Housing has snapped back this year even as the broader economy and the nation’s employment situation have proved lackluster.”</p> <p>Jim Puzanghera and Alejandro Lazo, “US Home Price Index Reaches Highest Level in Almost 2 Years,” <i>Los Angeles Times</i>, September 26, 2012.</p>	
JANUARY 21, 2013	484.52
<p>“House prices are vulnerable to a new wave of foreclosures now that mortgage modifications have been tried and largely failed.”</p> <p>A. Gary Shilling, “Prepare for a Stock Market Plunge,” <i>Forbes</i>, January 21, 2013.</p>	

DATE	S&P HOMEBUILDING SUB-INDEX
JANUARY 30, 2013	503.65
<p>“Sharp home price increases—particularly in once-decimated cities such as Phoenix and Las Vegas—are raising concerns among some economists that speculation could return to certain markets if such double-digit gains continue.”</p> <p>Alejandro Lazo, “Prices Rise, and So Do Fears of a Bubble,” <i>Los Angeles Times</i>, January 30, 2013.</p>	

BOTTOM LINE

Many observers in recent years predicted that a recovery in the housing industry would be agonizingly slow, and they were right. Many investors in recent years have avoided housing stocks as a consequence, and they’ve been wrong: Housing stocks have outperformed the broad US stock market by a healthy margin from the market low in March 2009 to the present day.

Bottom Line: Markets have 101 ways to remind us of Nobel laureate Merton Miller’s observation: Diversification is the investor’s best friend.

REFERENCES

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- S&P data provided by Standard & Poor’s Index Services Group.

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