

We Learn From History That We Do Not Learn From History

The grainy, herky-jerky films show newly-mobilized French, British and German soldiers marching off to war in August 1914 to wildly cheering crowds. The widespread assumption was that the war would be short and regional, just like the Crimean and Franco-Prussian wars of the middle to late 19th century. The U.S. Civil War had provided a glimpse of the unspeakable carnage that was to come, but it was ignored by most Europeans. After all, it had happened on a different continent.

“History is the version of past events that people have decided to agree upon.”
-- Napoleon Bonaparte

Japan has for 10 years been mired in an economic depression and financial slump following the piercing of their stock market bubble. At the peak of that bubble, the Japanese were considered to be economic supermen, dominating the slothful United States. Maybe it's just us, but we find it hard to believe the Japanese have become significantly less intelligent or hard-working in the last 10 years. Despite the current status of the U.S. as the entrepreneurial colossus astride the world, we also don't feel much smarter than 10 years ago. While we will admit to a touch of sloth, that has remained fairly constant over the decade.

The blight in Japan's financial markets since 1989 is largely ignored by U.S. stock market analysts and economists. After all, that happened on a different continent. Any past event can be made to appear inevitable by a competent historian. We are not predicting similar economic or financial calamities in the U.S. It is sobering, however, to consider that the primary bases for our current belief in our genius, our current belief that the Japanese system is flawed, and our belief a decade ago in the superiority of the Japanese system are, respectively, our rising stock market, their falling stock market, and their then-rising stock market. A rising stock market and brains are two different commodities.

Just because there hasn't been a major earthquake in California recently doesn't mean all danger has passed. Many investors, however, seem to be making the analogous assumption about financial markets. The Employee Retirement Income Security Act of 1974 (ERISA) created the pension plans where most investors have stored their money. ERISA became law in a year when the Dow Jones Industrial Average was at about 600. Given the Dow's high this year above 11,700, the experience of most investors today has consisted solely of a period in which the stock market has essentially gone steadily upward.

A recent survey by Scudder Kemper showed that retirement plan participants, taken as a whole, think a reasonable average annual rate of return for

their retirement assets is 21 percent. Participants under the age of 35 expected a 26.5 percent average annual rate of return on their assets.

How realistic are the expectations of these retirement plan participants in a historical context? Since 1802, the real (adjusted for inflation) average annual return on U.S. stocks through 1998 has been 6.42 percent. Neither 19th nor 20th century returns varied from this long-term average by as much as a quarter of one percent. So even if the retirement plan investors had all their money invested in stocks, they expect their returns will be more than three times the historical average real returns, with younger participants expecting more than four times the average real returns.

***" Human history becomes more
and more a race between
education and catastrophe"
-- H.G. Wells***

In the survey, 72% of retirement plan participant balances were invested in equities, representing a dramatic increase from relatively low level of equity investments in self-directed retirement plans a few years back. Plan participants have converted their conservative investments to aggressive investments as market advances swelled their confidence, their buying further fueling the bull market, a self-fulfilling prophecy in a virtuous circle. Bear markets reverse this process, creating a vicious circle where increasing fear leads to selling equities, depressing market prices and creating more fear.

But the recent past is not the only thing that matters. In the literary world, nobody suggests having an arbitrary date before which all work is ignored. Modern authors are important, but so are the classics. Would you mandate a focus on Tom Stoppard to the exclusion of Shakespeare? Maya Angelou while ignoring Dante Alighieri? Steven Covey while neglecting Aristotle? The retirement survey, however, indicates that people tend to adopt an arbitrary rule in their investments – nothing matters if it happened before the start of the so-called new investment era.

While the past doesn't precisely predict anything, it is part of a useful context for thinking about the future. One of the ways we help our clients is by analyzing the past, providing discipline and (sigh) being old enough to remember less effervescent times before the recent bull market. If you would like help in developing a disciplined, appropriate sense of history and perspective in your investment program, contact us.