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Facing the Future with Optimism and Courage
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I Couldn't Help Noticing

I couldn't help noticing that August 31st marked the 30th anniversary of the publication of the most infamous example of journalistic pessimism since Gutenberg first got ink on his fingers. In a classic case of rearview mirror prophesying, *BusinessWeek* ran a cover story on August 13, 1979 entitled *The Death of Equities*. The article gave readers plenty of reasons why investing in stocks had become an outdated idea ---

- Individual investors had already panicked out of the stock market and a recent change in federal law allowed pension plans to diversify their holdings into alternative investments such as real estate, commodity futures, mortgage-backed securities, foreign stocks and hard assets such as gold and silver. If pension plan managers dramatically shifted their asset allocation from US stocks to these alternative investments, "The implications for the US economy could not be worse."
- Stock prices were hammered by inflation during the 1970s and investors fled to the double-digit interest rates then being paid by bonds - whose yields were rising along with inflation. In the 1970s, the best returns came from those investments that took the fewest risks. Stocks appreciated at a compounded annual rate of 3.1% while the consumer price index surged 6.5% and gold rose at a 19.4% annualized rate. One year CDs yielding double-digit interest rates looked mighty attractive to investors while low stock prices were a disincentive to buy more stocks.
- Corporations were finding it difficult to find buyers for their stocks and the decade's poor stock performance "Can no longer be seen as something a stock market rally -- however strong -- will check."
- Younger people (that was me!) were avoiding stocks. Only individuals age 65 and older were adding to their stock holdings. "Have you been to an American stockholders' meeting lately? They're all old fogeys. The stock market is just not where the action's at."
- "Only the elderly who have not understood the changes in the nation's financial markets, or who are unable to adjust to them, are sticking with stocks." (Ah, the eternal folly of youth – heeding the counsel of its peers and ignoring the counsel of its elders.)
- "For better or for worse, the US economy probably has to regard the death of equities as a near permanent condition -- reversible someday, but not soon." (The following year, the S&P 500 Index rose 32.5 %.)
- "We have entered a new financial age. The old rules no longer apply." (You didn't really believe that this foolish notion had just recently materialized, did you?)
- "Given the type of constant high level inflation we've been experiencing, the stock market represents speculation and tangible assets represent the opposite." (Gold, the tangible asset darling of the time, peaked at $825/oz. just five months after the publication of *The Death of Equities*. Inflation-adjusted, it should be priced today at $2,160/oz. - more than twice its current price.)
- "The institutionalization of inflation (what does that mean?) along with structural changes in communications and psychology (say what??) have killed the US equity market for millions of investors." "Today, the old attitude of buying solid stocks as a cornerstone for one's life savings and retirement has simply disappeared."

At the time of the publication of this article, the S&P 500 Index was sitting at 107. Today, as I write this, it sits at 1087. Despite this decade's two market crashes, the annualized rate of return of large-company US stocks since August of 1979 has been 8.0% - excluding dividends. Small-company stocks have fared even better, returning about 1% more annually. Inflation has averaged 3.5%.

To their credit, *BusinessWeek* has re-published the article, along with a commentary, on their website. "At the time the story was written, the stock market had sustained serious losses and the long-term health of the US economy was a significant concern." But this is what always happens after a large market decline. Invariably, investors flee to bonds and whatever alternative investments rose when stocks declined. Prudent,

as compared to sensationalistic, journalism would have reminded readers of the cyclicality of markets and that there's nothing new under the sun - especially when fear and greed are involved.

I couldn't help noticing that Russell Investments has replaced one of the five managers of the Small Cap Equity Fund in the United Pilots' 401k plan. Once again, the old guys apparently started taking stupid pills and had to be replaced. About the same time, I couldn't help noticing a research paper by Boston University professor of finance Scott Stewart. He wanted to see if the "smart money" - pensions, endowments and foundations - made better decisions than individual investors when picking investment managers. It has long been known that individual investors trade too frequently and chase returns, yielding them lower returns than what can be earned by investing in index funds. Specifically, he wanted to determine if large institutional plan sponsors make or lose money when they hire and fire money managers. Stewart's conclusion is that sponsors actually destroy value when shifting assets among managers. In his study, the fired managers outperformed their replacements by an average of 1% annually over the subsequent five year period. Professor Stuart concludes, "The effort that plan sponsors are putting towards hiring and firing managers is not just a waste of time. It is actually hurting them." I don't imagine that we'll be hearing from Russell any time soon that our replacement managers have fared any better.

I couldn't help noticing two new reports this past week. The first, by Boston College's Center for Retirement Research, claims that 51% of Americans will not have enough money saved to retire by age 65. In the second report, Nationwide Insurance estimates that half of American households have become "disengaged" from managing their retirement savings. These hapless folks have apparently been stunned into in-action by demoralizing and unexpected declines in the values of their retirement portfolios and homes. They are no longer seeking financial advice, worrying about their retirement nest egg or funding their retirement accounts. One bright spot is that they're saving more and putting money into investments that they understand - savings accounts, CDs and money market funds. Today, $3.3 trillion is invested in money market mutual funds yielding an average annual return of 0.3%. Excessively conservative retirement investing almost guarantees that the retirement funding shortfall will persist well into the future. Benign neglect has never been a viable investment philosophy. If Nationwide's survey is correct, 50% of your fellow citizens have their heads in the sand, their tails in the air and are trying to figure out which way the wind is blowing. Now more than ever, Americans need comprehensive and comprehensible financial planning provided by professionals worthy of their trust.

