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It's Time For A Bounce

Happy Asian New Year! 2008 is year of the rat. Well that's all well and good, except that these days a simple urban rat is a bit drab. Since the bottom has fallen out of financial markets in general, this month we could all use a bit of something different.

This downturn is not unexpected. As I write this, the S&P 500 is down and people are scared witless.

12/31/2007 S&P 500	01/30/08 S&P 500	Percent Change
1,468.36	**1,355.81**	**-7.67%**

In the midst of all this panic I can see mounting evidence that we are entering a recession, including today's higher unemployment report. But still I'm not seeing a lot of evidence that the stock market is about to experience a terrible multi-year downturn. That may happen, but the numbers are not there to suggest that it's likely.

There have been many market environments like this. Some of them I missed because either I was not born yet or I was too young to be investing. I have to study those events in books. Others I have actually experienced.

In 2008, Andresen & Associates will have been in existence for 20 years. We've been around 21 years if you count the 10 months in 1987 when we worked under another license. During those 21 years I can recall several deeply frightening downturns. I thought I'd go back and look at them again, and see what happened afterwards. Why is this important? Because in every case we had good reason to be terrified...and in every case the financial system recovered. What follows is systemic evidence that what we are experiencing now will pass.

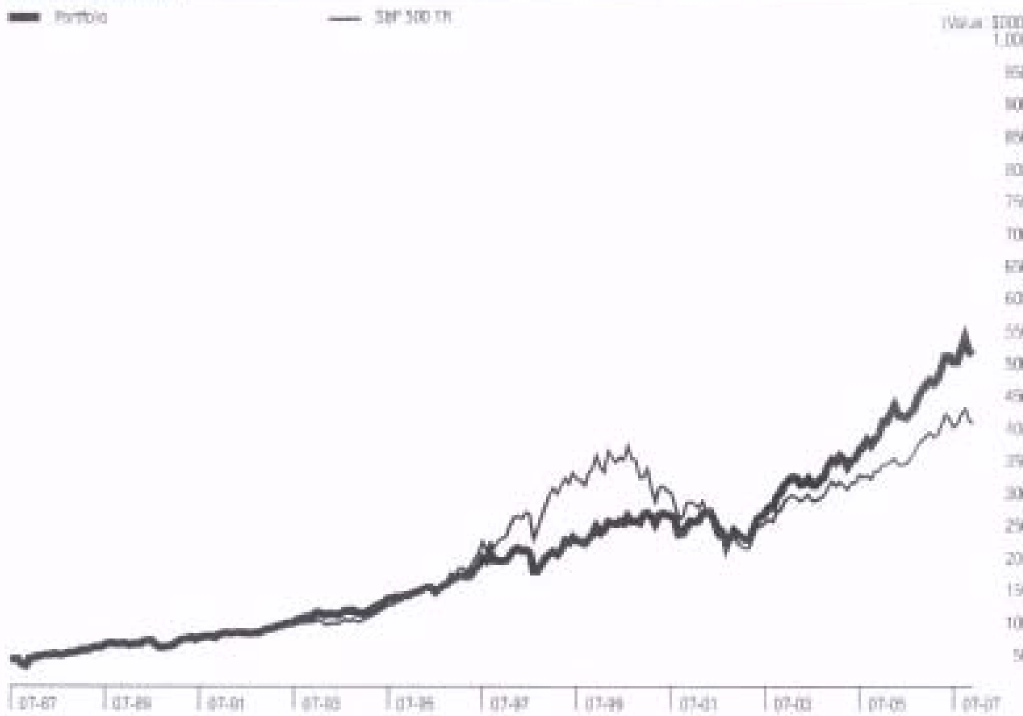
My first market crash was in 1987. I still had some hair. Madonna was queen. Ronald Reagan was president. "Moonstruck" starring Cher and "Wall Street" starring Michael Douglas were the movies du jour. Fawn Hall, Oliver North's assistant was taking heat in the Iran-Contra hearings for hiding classified documents for her boss. The median household income was $26,000. The S&P 500 went up 37% in the first 8 months of the year, and had reached overvalued levels. But interest rates were also heading up sharply, and my clients were taking a bath in the bond market. So I turned timid. The stock markets tripped around sideways from August through September, and then dropped about 33% in October, to finish with an essentially flat return for the year.

