ADDING VALUE

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CATCHING A MARKET LOW

Stock market returns have two components: enterprise and emotion. The enterprise return is predictable and constant. The emotional return is erratic and uncontrolled. This newsletter explains why we are at the mercy of emotions in these uncertain economic times.

As John Bogle once so succinctly stated: "In the stock market, *anything can happen*." From the bankruptcy of Lehman Brothers on September 18, 2008, we have watched with awe and terror as that statement came true and repeated itself ad nauseam with heretofore unimaginable ferocity and tenacity for another 6 months. Changes in the nature and structure of our financial markets-and a radical shift in its participants-are making shocking and unexpected market fluctuations ever more probable. The amazing market swings we've witnessed in the past few months tend to confirm the likelihood of continued future fluctuations.

As one would expect, economists and scholars have begun to analyze these types of market dislocations. One of the more famous analyzers is Nassim Nicholas Taleb whose book is entitled The Black Swan. His definition of a black swan is:

1. An outlier beyond the realm of our regular expectations (**rarity**);
2. An event that carries an extreme impact (**extremeness**); and
3. A happening that, after the fact, our human nature enables us to accept by concocting explanations that make it seem predictable (**retrospective predictability**)

Well, there it is: rarity, extremeness, and retrospective predictability. . . the events of the last six months seem to fit neatly into the "black swan package".

Fortunately, for all of us, the stock market over the long-term has experienced relatively few of these extreme changes. That is not to say that these periods are unprecedented, just infrequent. Most of the time, we are underwhelmed by the frequent (dare we say monotonous?) fluctuations that take place each day within normal ranges. So we can say with relative confidence today that volatility will be lower at some point in the future. (For some of us, monotony cannot come soon enough!) The primary reason for this is that the underlying businesses in the stock market are far less volatile that the markets themselves. Put another way, investors are more volatile than investments. Economic reality governs the returns earned by our businesses while emotions and perceptions-the swings of hope, greed, and fear among participants in our financial system-govern the returns in our markets.

More than 80 years ago, a distinguished economist John Maynard Keynes, not coincidentally, wrote about this critical distinction between

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economics and emotions in a book entitled The General Theory of Employment, Interest, and Money. The date of the book was 1935, immediately after the stock market collapse of the Great Depression, a period to which the last six months has been compared. In Chapter 12 of that book, he focused on two broad reasons that explain the return on stocks. The first was what he called enterprise, or "forecasting the prospective yield of an asset over its entire life." The second was speculation, or "forecasting the psychology of the market," otherwise known as the madness of crowds.

In the late 1980's, after the Black Monday crash of October 19, 1987, John Bogle, again with timing that is not coincidental, insightfully expounded on the Keynesian theory. Mr. Bogle defined Mr. Keynes "enterprise return" as "investment return," or the initial dividend yield on stocks plus the subsequent annual rate of earnings growth. Similarly, Mr. Bogle defined Mr. Keynes "emotional return" as "speculative return", or the change in the price investors are willing to pay for each dollar of earnings. In either case, simply adding investment return to speculative return produces the total return generated by the stock market.

Let's give a simplistic example. If stocks begin a decade with a dividend yield of 4 percent and experience subsequent earnings growth of 5 percent, the economic/investment return would be approximately 9 percent. If the price-earnings ratio rises from 15 times to 20 times, that 33 percent increase, spread over a 10-year period, would translate into an emotional/speculative return of about 3 percent annually. Simply adding the two returns together, the total return on stocks would come to 12 percent. Mr. Bogle mathematically extended Mr. Keynes's original concept. Surprisingly, using this math decade by decade over the past century has proven to be remarkably precise for the total returns actually earned by U.S. stocks. In addition, Professor Javier Estrada in Spain has confirmed that this concept works in stock markets all over the globe.

So what is the point of this example? As Mr. Bogle, Mr. Buffett, and many others, including the managers of the mutual funds in your portfolio state: "Over the long-run, it is the economics of investing that has determined total return; the evanescent *emotions* of investing have ultimately proven to be virtually meaningless. In the past century, for example, the 9.6% average annual return on U.S. stocks has been composed of 9.5 percentage points of investment return and only 0.1 percentage points of speculative return. Despite the Black Swans of market history, ownership of American business has been a **winner's** game."

