

The Un-Bubble of 2008

“The behavioral characteristics of the panic are the obverse of those of the boom. Excessive confidence is replaced by extreme fearfulness and a nervous distrust takes the place of blind trust. During the panic, the buying frenzy of the boom gives way to panicky disposals.”

- Edward Chancellor, in the 10/14/08 edition of *Financial Times*

Global financial markets are currently in full-blown panic mode. As famed writer Edward Chancellor notes above, market panics are, always and everywhere, the exact opposite of bubbles:

Bubble	Panic
Examples: Gold in the 1970's, Internet stocks in 1999, real estate prices in 2005-2007, commodity prices from 2005-2008.	Examples: U.S. stocks in 1973-1974, Internet stocks from 2000-2002, worldwide stock markets in 2008, commodity prices since 6/30/08.
Asset prices rise exponentially, with no apparent end in sight.	Asset prices fall persistently, with no apparent end in sight.
At or near the peak of the bubble, valuations are extremely high when compared to long-term historical values.	At or near the peak of the panic, valuations are extremely low when compared with long-term historical values.
Investors are extremely optimistic and are certain prices will continue to rise. Greed rules the day.	Investors hoard cash, because they are certain that prices will continue to fall. Fear rules the day.
The financial media is bullish.	The financial media is bearish.
Biggest investor concern: missing out on the coming boom.	Biggest investor concern: losing everything in the coming crash.
The most-famous market prognosticators are bulls.	The best-known market prognosticators are bears.
Opportunities for profitable investment appear limitless in number. Everything seems destined to increase in value.	There appear to be no profitable investment opportunities. Everything seems destined to decline in value.
Consumers are optimistic about the economy.	Consumers are pessimistic about the economy.
The major concern is return <i>on</i> capital.	The primary concern is return <i>of</i> capital.
Favorite investment idea: anything that is showing the biggest increase in value.	Favorite investment idea: anything that is <i>not</i> going down in value.
Mutual funds experience massive inflows as investors seek to maximize their returns.	Mutual funds experience massive outflows as investors seek to limit their losses.
Brokers and investment advisors are popular and admired for their wisdom.	Brokers and investment advisors are unpopular and broadly considered to be “out of touch” with reality.
Favorite cocktail party question: “How much is your portfolio up this year?”	Favorite cocktail party question: “How much cash are you holding?”
Prevailing view: <i>This time is different! Prices will never fall, because (a) demand will continue to rise forever; (b) the markets are more efficient now than they have ever been; (c) government regulators will save us from any bad market events; or (d) all of the above.</i>	Prevailing view: <i>This time is different! Prices will never go up, because (a) Capitalism as we know it is dead; (b) investors are so scared that they will never invest again; (c) government regulators will doom any recovery; or (d) all of the above.</i>

For as long as financial markets have existed, investors have been greediest at or near the top of the market, and they have been most fearful at or near the bottom of the market. This has always been the case, and it always will be.

Right now, fearful investors are selling stocks frantically and fleeing to cash equivalents. On the surface, this may seem to make good sense. After all, cash holdings typically do not decline in value from day-to-day, in contrast with stocks, which have been losing value for months. So the equation seems simple: sell the stuff that is going down in price (stocks) and buy the stuff that “never” goes down in value (cash).

But is cash *really* a safe hiding place? Warren Buffett addressed this point in a New York Times op-ed last month:

“Today people who hold cash equivalents feel comfortable. They shouldn’t. They have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value.”

