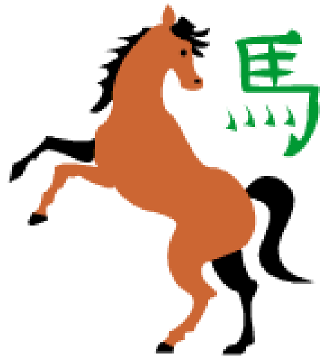

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The Pete Andresen Investment News

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The Next Ten Years

It is February once again. We wish you a happy and prosperous Asian New Year in Year 4700, the Year of the Horse. Traditionally we enclose a small "lei-see" envelope to convey our hope for your increased wealth. It contains an unissued pre-Taliban Afghani note. This is meant as a souvenir of 2001, one of the most tumultuous years in the history of the United States. You might keep this currency on your refrigerator to remind yourself how life can turn on a dime. We've also included a copy of a Wall Street Journal article revealing this money's strange history.

As 2002 unfolds, we find financial markets at a great crossroads. After eleven interest rate cuts by the Federal Reserve, short-term interest rates are at historic lows. We are in the midst of our first genuine recession in a generation, and we are at war. Stock markets have gone down for the past two years. As the fortune cookie says, "May you live in interesting times".

UNISSUED PRE-TALIBAN AFGHANI NOTE

The financial markets are struggling to reach consensus about our economic future. Is our social and financial condition so bleak that stock values should continue to decline? Or are current stock prices bargains?

A favorite college professor once said, "People always think tomorrow will look just like today". So far in my life he's been proven correct. Remember the glory days of 1999 and 2000, when the stock markets were soaring, and almost everywhere you turned (except here) the predictions were full speed ahead? Now what are we hearing, and what are we thinking? It's almost all bad news out there, and many investors are fed up with losses. They can see nothing but bleakness for years ahead. Yet in reality, tomorrow seldom looks like today. In fact, history tells us that change is the only constant. History can teach us a lot right now.

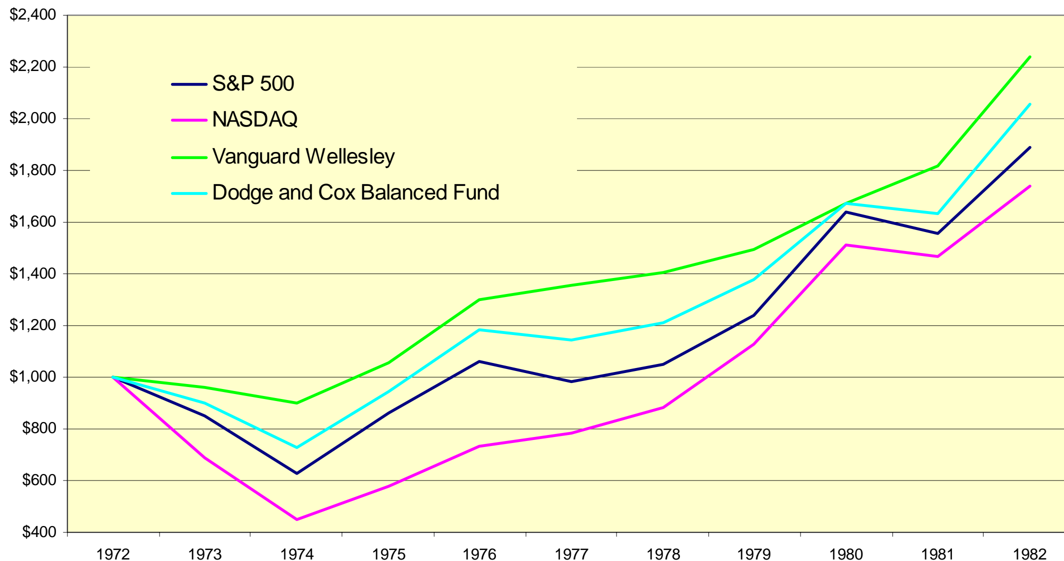
If you study the performance records of the past, you'll quickly notice that there are few examples of consecutive two-year stock market declines. There are virtually no examples of three-year declines except for 1929-1931, and even that occurred mostly in the first two years. How does that event compare with what we are experiencing now?