I couldn't help noticing a recent report from Morningstar revealing that 51% of mutual fund managers don't have a single cent invested in the funds that they manage. This is just more proof that investment managers' interests are often not aligned with those of their shareholders. Shareholders are looking for long term stewardship of their money and most managers live and die by short term performance. (See Russell Investments above.) It seems to me that something's not right in the kitchen if grandma refuses to eat her own cooking on Thanksgiving Day.

I couldn't help noticing that it's déjà-vu all over again. In a repeat of what happened at the end of the 2000-2002 bear market, the largest mutual fund in America today is the Pimco Total Return Fund – a bond fund. The last time this happened US stocks were just beginning a new bull market which would see prices double over the next five years. Last year, investors withdrew $234 billion from stock mutual funds. Through September of this year only $18 billion has made its way back into stock funds while bond funds have received a staggering $255 billion. Much of this new bond money has come from frightened investors who are chasing last year's good bond performance. (Now might be a good time to remind ourselves that there's nothing easier to sell, or more comforting to buy than good past performance.) But with interest rates at 50 year lows, the prospects for bonds providing any capital appreciation going forward are somewhere between slim and none.

I couldn't help noticing that any poor soul who panicked out of the stock market in the past 12 months and is still on the sidelines has lost money. And I can't imagine how anybody who fled the market in panic would have had the nerve to return. The media's continual refrain since the market's low point in early March (the month in which more money was withdrawn from stock mutual funds than any month in history) has been that the rebound is an illusion and cannot last. The market is up 60% since then, yet they're still spewing out the same negative nonsense. Take, for example, the predictions of Nouriel Roubini – who received global notoriety for having predicted last year's market debacle. But so far this year, his predictions (annotated in

blue on the following chart of the Dow Jones Industrial Average) have been something less than divinely inspired --

(Chart courtesy of Wall St. Cheat Sheet)

To be fair to Mr. Roubini, he's an economist and not an investment manager. He probably answers too many phone calls from media types badgering him for predictions about the near term direction of stocks. But that's the problem with market timing. First, you have to decide which of the many shouting voices you're going to listen to. Then you must hope that your guru will be right - on both the get out and the get back in calls. Good luck and God bless.

I couldn't help noticing that the humiliation Wall Street so deservedly experienced last year has been pretty much forgotten and now they're back to business as usual. Last year we were told that it was a stock picker's market because investment success in a declining market requires the steady hand of active managers. Well that didn't work. Now we are told that it's a stock picker's market because investment success in a weak economic recovery will require the steady hand of active managers - who can pick stocks that are sure to outperform. Blah, blah, blah. Today, Wall Street is generating economic forecasts attempting to identify which segments of a slowly recovering economy will do well in the near term (a smart sounding idea). But this is nothing more than a recommendation for investors to become under-diversified (a stupid idea). Market timing by any other name still smells as bad and renaming it "tactical asset allocation" or "sector rotation strategy" should be a punishable offense. Wall Street remains primarily a distribution channel for commissioned products. Financial relationships with clients are based on performance comparisons, technical analyses, short-term market outlooks and persistent trading. Despite assertions to the contrary, there is little or no comprehensive or comprehensible financial planning involved in Wall Street's relationships with its clients.

On America, at Thanksgiving

When America's glass is three fourths full, why do two thirds of Americans see it as half empty? There is a discontinuity between the contentment and happiness that most Americans tell pollsters that they feel about their personal lives and the discontentment and gloom that they tell pollsters that they feel about our collective American life. Of course, gasoline prices and unemployment are too high, the dollar is too weak and credit is too tight. But these are the complaints of a society that has successfully dealt with most of the serious issues of life. The fault, dear Brutus, lies not in our stars but in ourselves. We spend too much time listening to jabbering journalists and pontificating politicians spewing out an endless stream of declinist

drivel. We permit ourselves to be influenced by media doomsayers who have perfected the ability to make the unpleasant sound catastrophic as they envisage a future as bleak as the lunar landscape. Blame must also be shared by our political ruling class. Considering us nothing more than their underlings, they are too eager to present themselves as sages capable of solving all our problems, be they imagined or real. But American history is the story of a repetitive cycle of lean and affluent times superimposed over a continually rising slope. This happy fact of history is one that we forget at our personal and collective peril.

After another year of economic and political stress and uncertainty, I would like to refocus our thinking and reprint a poem that has become a part of each November issue –

America

By Ray Bradbury

We are the dream that other people dream.
The land where other people land
When late at night
They think on flight
And, flying, here arrive
Where we fools dumbly thrive ourselves.

Refuse to see
We be what all the world would like to be.
Because we hive within this scheme
The obvious dream is blind to us.
We do not mind the miracle we are,
So stop our mouths with curses.
While all the world rehearses
Coming here to stay.
We busily make plans to go away.

How dumb! newcomers cry, arrived from Chad.
You're mad! Iraqis shout.
We'd sell our souls if we could be you.
How come you cannot see the way we see you?
You tread a freedom forest as you please.
But, damn! you miss the forest for the trees.
Ten thousand wanderers a week
Engulf your shore,
You wonder what their shouting's for,
And why so glad?

Run warm those souls: America is bad?
Sit down, stare in their faces, see!
You be the hoped-for thing a hopeless world would be.
In tides of immigrants that this year flow
You still remain the beckoning hearth they'd know.
In midnight beds with blueprint, plan and scheme
You are the dream that other people dream.

Happy Thanksgiving.

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