



2008 Market Commentary: Oh, What a Year it Was!

Winter 2009

If 2008 weren't such a memorable year in the financial markets, it would be entirely forgettable. Last year marked the beginning of what economists are calling the worst recession in a generation, together with the largest one-year stock market loss since 1931—in the midst of the Great Depression

Politicians and pundits have been stumbling over one another to assign blame for our economic difficulties. There is plenty to go around. At its core was an excess of debt on the part of both consumers living beyond their means and speculative investors trying to earn profits on the spread between cheap credit and perceived opportunities—combined, naturally, with ineffective regulation.

Mostly, this recession can be attributed to the bursting of the U.S. housing bubble and its exportation, via complex securities and derivatives, to the rest of the world. When prices began to fall, it all unraveled, resulting in mortgage foreclosures, margin calls, and massive deleveraging in all corners of the economy.

Credit markets have become frozen. Governments around the world have embarked on major bail-outs of the financial system, interest rates are reduced to near zero and a massive stimulus is in the works. Although it seems special to us, it is not much different from the excesses and downturns of the past (tulip-mania, South Sea and dot-com bubbles, Ponzi and now Madoff). Two great reads to place our current predicament in perspective are *Manias, Panics and Crashes: A History of Financial Crises* by Charles P. Kindleberger (Wiley, 1978) and *Devil Take the Hindmost: A History of Financial Speculation* by Edward Chancellor (Farrar, Straus and Giroux, 1999).

On the Brink

This recession will no doubt be unusually severe. Unemployment will likely reach double digits. We are already experiencing consumer price deflation. And negative economic growth will probably endure for many months. But, while the prospect of another Great Depression has been bandied about, that seems unlikely.

My favorite analogy has to do with the City of Galveston and its hurricanes. In 1900, Galveston experienced a direct hit by a massive hurricane in which 10,000 people lost their lives. No one saw it coming and no preparations were made. Emergency and evacuation services were rudimentary. A century

Summary:

No one can say exactly what will happen next with the markets—after all, that is rather the point of investing. But, we might conclude that time-tested practices, like diversification and rebalancing, together with some patience and discipline, seem to still make sense.

Annual income twenty pounds,
annual expenditure nineteen, nineteen and six,
result happiness.

Annual income twenty pounds,
annual expenditure twenty pounds ought and six,
result misery.

Charles Dickens, *David Copperfield* (1849)

later, the summer of 2008 brought Hurricane Ike to Galveston. Weather satellites enabled it to be forecast a week in advance. Thousands were evacuated and casualties were minimal.

In eerie parallel, The Panic of 1907 saw thousands bankrupt followed by a long and difficult recession. The nation had no central bank. Famously, J.P. Morgan assembled a team of private bankers to save the system from collapse and failed. As with the hurricanes, we have learned lessons that will alter our response to—and the outcome of—this financial crisis; further, we have different technologies:

- The central bank (the Federal Reserve was established in 1913) has been expanding, rather than contracting the money supply, as it unfortunately did early in the 1930's.
- A massive fiscal stimulus is in the works.
- Tax rates are much lower overall.
- Presumably, we will resist the urge to become protectionist.
- There is now a panoply of safety nets: FDIC insurance, unemployment compensation, Social Security and Medicare, etc.

With any luck, this recession will be either long or deep but not both.

Downturns and Recoveries

The course of the economy and equity markets is inherently cyclical, with downturns inevitably having been followed by recoveries. It is impossible to know in advance how deep and for how long a recession will be or when the recovery will ensue. The market is usually a discounting mechanism, rapidly anticipating changes in the economy, both positive and negative. Since 1929, downturns have ranged from 5 months to 34 months and recoveries have ranged from 3 months to 151 months.

From 1926–2007, the average return of the S&P 500 index has been 10.4%. During that time, there has been one consecutive 4-year period of negative returns, one such 3-year period and two such 2-year periods.

Following past recessions, over the ensuing three years, large company stocks have risen, on average, 47%—while small company stocks have risen 74%. And, historically, stocks recover about one-third of their losses in the first 40 days following the bottom. As tempting as it may be to try, consistently and successfully timing the market is impossible. Even if you were lucky enough to have moved timely into cash, being just a few weeks late getting back in adds years to the period of recovery. We can't know for sure when a bottom has been reached, except in retrospect; but from November 20 to December 31, 2008, the return on the U.S. Total Stock Market was 22.01%. Other asset classes have had gains as well.

Valuation Matters

Are stocks cheap? It's hard to say. Stocks are typically valued by a variety of ratios—all with price in the numerator and any number of metrics; such as earnings, dividends, cash, book value, etc. in the denominator. If these denominator metrics are anywhere near stabilized, prices are historically low.

Moreover, cash holdings (bank deposits and money market funds) as a percentage of stock values are at 74%—levels not seen since 1990 and one of the highest levels ever. This percentage tends to peak just before the bottom of the stock market. In addition, over 2,000 companies world-wide hold more cash than their enterprise value—the sum of stock and debt.

Remember, not everyone can sell. There have to be buyers. Certain stocks may go to zero, but the entire market won't. None of this is to suggest, as have some, that this is the “buying opportunity of a lifetime.” It may be and it may not. But for those investors who rely in some measure on the risk premiums historically accorded to equities over the long term, this should offer some reassurance. We've already paid for a great deal of the risk, so we might as well stick around for the return.

Rebalancing

A colleague of mine recently quipped, “Panic selling is a felony. Not rebalancing is a minor misdemeanor.”

Once a generation, investors are presented with an opportunity to go from being good investors to becoming great ones. Now *may* be that occasion. That's not to say this challenge is guaranteed to succeed—strategy should never be confused with outcome—but the hallmark of successful investing is being enough of a contrarian to take advantage of the emotions that plague the average investor.

And, you can probably shred your risk tolerance questionnaire. That was just a paper exercise, a mental dry run. Assessing risk tolerance, either on your own, or via the services of a skilled advisor, asks questions about attitude and experience and what you might do or how you might feel in the event certain circumstances arise. But if 2008 didn't tell you what your *actual* risk tolerance is, nothing will. After careful evaluation, if you determine your portfolio was too risky, then by all means adjust.

The proper allocation for the future should nevertheless be based not on what just happened, but on your current circumstances, goals, re-assessed risk tolerance, and time horizon—just as if you were a brand new client coming in the door. Remember, there are other risks beside market risk. Long-term treasury bonds now yield less than 3%. Investing too conservatively will expose you to inflation risk and the risk that you may out-live your money. Of course, there is no right trade-off in the abstract—only the right one for you.

The Certainty of Uncertainty

As with most things in life—such as relationships and health—investing is fraught with uncertainty. But it is virtually certain that crises will occasionally emerge. The key is avoiding the big mistake and maintaining your resilience in the face of adversity.

Pay attention to the things you can control. Keep your costs low. Be thoroughly diversified among the risky assets and with a proper dose of less risky bonds. If you are already retired there is probably little choice but to reduce or stop portfolio withdrawals altogether for a while to give your portfolio a chance to catch up. Retired or not, a cash or cash-like reserve should be maintained for emergencies.

As Warren Buffet wisely observed, “Investing is simple, but not easy.”