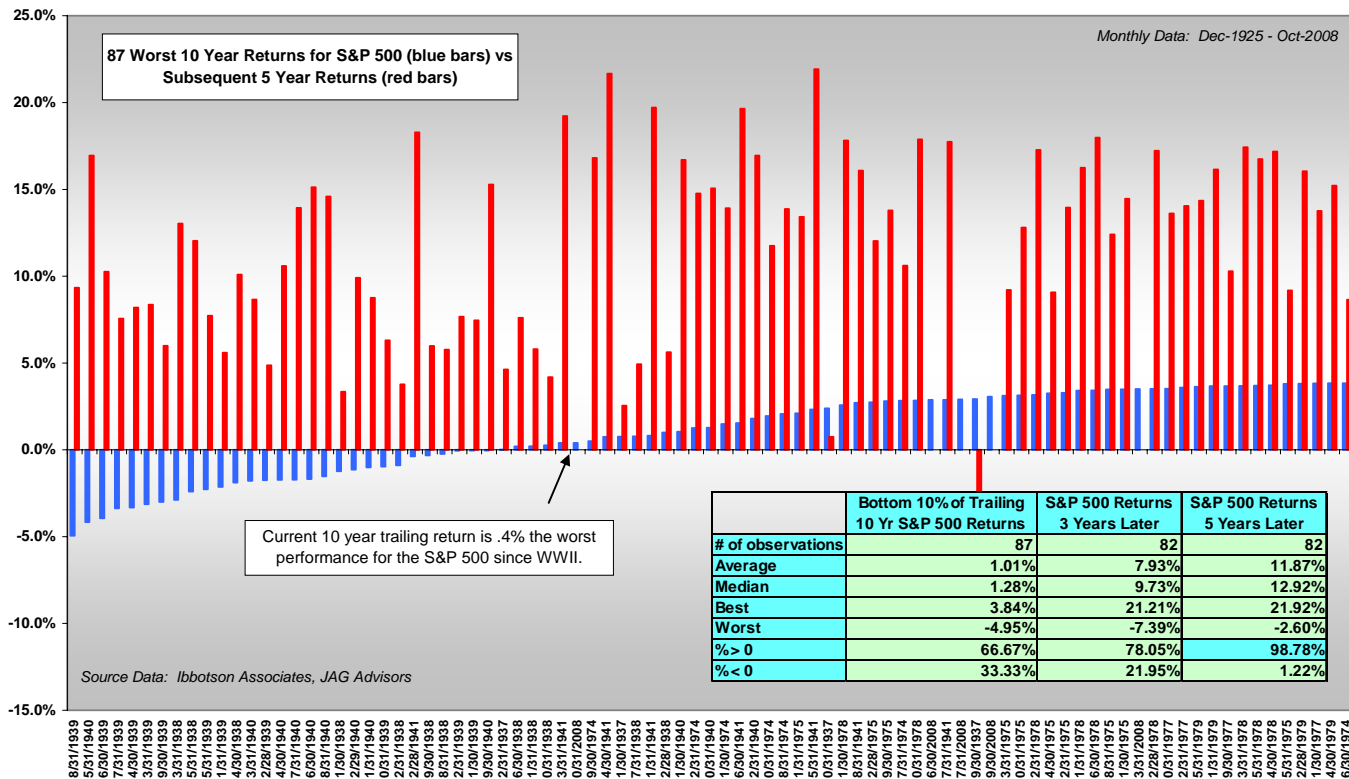
Wait a minute... How can Buffett call our friend Cash a “terrible long-term asset?” How can something that “feels” so good be wrong? The answer is *inflation*. Over the long-term, price inflation annihilates the purchasing power of cash. That’s right... *inflation* is the hurricane that destroys our “safe port in a storm.”

Inflation Rate	Purchasing Power of \$1			
	Years			
	1	5	10	20
0.5%	\$1.00	\$0.98	\$0.95	\$0.91
1.0%	\$0.99	\$0.95	\$0.91	\$0.82
1.5%	\$0.99	\$0.93	\$0.86	\$0.74
2.0%	\$0.98	\$0.91	\$0.82	\$0.67
2.5%	\$0.98	\$0.88	\$0.78	\$0.61
3.0%	\$0.97	\$0.86	\$0.74	\$0.55
3.5%	\$0.97	\$0.84	\$0.71	\$0.50
4.0%	\$0.96	\$0.82	\$0.68	\$0.46
4.5%	\$0.96	\$0.80	\$0.64	\$0.41
5.0%	\$0.95	\$0.78	\$0.61	\$0.38

The impact of inflation on our purchasing power is really quite devastating. As the above table demonstrates, even if we assume a modest inflation rate of 4% over the coming decade, the purchasing power of today’s dollar will fall to just **68 cents** by 2019 – equating to a drop in the real value of the dollar of **32%** from today. If you are willing to assume, as we at JAG do, that inflation could run as high as 5% over the coming years, the destruction of purchasing power is an even more stunning **39%**.

