

The Rule of Nine

If you were playing bridge, you would think it bizarre if the dealer insisted that the players predict the cards they will receive in the next hand. What would be the point? Everyone understands that they sometimes will get good cards and sometimes bad. The score of the game over time depends on the skill of the players, not how lucky anyone is in the next hand. Think about that as the deluge of investment predictions for 2011 inundates you.

Is there any more point to those market forecasts than there is in predicting the next bridge hand? While the cards dealt are random, it may seem reasonable to assume that smart, highly educated investors and economists should be able to predict future market events. Reasonable, perhaps, but incorrect. As evidence, we present our Rule of Nine: Think about perceptions of the world over the last century in all years ending in a “9.”

In 1919, Great Britain was the dread and envy of them all. Despite the huge costs of World War I, Britain emerged from the war with its Empire intact, playing a leading role in the Versailles peace treaty. The Empire reached its peak as Britain snapped up colonies from defeated Germany and Turkey. Britain’s Empire covered one-fourth of the world’s land surface and included one-fourth of the world’s population.

In 1929, the United States was the colossus astride the world. The Roaring Twenties had produced a surging stock market and the exciting new technologies of autos, radio and, for the first time in many areas, electricity. Jazz was popular and began spreading U.S. culture worldwide.

In 1939, Germany was the dread and envy of them all. In the suffering of the Great Depression, most of the world was insecure and depressed, while Germany and its ally Italy were assertive and confident. Their economies were booming, their trains ran on time, and within a year, Hitler’s Germany would dominate most of Europe.

At the start of 1949, the U.S. was again the colossus astride the world, winner of World War II, implementer of the Marshall Plan, developer and sole possessor of the atomic bomb. Nothing could stop the American juggernaut.

In 1959, the Soviet Union was the dread and envy of them all. The Soviets matched the atomic weaponry of the U.S. and beat us into space with the launch of Sputnik. Khrushchev proclaimed “We will bury you,” and many economists, impressed by the reported growth of the Soviet economy, agreed.

In 1969, the United States was again the colossus astride the world. The U.S. had contained communism, and the go-go years of the 1960s stock market had raised the self-esteem of Americans. French politician Jean-Jacques Servan-Schreiber penned *The American Challenge* to warn Europeans of the hegemony of U.S. business and culture.

“To every thing there is a season, and a time to every purpose under the heaven.”

-- Ecclesiastes

In 1979, Saudi Arabia was the dread and envy of them all, controlling the oil spigot. The rest of the industrialized world sat in gas lines, waiting to pay sky-high prices. We lived in fear that the Arabs would decide to withdraw their deposits in U.S. commercial banks, bringing the Western financial system to its knees.

In 1989, Japan was the colossus astride the world. Everyone began to imitate Japanese manufacturing practices. Politicians and government officials raced to tell us that we were doomed unless we somehow replicated the Japanese government’s direction of industrial policy and research. Japanese investors bought iconic properties such as Rockefeller Center and Pebble Beach.

In 1999, hooray! It was us again – the dread and envy of them all. The U.S. high-technology entrepreneurial economy dominated worldwide commerce, outsourcing low-margin, polluting manufacturing overseas while retaining high-ticket, high-margin services and ingenuity. It seemed a wonderful new era, but like all new eras, it did not last – we were about to start a *decade* in which U.S. stocks lost value.

By 2009, emerging China was the new colossus astride the world. We now live in fear that they will stop buying our Treasury bonds.

Enclosed is our annual listing of asset class returns, with a box around the best-returning asset each year. Just as with our Rule of 9, whenever you detect a pattern, it disappears. After several years of foreign stock dominance, small U.S. stocks took the honors in 2010 for the first time since 2003. On the right are portfolios mixes – both the aggressive and balanced mixes have tended to do better than U.S. large company stocks with less volatility, contrary to the expectations of academics.

In each year ending in a “9,” it seemed obvious that things would continue as they were, but in each case, that assumption was dead wrong. Investing is not about predicting the future but skillfully playing the hand you are dealt. When bad-guy Clubber Lang (played by Mr. T) in Rocky III was asked his prediction for the climactic boxing match, Lang replied “pain.” Our prediction for the markets is “uncertainty,” but given people’s aversion to that concept, perhaps Lang’s reply is just as informative and more succinct.