Hypothetical Portfolio Illustration

GRAPH 1

07-01-1987 to 12-31-2007

Portfolio Summary



Planning Assumptions

Federal Income Tax Rate	0%
Capital Gain Tax Rate	0%
State Tax Rate	0%
Tax Paid	Out of Pocket
Annual Fee Paid	Sale of Shares
Rebalance	No

Performance

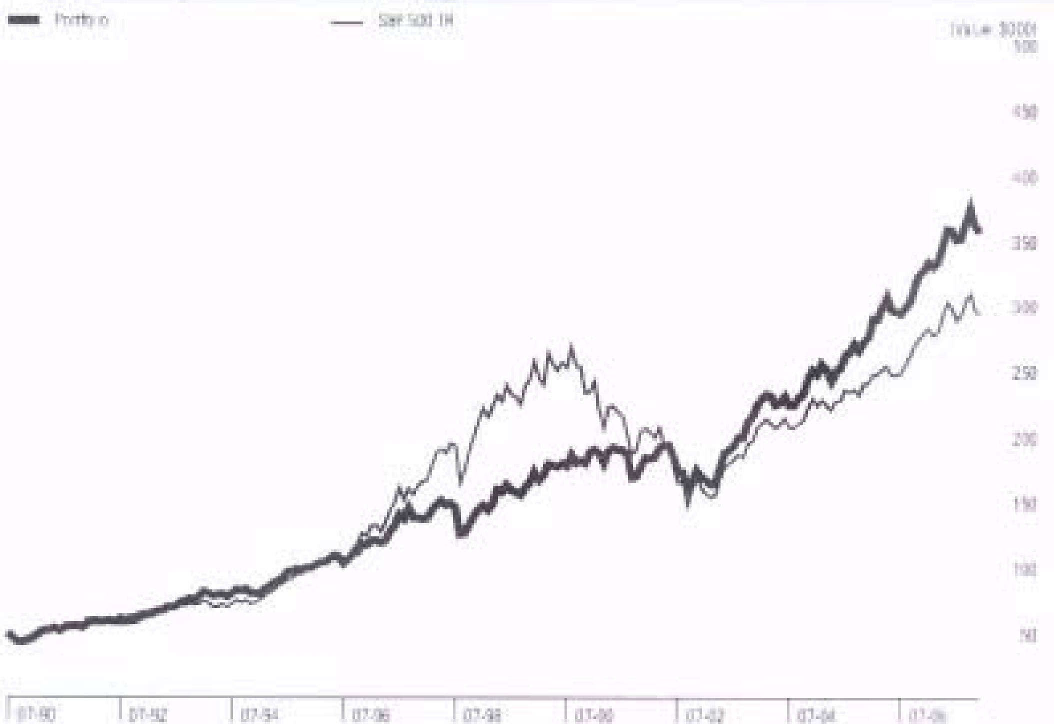
Net US Dollars Invested	$50,000
Final Market Value	$513,193
Average Annualized Return	12.09%
Cumulative Return	937.80%

Hypothetical Portfolio Illustration

GRAPH 2

07-01-1990 to 12-31-2007

Portfolio Summary



Planning Assumptions

Federal Income Tax Rate	0%
Capital Gain Tax Rate	0%
State Tax Rate	0%
Tax Paid	Out of Pocket
Annual Fee Paid	Sale of Shares
Rebalance	No

Performance

Net US Dollars Invested	$50,000
Final Market Value	$357,491
Average Annualized Return	11.90%
Cumulative Return	614.98%

Despite dire predictions and fear all around, recovery happened quickly. The hard part for all of us was getting back in. Some mutual funds such as the Mathers fund avoided most of the damage by holding lots of cash….but then could never quite build up the courage to re-invest as the financial markets recovered and left them lagging. In general, the money managers who avoided the debacle surrendered their out-performance by investing with excessive caution later.

The talk on the street was that we would experience a new 1929-style depression. A new Indian financial guru named Ravi Batra made millions of dollars predicting a great financial collapse.

But, here is what really happened. Here is what a hypothetical portfolio of $50,000 would have done if, on July 1st, 1987, just before the downturn, you invested 20% in Dodge and Cox Balanced fund, 20% in First Eagle Global, 20% in Longleaf Partners, 20% in Harbor International, and 20% in Brandywine. If you were a client in 1987 you recognize the names, and you remember the results. $50,000 invested then would be $513,000 on December 31st, 2007. That's a 937% return. (**GRAPH 1**)

And then there was 1990. George Bush was president. Mikail Gorbachev won the Nobel Peace Prize. In fact the entire Communist Bloc was about to crumble and we didn't have a clue. The median US household income was $30,000. We went to the theater to see "Dances with Wolves", where we discovered that all Sioux Indians have great hair all the time. On TV there appeared a bizarre show immediately denounced by churches nationwide: the Simpsons. Meanwhile, in the stock market, the Dow Jones Industrial Average was at 3000, which seemed an impossibly high level at the time. But what caused the market to tumble 21% was a tinhorn dictator in Iraq named Saddam Hussein who sent his pals the Republican Guard into neighboring Kuwait in August. The stock market dropped like a rock. I didn't personally care what was happening in Iraq. I was a Marine Reservist with a booming business. My wife and I had a 3 month old baby. I was called down to Camp Pendleton anyway. The consensus was that the war would last for three years and the 1st Marine Expeditionary Force would take 10,000 casualties due to chemical weapons.

