

January 2002

Shaken, Not Stirred

Bonds. Treasury Bonds.

Bonds have been the unexpected hero for the past two years in our enclosed annual listing of the performance of the four major asset classes: large stocks, small stocks, foreign stocks and bonds. The best performer each year has a box around it.

In the bull market of the late 1990's, investors imprinted like baby ducks on the performance of large U.S. stocks, the winners for four straight years and double-digit gainers for five straight years. Academics trumpeted the long run superiority of equity investing. Money managers bragged to the media about moving away from "under-performing" assets, i.e. anything other than large technology growth stocks.

***"Among all forms of mistake,
prophecy is the most gratuitous."
-- George Eliot, Middlemarch***

Instead of bragging, they should have been studying history. At the beginning of 1995, large US stocks had been the best performing asset in only one of the previous 29 years. As surprising as the recent success of bonds may seem, they have been the best performers twice as often as large US stocks. Once a "trend" of superior performance is discoverable, it may be about to disappear. Our diversified approach, maintaining a disciplined balance instead of trying to predict the future, is illustrated in the two columns on the right. Diversified portfolios are more boring than trying to guess next year's winner, but you get good relative performance with relatively low risk.

It is natural to expect the future to be an extension of the recent past, and this decision rule seems to work in most areas of our lives. If you like eating grapes today, you are likely to enjoy eating them tomorrow. The investment markets, however, fluctuate in cycles around a long-term average. Markets act like a rubber band that can be stretched only so far in one direction (e.g., the superior performance of large growth stocks in 1999) before they snap back in the other direction (the destruction of growth stock prices in 2000 and 2001). It is almost as if liking grapes today was a predictor of distaste tomorrow.

The great bull market has created a new generation of equity investors, a generation that has now experienced its first bear market. As one measure of how much the world has changed, statistics from the Investment Company Institute show that in 1980 fewer than 6% of American households had money in a mutual fund, mostly in bond or money-market funds. Now, over half of all households have invested in mutual funds, and almost three-quarters of the money is in equity funds.

As measured by the Standard & Poor's 500 index of large company stocks, the recent decline was the second worst since World War II. The more severe bear market was in 1973-74, a period encompassing the resignation of the president, the first oil crisis, a severe recession and double digit inflation. Fans of numerology point out that we're "due" for a bull market, since the 1973-74 bear was the only other post-war occurrence of a two-year decline. This only works if you don't go too far back, however, since the market declined four straight years from 1929-32. The five year consecutive double digit gains from 1995-1999 were unprecedented in U.S. market history, so bulls shouldn't try to carry the "we're due" logic too far.

***To act would be to analyze,
to analyze would be to realize,
and to realize would be to despair***

Despite the severity of the recent bear market, however, investor sentiment has remained relatively sunny. Many investors continue to expect returns far above the historical long-term average. Equity funds had the smallest inflow in 10 years in 2001, but at least it was still an inflow. Other sentiment measures tell a similar story -- investors are shaken by market declines, but not stirred into action, at least not yet.

Many apparently believe the new era prosperity is back. Analysts and investor public relations firms strain to find something kind to say about current business conditions, resulting in earnings releases with headlines like "XYZ Corp. announces positive earnings before costs" and similar nonsense. Describing another technology boom, that of the late 1960's, Warren Buffett once said "We live in an investment world populated not by those who must be logically persuaded to believe, but by the hopeful, credulous and greedy, grasping for an excuse to believe."

What is reflected by continued positive sentiment -- the steely nerves of well-informed investors, or paralysis? Are investors sitting on losses, waiting for the market to rebound so they can "break even?" Perhaps they remain inert because to act would be to analyze, to analyze would be to realize, and to realize would be to despair.

Two types of sailors are confident when a storm approaches -- the most experienced, because they know their skill can see them through the rough waters, and the least experienced, because they have no idea of the magnitude of the trouble they face. Stock market optimists believe inaction by investors reflects a preponderance in the former category. Pessimists believe it reflects a preponderance in the latter.

If you know anyone shaken by the specter (or reality) of the investment storm, have them contact us.