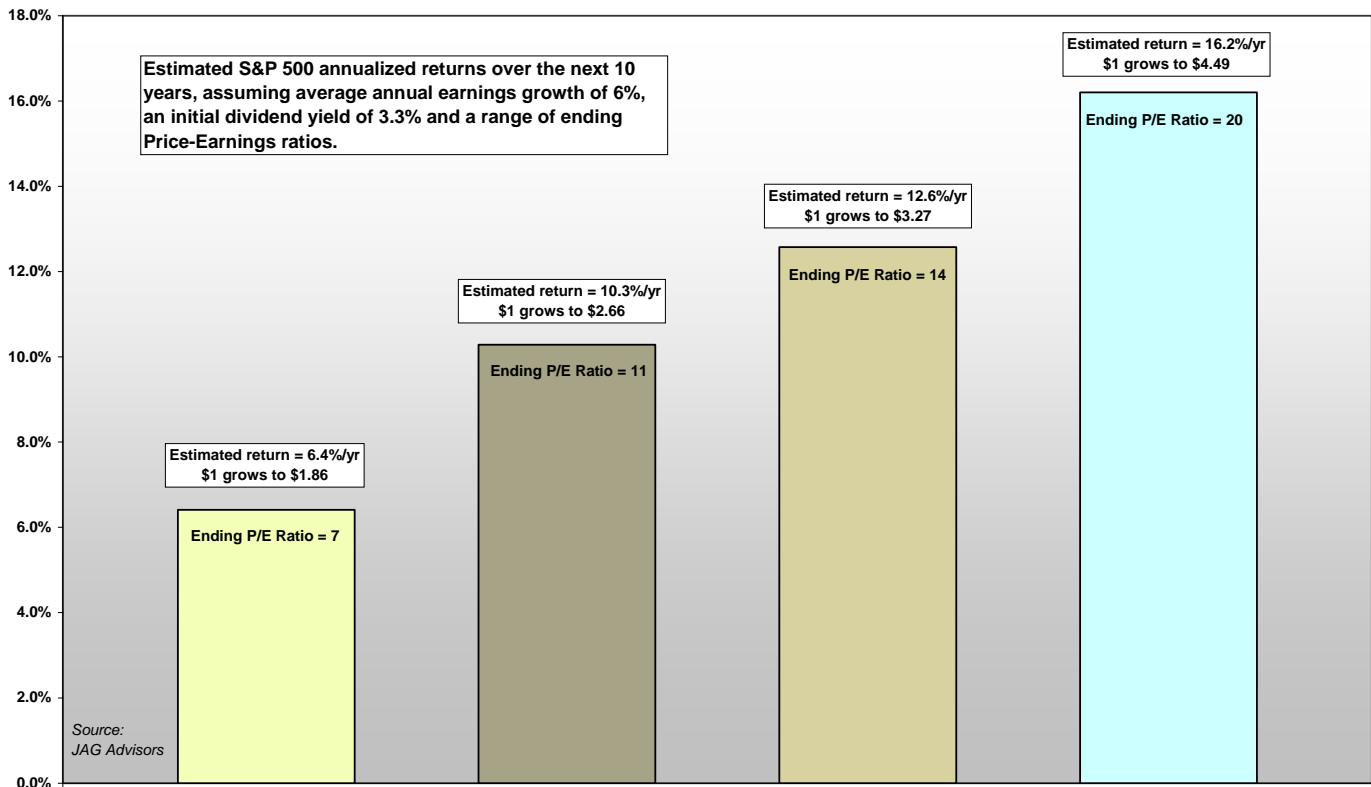
Over the past century, over almost all market cycles, stocks have provided the best measure of protection against inflation. “But,” you might say, “So what - stocks have performed terribly for a long time.” And you would be correct in that assertion, at least when looking through a rear-view mirror at the last decade. The chart below details the worst 87 rolling 10 year periods in stock market history, going back to 1925. The most recent

10 year period shows that through 10/31/08, the total return of S&P 500 (including dividends) averaged .4%. This means that the last 10 years were the *worst* 10 years to have been a stock market investor since the period ending 3/31/41:



This chart certainly tells a sad tale, but it also points to a surprisingly happy ending. If history is any guide at all, the S&P 500 is likely to post much better returns in the coming years than it has over the last decade. See the table inside the chart, and take special note of what happened *after* the worst 10 year returns in history. The data shows that over the subsequent three years, the S&P 500 on average produced an annual return of **7.93%**. Over the subsequent five years, the S&P 500 on average produced a very strong annual return of **11.87%**. Take special note, also, of the fact that **98.78%** of subsequent five year periods produced positive returns for the S&P 500. Therefore, although there are no guarantees in life or the markets, the historical odds are very strong that stocks will recover substantially over the next several years.