I accumulated cash in my clients' accounts. Everything went sideways through Christmas, with everyone deeply afraid that either the Iraqis would win or the Russians would come in to help them.

I watched my friends deploy, and mostly waited in Pacific Grove for my own orders to come through. In 1991, I was down for another visit at Camp Pendleton when I realized with sudden clarity that we were going to do much better than the markets expected. I ran to a phone booth (no cell phone or Internet then!) and began frantically buying for my clients. I was already back on the ranch when the war ended. We did well.

You can see what happened next. Let's take the same five funds and invest them on July 1st, 1990, right before the axe fell. As you can see, your fifty thousand dollars would have grown to $357,491.That was a total return of 615%. The crash of 1990 was not a permanent ruination at all.
(**GRAPH 2**)

2000 was the Year The Bubble Really Burst. For most of us it seemed cataclysmic. But what history will probably remember most about the actual events of 2000 was that this was the year when the human genome was deciphered. Bill Clinton was president. On a new TV show named "Survivor" a cynical spear-fishing (and very naked) Richard Hatch garnered the prize. The movie to see was "Gladiator". The median US household income was $45,000. Ignored by most citizens, a small band of Moslem extremists launched a successful boat-mounted suicide bombing of the US destroyer Cole, killing 17 sailors and wounding many more. George W. Bush became president after an election in which the words "hanging chads" became common knowledge.

Meanwhile, professionally, I was caution personified. I had held clients to very conservative holdings as the stock market tech bubble swirled around us, and as a result client returns had lagged badly in 1998 and 1999. You can see that lag if you look at our hypothetical portfolio. The pressure to invest in technology stocks was intense. Then the bubble burst, and it burst big. If you were in tech stocks (we mostly were not), this was a one-in-a-century crash. I gradually added to my clients' risk exposure, buying diversified mutual funds all the way down until 2003.

Once again let's look at our hypothetical portfolio. Let's see the results from investing our $50,000 on July 1, 1996. This allows us to experience the lag of 1996, 1997, 1998 and 1999, as well as the crash of 2000. By staying so diversified, did we give up so much in those years that we would have been better off buying an index fund and taking the hit in 2000? (**GRAPH 3**)

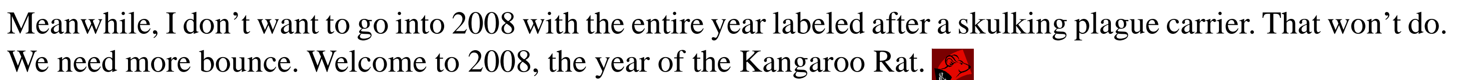
You can learn two big lessons from this illustration. The first is that while our diversified portfolio lagged for three entire years, that lag was more than recovered in the post crash era. Diversification paid. $50,000 invested became $166,409 for a cumulative return of 233%.

The other lesson is that even if we had simply stayed in an index fund we would have eventually regained our losses, although not as elegantly. The crash of 2000 was one of the great meltdowns in stock market history and still the financial markets recovered.

The great real estate and mortgage meltdown of 2007 will also be remembered as gigantic. The real estate markets themselves should take years to return to 2006 prices. But within the stock markets, valuations remain reasonable and earnings remain substantially attractive. As you can see in what I have just written, my entire career has been punctuated by market downturns which rode on the backs of fear and pessimism. Since our 2008 downturn is behaving like every other correction I have experienced, you can now see why I expect it to behave the same as all the others. I continue to believe that this is a buying opportunity. It may take awhile, but we'll be OK.

Our annual gift of good-luck money is emblematic of the Asian Century. Behold the Vietnamese Dong. Vietnam is one of the many countries now awakened to the blessings of capitalism, and not likely to go back to sleep soon. Bonus points to anyone who can recognize the portrait of our venerable uncle on the face of the bill. Now you can walk up to anyone on the street and say, "Hey, wanna see the face of 21st century capitalism?" Won't they be delighted and surprised to see Ho Chi Minh smiling up at them. As though they were expecting Donald Trump.

Meanwhile, I don't want to go into 2008 with the entire year labeled after a skulking plague carrier. That won't do. We need more bounce. Welcome to 2008, the year of the Kangaroo Rat.



Hypothetical Portfolio Illustration **GRAPH 3**

07-01-1996 to 12-31-2007

Portfolio Summary

Planning Assumptions

Federal Income Tax Rate	0%
Capital Gain Tax Rate	0%
State Tax Rate	0%
Tax Paid	Out of Pocket
Annual Fee Paid	Sale of Shares
Rebalance	No

Performance

Net US Dollars Invested	$50,000
Final Market Value	$166,409
Average Annualized Return	11.02%
Cumulative Return	232.82%