

The Only Thing We Have to Fear Is Fear Itself

MARKET COMMENTARY BY JIM O'SHAUGHNESSY: SEPTEMBER 2008

"THE ONLY THING WE HAVE TO FEAR IS FEAR ITSELF."

FRANKLIN D. ROOSEVELT

It's time to take a collective breath.

Amid the Fed-engineered takeover of Bear Stearns by J.P. Morgan, the collapse of Lehman Brothers, the nationalization of AIG and Merrill Lynch's rush into the arms of Bank of America, we need to ask ourselves "Why do we invest in the stock market?" The answer is simple and straightforward: we invest in the stock market because, given all the alternatives—from bonds and t-bills to real estate and commodities—the stock market has historically offered the best long-term performance—even when every-one is afraid that the sky is falling and that the bottom is dropping out of the market. If we compare all of these investments over rolling 20-year periods and adjust for inflation, *only stocks* (as measured by a proxy for the S&P 500) *have never had a negative return*.

I realize that it is difficult—if not close to impossible—not to be nervous about your portfolio in times like these. But let's take a walk down memory lane to remind us to keep things in perspective. Look at the worst 20-year period the stock market has ever experienced: the years from 1928 to 1948. Now keep in mind that these two decades included the Great Crash of 1929 and the Great Depression of the 1930s, where unemployment soared to 25%, Gross Domestic Product plunged by more than 30% and land values plummeted more than 50%. Through all of that, the S&P 500 posted

a *gain* of 0.55% per year over those 20 years, and a patient and committed investor still *made money*. An investor in small stocks did even better, earning 3.62% annually during that same period. The key, of course, is patience. An investor who panicked and sold out near the market bottom in 1932 would have lost nearly all his money, but an investor who stayed invested came out ahead.

Now let's compare this to an investment in bonds or t-bills (what most people consider "safer" investments than stocks). U.S. Long-term Bonds, backed by the full faith and credit of the United States government, have had numerous 20-year periods where they *lost* money, the worst being an average loss of 3.72% over the 20 years. Had you invested an IRA worth \$100,000, you'd be left with just \$46,840 after 20 years! T-bills have not fared much better—the worst 20 year real return for T-bills was almost as bad with an average annual loss of 3.2% per year.

The Silver Lining

Of course, the bad news is that, whether fully aware of it or not, investors have been watching their portfolios slide since the beginning of the decade. When you adjust for inflation, \$1 invested in the S&P 500 at the start of the year 2000 is now worth just 75 cents, and \$1 invested in large-cap growth stocks is now worth only 50 cents. But herein lay the silver lining—markets like these are tremendous times to buy. Based on my extensive research for *Predicting the Markets of Tomorrow*, I believe the S&P 500 will earn a real annual return of between 3% and 5% per year between 2000 and 2020. With that in mind, large stocks are poised for some excellent performance over the next 10 to 12 years.

For the S&P 500 to reach the low-end forecast of a 3% annual return I made in the book, the index must earn a real 5.5% annually between 2009 and 2020. To reach the high-end forecast of a 5% annual return, it needs to earn a real 10.2%. (Note, these are *real* returns, after inflation is stripped out. The nominal returns would be closer to 13% before adjusting for inflation.) Either way, both forecasts are well ahead of what we can expect from alternatives like Treasury bonds. The current yield on the ten-year TIPS bond is 1.8%, well below both the forecasted returns for the S&P 500.

What answer can we give the super-bear who thinks that through the year 2020 the market will only match the returns of the Great Depression? To do that, the S&P 500 would have to return a real 3.1% per year, still comfortably ahead of the 1.8% return you would earn from a 10-year TIPS bond.

The news is even better for large-cap growth stocks. Because of the damage they have suffered over the last nine years, to reach the low-end forecast of 1.97% real return through 2020, large-growth stocks will have to earn a real rate of return of 8.65% annually; to hit the high-end target of 3.97% they will need to earn 12% per year between now and 2020. And for that super-bear who thinks that we are slated to earn depression-era returns for large-cap growth stocks as well, given how much the market has already declined, the next 11 years should still offer up 4.6% real returns! And remember, these returns are for the broad market averages. Historically, both in backtests and with real time results, most of our strategies at O'Shaughnessy Asset Management have done significantly better than their underlying benchmarks.

The U.S. Stock Market has Recovered from Every Downturn Since 1792

It has been a very rough ride for investors over the last three months; yet look at the chart below. It graphs the real rate of return to the S&P 500 for all three-month periods going back to 1926. It looks like an EKG of someone having the world's worst heart attack! Now look closer. By focusing on very short periods of time, we wind up clouding—rather than clarifying—our vision. Markets like those we are suffering through today encourage panic and selling, relegating investors to the sidelines for the inevitable recovery. The U.S. stock market has recovered from every major bear market. It has survived countless wars and a depression that threw the world and the U.S. into what many worried was a death spiral. It has survived terrorist attacks on our buildings, Internet bubbles and a cornucopia of other crises.

But it is only the patient investor who reaps rewards in times like these. Dalbar, a financial consultancy in Boston, has done a study going back to 1984 comparing the returns earned by actual investors with the actual returns of the S&P 500. The results

are terrifying—between 1984 and 2002, the S&P 500 returned an average annual return of 12.22% whereas the average investor earned just 2.57%! Dalbar determined that virtually all of the difference was due to investors overreacting to short-term market conditions—panicking and selling when short-term conditions were volatile and getting greedy and buying near market tops.