The next chart makes an even more optimistic case about the future. We make several reasonable assumptions, all of which are rooted in market history. First of all, we assume that corporate earnings will increase at an average annual rate of 6%, which has been the average rate of earnings increases for almost 100 years. Next we assume that the current S&P 500 dividend yield of 3.3% holds true. Finally, we project a range of terminal Price to Earnings ratios. When we mix all of this together, we can come up with a range of expected returns for the S&P 500 over the next 10 years:



As you can see, using some modest assumptions, stocks could produce an average return of between **6.4%** (worst-case) and **16.2%** (best-case) over the next 10 years. In the worst-case scenario, a dollar invested in the S&P 500 today would grow each invested dollar to **\$1.86**. The best-case scenario would grow a dollar to **\$4.49**. Even in the worst-case scenario, stocks should handsomely outperform cash and inflation in the coming years. In fact, the prospective 10 year returns on stocks right now are as high as they have been in decades (since the early 1980's, if you are keeping score at home). In a nutshell, this is why we are not advocating that our clients liquidate their stock portfolios.

Again, if history is any guide at all, a broadly diversified equity portfolio is likely to produce returns well in excess of inflation over the next 10 years. Investors who are selling stocks today are, in effect, *selling* an asset that will very probably produce strong returns over the next several years – only to turn around and *buy* an asset that is guaranteed to lose much of its purchasing power in the future. Let's think this “panic mentality” through... Investors are rushing to sell stocks at prices that are 50% or more below their peaks, only to put the proceeds into cash, which is destined to *lose* 30% or more of its purchasing power over the next 10 years. In other words, people selling now are willingly taking losses, in order to have the privilege of... taking more losses! We think this makes zero fiscal sense for anyone with a reasonable investment timeframe of three to five years or longer.

True, stock prices may get cheaper before they ultimately recover. There is always short-term risk in stock prices, even after a prolonged market decline. But it is also true that over the last several generations, it has never paid off for long-term investors to sell equities when the major stock market averages have fallen by 50% or more.

But so far, all of this historical evidence is not swaying the sellers. Plenty of people are still hitting the “sell button.” This will seem to be “smart” only so long as the market continues to decline. And when the decline stops, if history is any guide at all, we are likely to see a rally of epic proportions. This happened in 1933, 1975, 1982, 1987, and 2002, and it will likely happen again – perhaps very soon. Those who are in cash for this rally will almost certainly miss out on very substantial gains.

It is interesting to note, by the way, that Warren Buffett has made only three publicly bullish comments on the broader stock market in his entire career: in 1974, 1978, and 2008. In each of these instances, he was not correct immediately. It took months or years for his bullish view to become conventional wisdom. This is fascinating, because while almost everyone admires Warren Buffett’s investing acumen, they do not tend to follow his advice with their own capital. So when he says that he is buying stocks, many people are only too happy to sell their stocks to him and other investors like him. We think that Buffett’s willingness to be “greedy when others are fearful” is a key reason that he is one of the wealthiest human beings in history. Too many of the rest of us find it easier to be “fearful when others are fearful” or “greedy when others are greedy.” This is a sure-fire path to poor long-term investment results.

Market Outlook

The ends of bear markets are characterized by extreme price volatility, persistent and increasingly negative investor sentiment, massive outflows from mutual funds, large cash balances in investment and savings accounts, and depressed valuations in a wide variety of stocks. All of those attributes are in place today.

That said, no one can say with any certainty where or when the stock market will bottom in the short-term. Our educated guess is that we are getting close. Even if we are correct about this, we do not anticipate that the market will rocket straight back up to previous highs immediately. Bear market panics take time to heal themselves.

It is vital to remember that our markets and our economy have been through terrible periods before. Over the last century, we have made it through the Great Depression, World War II, the Korean War, the Vietnam War, multiple oil shocks, and 9/11. We recovered from each of these crises, and we at JAG have no doubt that we will recover from the current financial crisis.

In the meantime, as always, we are working to position our clients’ portfolios into investments that we expect will perform well in the future. We focus on owning the securities in companies with manageable debt loads, strong earnings outlooks, and leading market positions. There are more of these opportunities available today than there have been in decades, and we will do our best to find them.

Norm Conley, CEO
JAG Advisors
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