In the 1920's and 1930's, investing was the province of the rich: only about 2% of families owned stocks, compared to 60% now. In the three-year span of 1929-1931, the Federal Reserve RAISED interest rates to curb what they regarded as unacceptable levels of market speculation. Of course, this is the complete opposite of current Federal Reserve behavior. Finally, the 1930's featured a series of bankruptcies and corporate collapses which are the consequences of any stock market bubble. What we are seeing now with Enron, Global Crossing, and Kmart is, unfortunately, quite normal, and so far not nearly as severe as the 1930's.

In short, history suggests that if stocks continue to decline in any meaningful fashion throughout 2002, it will be a first in the history of the United States. Most notably, history tells us that the massive amount of liquidity (that's Federal Reserve-speak for "money") now entering our financial system has ALWAYS resulted in strong recoveries in the financial markets. A decline in the stock markets this year would surely be a first. Our urge to run and hide is not supported by the historical record.

A much more vital question for you as an investor is, what will happen in the next ten years? Nobody knows, not even those shiny talking heads on the TV who say they know. They say they know because they want you to watch the advertising. Instead of listening to them, let's focus on reality.

The last time the stock markets declined two years in a row was 1972. We were facing double-digit inflation, the Japanese were destroying our market share, and that giant sucking sound we all heard was our cash going to the Saudis to buy oil. The Soviet Union was running us in circles in Central America, Afghanistan, Rhodesia, Angola, and especially in Vietnam and Cambodia. Either global domination or global holocaust by the Soviets was regarded as a genuine possibility. The financial markets responded as follows.



During the decade from the end of 1972 to the end of 1982, the stock markets experienced one of the worst downturns in their histories. An investment at the end of 1972 of $1,000 in the S&P 500 shrank to $627 at the end of 1974. $1,000 invested in the NASDAQ declined to $447. Despite this setback, the NASDAQ still delivered a decade long return of 7% per year while the S&P 500 delivered an average 9% per year. Both these indexes lagged most value funds and balanced funds. Vanguard Wellesley, for example, delivered an annual rate of return of 12% for the entire decade. Dodge and Cox Balanced Fund invested in more mainstream stocks and thus delivered an average of 11% for the decade. A slow recovery does not mean mediocre returns.

Of course things were different then. They were worse. If you invested in the high-tech NASDAQ during the decade depicted in the graph, it took you five years after the down market to recover. However, if you invested in the value-oriented Vanguard Wellesley Income fund or the Dodge and Cox Balanced Fund, you recouped any loss in one or two years, and then went on to a decade-long performance that beat the indexes. In such a troubled stock market, value and balanced funds typically deliver index-beating long-term performance. A little diversification goes a long way.

It is quite possible that we may experience a slow stock market in the next ten years. The current valuation of the stock market is still quite high. Also, the natural consequences of any stock market bubble include the slow uncovering of shady deals and bogus accounting practices, such as those discovered at Enron. The revelations may take years. Meanwhile, grizzled investment guru Warren Buffet revealed in Fortune Magazine's Investor's Guide for 2002 (February 10th) that he expects the S&P 500 Index to produce an average of 7% a year for the next decade. That's why we want at least some of our money in value funds and balanced funds.

But what happens if Warren Buffet is WRONG? We would then experience a "V" shaped recovery and stocks would return to their soaring ways within a few years. We can make a reasonable argument that such a rapid recovery may actually take place. The Federal Reserve's eleven interest rate cuts ought to act like rocket fuel, at some point, and send the stock markets into space. Increased government spending required by our new security needs should have a tremendously stimulative effect. History demonstrates that war-created downturns usually are followed by sharp recoveries. Finally, the large valuations we are seeing may be due to smart investors, including insiders, buying stock in expectation of large future earnings improvements. Prudence indicates that we should have some of our money in recovery-friendly investments including growth and technology stocks. History suggests that we want some of our money where it can rise with the indexes in case they take off like the Blue Angels.

As you can see, we stand at the crossroads of a "slow recovery" scenario and a "v-shaped" recovery scenario. Both will not happen. It is not likely that you will be able to forecast one or the other in time to successfully invest. Therefore, we need to invest now, for one or the other or both. This is a decision only you can make, so we should continue to communicate. In the meantime, my intrinsic bias (and my personal portfolio) is oriented to take partial advantage of either scenario. We live in interesting times. ☯