There is one other economist who deserves mention because he is not a household name. Hyman Minsky (1919-1996) added a crucial ingredient to providing a solid framework for understanding stock market returns. His most important works were written after the 1973-74 recession (another period of great financial stress) and concerned the "financial instability hypothesis." He observed that our financial system swings "between robustness and fragility, and these swings are an integral part of the process that generates business cycles." But what is really important about the writings that he produced at the end of his life concern a stage of capitalism that he called "money-manager capitalism." He stated that when the 1980's began, the structure of capitalism began to change. Ownership of stocks shifted from individual ownership to institutional ownership. Over this period of twenty years, money managers became accountable to their clients over increasingly shorter time frames. Further, whoever could market and advertise their "brand" better increased their assets under management faster. As institutional investors turned increasingly to speculation (short-term thinking) to satisfy their client demands, their companies introduced more exotic products to give the impression of innovation. Securitized loans, structured finance products, and myriad of other exotic innovations became the norm. It was one big vicious cycle. In this downturn compared to those that preceded it, one fact that

is very clear is that the financial innovators liked their own innovations so much that they kept them on their books. The financial sector that focused on speculation overwhelmed the productive economy.

Michael J. Mauboussin, Chief Strategist of Legg Mason Capital Management, gives us his insight on the Minsky paradox and how we get into these situations. He believes that there are three reasons:

1. The first factor is induction.
2. The second factor is leverage.
3. The third factor is incentives.

First, all of us are guilty of induction. People generalize about a system based on a number of observations and often assume that the future will be like the past. When everything is going well—we expect it to continue. When everything is not going well—we expect it to continue. How many of you have lamented to me that you will never see the money that you "lost" in this downturn, ever again? Well, we got to this position by believing that the good times would never end and by having too much confidence in the knowledge of the system.

With respect to the second factor, almost all major financial calamities involve leverage—it was the culprit in the 1930's, the 1970's, the 1990's, and today. When volatility is low and competition reduces returns, investors start to feel comfortable using leverage to "buy more stuff" or boost performance. Investors, when confronted with an apparent reduction in risk, will seek to return to their normal or desired risk by leveraging up. In addition, when things are going well and volatility is low, leverage is cheap and accessible. Risk is ignored and debt levels soar until at the market peak capital gains (such as increasing home prices) are needed to merely pay the carrying costs.

The final factor behind overbetting is incentives. Everything is so competitive. When the bank down the street, your neighbor, or your business is making a lot more money than you are, you have a lot of incentive to imitate their behavior. In fact, if you don't imitate the behavior of others—you will lose. "Keeping up with the Joneses" is a strong rallying cry. But the paradox of risk is that what appears, by consensus, to be the least risky position based on past performance is often the most risky prospectively.

Continuing down this line of reasoning, it is our opinion that this current financial crisis is not only the result of toxic waste on bank balance sheets, but also a result of an orgy of speculation in the market. For example, Vanguard's Bogle Financial Markets Research Center, reports that during the Roaring Twenties, stocks had a 140 percent annual turnover. In the 1950's and 1960's, turnover had dropped from that speculative level to about 30 percent a year. In 2006, it rose to 200 percent. In 2007, it was 280 percent. In 2009, it was running at 320 percent!!!! Moreover, comparing the capitalization of the U. S. stock market with the U.S. GDP greatly **understates** the rise in speculation for the new financial "products" that have themselves overwhelmed stock market valuations. In 1957, the market value of stocks in the S&P 500 was $220 billion and futures and options on the index didn't exist. By 1982, the value of the S&P 500 had soared to $1.2 trillion and the then recently created S&P 500 futures and options outstanding totaled $438 billion. By the close of 2006, with the S&P valued at $12 trillion, futures and options had soared to $20 trillion; the "expectations" market was almost double the "real" market. But it is the financial derivatives market that is truly a staggering phenomenon. Again, using estimates from Vanguard, the aggregate nominal value of global financial derivatives is said to be $600 trillion, fully ten times as large as the $60 trillion of net goods and services produced by our entire world. Among the riskiest of these derivatives are credit default swaps, which alone total $45 trillion, an amazing ninefold increase *in the last three years*. These

swaps are five times the size of the U.S. national debt and three times the U. S. GDP. No wonder the market has reacted negatively to this monster of our own creation.

As we complete this newsletter during the last days of March, the stock market has staged a gladly welcomed rally, spring has officially begun, CNN has admitted to the tendency toward sensationalist headlines, and President Obama is a little over one-half way through his first 100 days in office. The winter of our extreme discontent may be ending. Every facet of the journey has been difficult and painful from a re-examination of each individual's risk tolerance to a re-capitalization of the world's financial markets. From this fragile precipice, we still really don't know what lies ahead on how long it will be until we are on more stable ground…but we do know that there will be a solution and America's irrepressible optimism will again be front and center. Hopefully, the changes that are being proposed to the regulatory systems and financial products are enlightened, prudent, and forward-looking. In these markets, the only thing we know for certain is that recovery will occur and the stock market will have rallied even though the market participants are still terrified of more losses. The emotional component of the stock market return is a wily, nonqualitative creature. We should all hope that the medicine needed to control the creature's jitters begins to work soon.

Respectfully yours,

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