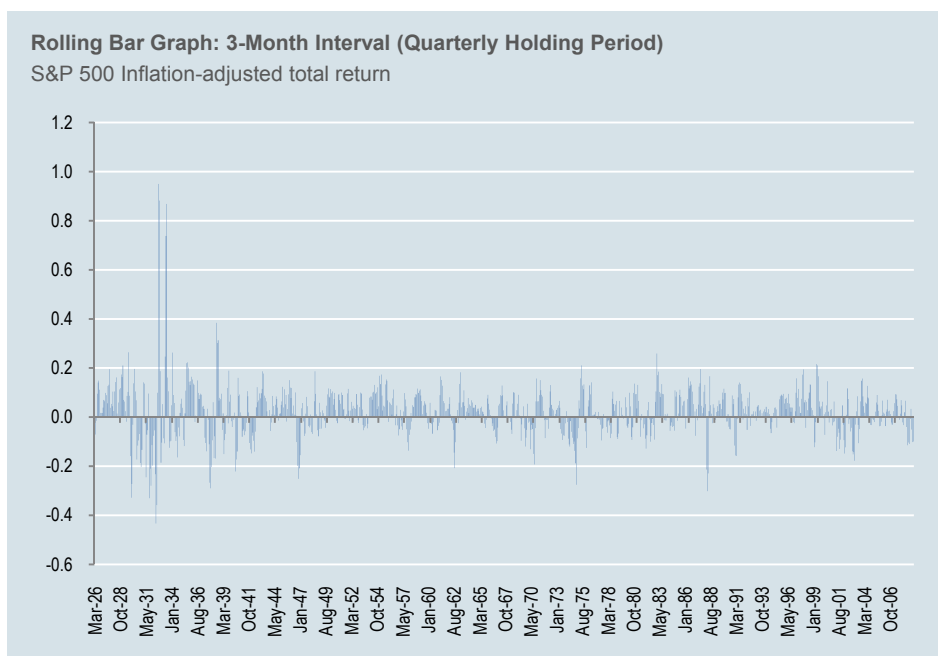
Nature has programmed us to be very poor investors. We let our emotions about current conditions blind us to the most likely outcomes that are fairly easy to predict when we extend our lens and look at what happens *after* horrible short-term events. Successful investing is an act of will. To be a successful investor you must understand that you'll never be right all the time, that you'll almost never buy at the low or sell at the high, and that there are no sure things, only great probabilities.

Indications of a Market Bottom

I am not a market timer. I have tested countless strategies and found them all lacking. We *have* been able to identify a list of rare signals that happen near major market bottoms, however, and the majority of them are flashing the green light right now.

- The behavior of retail investors.** Sadly, retail investors are almost a perfect contrary indicator, with a tsunami of sell orders hitting mutual funds near market bottoms. According to a press release from Trimtabs, a research company that measures mutual fund flows, equity mutual funds posted an outflow of \$11.9 billion in the week ending on Wednesday, September 10, and CNBC reported that the outflows for Monday, September 15th were \$11 billion, the highest single day outflow since the July 2002 lows of the last bear market.
- Stock/T-bill Return Ratio.** A ratio of the total expected return for stocks compared to 6-month T-bills has soared to the highest levels I've seen since 1980. This ratio tells you whether stocks or cash are the more reasonable investment by calculating the total expected return for the market by adding the earnings yield of the S&P 500 to its dividend yield and then dividing that sum by the 6 month yield. When stocks are the better investment, this ratio is above 1.50, suggesting that stock investors will be compensated by taking on the greater risk of stocks compared to T-bills. When the ratio is below 1.5, it suggests that investors are not being compensated for the risk they are taking and that bear markets may be near. It hit a low of .67 on March 31, 2000 (right before a bear market), averaged 1.78 from January 1, 1980 through September 17th, 2008, and on September 17th it soared to 7.60, suggesting that stocks are great opportunity right now.

- The VIX Index.** The VIX index is also known as the fear index. When low, market conditions are normal and there's very little fear about stock investing. It very rarely climbs into the mid 30s and only three times in the last ten years has it gone above 40, signaling fear gripping the market. Right now it's at 42, which points to a tremendous buying opportunity. The only other times it rose above 40 was in 1998—during the collapse of Long Term Capital Management, the default by Russia on its sovereign debt and the Asian



currency crisis—and in 2002, near the bottom of the worst bear market since the 1970s.

- **Money on the Sidelines.** Generally, when this number soars, it indicates how much buying pressure there will be when the market crisis ends. Since August 2007, \$930 billion has been added to money market funds. That exceeds the \$600 billion seen during the last bear market of 2000-2002 and points to a huge buying potential waiting in the wings.
- **The Leuthold Major Trend Index.** I have admired the work of Steve Leuthold for years. His firm maintains a Major Trend Index which indicated whether the market is bullish, bearish or neutral. In an update on September 17, 2008, they wrote that the index is the most bullish it has ever been in the 45 years they have maintained it.

An Historic Opportunity

It sure may not feel like it, but the market is presenting us with a rare opportunity. In times like these, most investors panic and sell. Behavioral economists have identified a consistent bias they have dubbed regency bias, where investors project the current market conditions way too far into the future. This causes them to seek safety from the volatility instead of leading them to see the market decline as a gift that allows them to buy stocks at vastly lower prices. Rational, historically driven methods like those we use at OSAM dictate that you and your clients must do the opposite. Successful investors study history. They unglue themselves from the present and make decisions using historical information that helps them understand what happened after *every*

other crisis. They understand and react to the present in terms of its antecedents and what can reasonably be expected for the future. Yesterday and tomorrow, as well as today, make up their *now*. By studying what has happened after similar downturns in the past, informed investors gain perspective, letting what they *know* transcend how they *feel*, and this becomes an emotional pressure valve.

What you and your clients do *right now* will affect both of your tomorrows. Urge them to do what I started doing in July and will continue to do over the next few months—convert all of your cash earmarked for investment in equities to investments in the stock market.