



The Ugly, the Bad and the Good

Summer 2007

Summer 2008 Market Commentary

As no one follows my advice to ignore market gyrations—including myself—let's at least put some effort toward an appropriate perspective.

The Ugly

The markets continue to grapple with difficult economic conditions—high energy prices and the unwinding of the U.S. housing bubble being the most prominent. Most recently, Congress rescued Fannie Mae and Freddie Mac, government chartered but privately owned entities that either own or guarantee more than half of the country's mortgages. Long term, this legislation is likely to result in permanent changes in the way mortgages are funded.

As of June 30th—depending upon who is measuring—we were officially in a bear market (20% top-to-bottom decline). This June was the worst June since the Great Depression. The first half of the year brought significant retreats:

- the S & P 500 was down 11.9%,
- the MSCI-EAFE Developed Markets Index was down 12.70%,
- and the MSCI-EAFE Emerging Markets Index was down 12.75%.

Share prices of financial firms have fallen dramatically. The XLF (exchange traded index fund of financial stocks) lost 29.65%, as the venerable Bear Stearns investment bank evaporated.

Thus far, the 2000s seems like a lost decade; we have been running in place. The S & P 500 is about even for the past 8.5 years—which is similar to the period from 1966–1982. By contrast, foreign markets are up a little more than 8% per year during the period.

The Bad

Bear markets are always painful—each seems like the end of the world. This time may be different, but I doubt it. Since the end of World War II, there have been 12 declines of 19% or more, lasting from just 45 days (summer of 1998) to 694 days (1973–74, a 45% decline.) Tea leaf reading pundits always have an explanation, but they're usually wrong.

Summary: You've Seen it All, But What's Your Plan?

There have been a few key—and genuine—economic issues fueling the current market downturn. But, bear markets always look ugly—and interminably bad—while we are enduring them. So, is your plan firmly in place to take advantage of the good side of this downturn: affordable securities?

Even when things look their bleakest, sticking to a comprehensive strategy usually provides the best approach over the long haul.

None of these bear markets has represented Armageddon. From 1946–2007, the S & P 500 has managed to achieve an average annual return of 11.4% despite these frequent setbacks. Additionally, more than 95% of the rolling ten-year periods since 1926 (822 out of 852) have had positive returns for the S & P 500.

Let's remember that equity returns are mean reverting: after long periods of out-performance they tend to go down and vice-versa. The longer the period of underperformance, the closer we probably are to a return to normalcy.

The Good

What good can come from this situation? A chance to buy at better prices, if your plan is in the accumulation phase or you are rebalancing. Securities prices, obviously, are more reasonable than they were last year. PE's are around average—at 15. The dividend yield is much more attractive as well. The Dow Jones Select Dividend Index Fund (DVY) (exchange traded fund consisting of the 100 highest yielding stocks in the Dow Jones universe) is yielding 5.24%—although 40% of this fund is represented by financial stocks, where there could be more dividend cuts.

Inflation—fueled by high energy prices—remains a worry. But, markets tend toward equilibrium. As someone once said, “the cure for high prices is high prices.” Aggregate demand in the developing world is slowing rapidly. Runaway inflation is almost always accompanied by a wage/price spiral: wages have been flat in this country for nearly two decades. And there seems to be little pricing power amongst firms, other than those closely related to energy.

The Plan

It remains critical to be reasonably comfortable with your asset allocation and its connection with your goals and your time horizon. Owning a healthy portion of equities—in a broadly diversified approach—has historically been the best way to achieve a rate of return sufficient to create and sustain wealth.

All of which means we should make certain our plans remain on track, adjust for any changes in our needs, and return to whatever we were doing before we got distracted by the markets.

Specific investments or resources mentioned are illustrations only and are not recommendations. Past performance does not guarantee future results.