WSIA Newsletter

QUOTABLE

“A courageous act is made without weighing its popularity or unpopularity. It relies solely on the belief that it is the right thing to do.” United States Senator Edmund G. Ross 1868

“If there’s 10,000 people looking at stocks and trying to pick winners, one in 10,000 is going to score, by chance alone, a great coup, and that’s all that’s going on. It’s a game, a chance operation, and people think they are doing something purposeful, but they’re really not.” Merton Miller - Nobel Laureate and Professor of Economics, University of Chicago.

“ Investing is not a struggle, a battle, a game or a contest; it is a continuous process that lasts a lifetime. Whether you are winning or losing at any given moment is beside the point... The only thing that matters is whether you prevail in the end. The factors that determine long-term victory are the exact opposite of the ones that tend to create short-term success.” Jason Zweig

Dread is not an investment policy

Perhaps the most important thing we can communicate to our clients after we finish a quarter like the one that just ended is that there is a critical difference between having an investment philosophy and having a market outlook. All successful investors—and heaven knows all successful advisors—work from a philosophy rather than an outlook. All unsuccessful advisors and investors work from a market outlook, which is what ultimately renders them into manic/depressive paupers.

The challenge to advisors seeking to establish and maintain such a practice is that they are forced to create, in the minds of their clients, a whole new system of reality, because the entire world—not to mention their own terrible instincts—conspires to make investors believe that the essential question in investing isn’t "What are your goals?" but "What is the market going to do?"

But even clients who have been taught this critical distinction, and who claim to have accepted it when the sun is shining, will default to their old system of thought in, and indeed even long after, a significant market decline. This helps to explain why equity mutual funds remained in net liquidation more than a year and a half after the market trough of March 2009: the fear of Armageddon remained so paralyzing that people were sure that fresh disasters would soon overwhelm the market again, and they were just relieved to be able to get out on an uptick.

Fear remains, we think, the dominant presenting emotion in many or most of our client/prospect interactions, and we would admonish you to welcome this regardless of how vexing it can be: if you have to be concerned about something, we would far rather it be dread than performance mania. And the fact that the preponderant emotion is still fear can only mean that the great bull market which began two years ago has much, much further to go.

But on the ground, as it were, we must still deal with unfocused dread as it serially alights, and momentarily focuses on, the chosen terror of the day, be it the China crisis, the euro crisis, the Japanese nuclear crisis, the dollar crisis, the inflation crisis, the deflation crisis, or—when absolutely nothing else seems to be going wrong on the planet—a new-strain-of-flu crisis.

We’ve developed at some length the policy that the way an advisor responds to crisis is essentially by refusing to respond to it. Our motto remains "Thou Shalt Not Read, Neither Shalt Thou Rebut," and we certainly stand on that statement. But today we’d like to expand on that theory and the practice of crisis non-response to the philosophical underpinnings of that approach. But we also do it because this just feels to us like a moment to pull together and restate the fundamental philosophy, as follows:

1. The only sane definition of "money" in the long run is "purchasing power." The "safety" of an asset class should therefore be measured by the lifetime/multigenerational investor in terms of the extent to which it defends purchasing power.

2. Equities have a peerless long-term record of preserving and enhancing purchasing power, far superior to that of bonds. The Ibbotson/ Morningstar findings are that since 1926, an equal mix of large- and small-company equities compounded at nearly 11%, while high quality corporate bonds compounded at just less than 6%. Net of 3% inflation, the blended equity portfolio produced a real return more than two and one half times that of bonds. When one factors in taxation (immediately and at ordinary income tax rates on bonds interest, postponed until sale and at capital gains rates on equity appreciation), the real return gap widens even further in favor of equities. Hence, in terms of building and preserving real wealth over time, ***equities are safer than bonds.***

3. The premium returns of equities can be purchased, in an efficient market, only by one's willingness to accept equities' incremental volatility. Fortunately, the premium returns abide, while the volatility evanesces. There have been thirteen bear markets since the end of WWII, averaging a 30% peak-to-trough decline. The market's peak just before the first one was 19 on the S&P. Thirteen ends of the world later—and still far below its all-time peak—the Index stands at 1200. Even thirty years ago—before six bear markets including the Crash of 1987 and the monster bears of 2000–2002 and 2007–2009—the S&P was about 135, about one tenth of its current value.

4. Unfortunately, the declines cannot consistently be predicted, much less "timed." Thus, the only way one can be sure to capture all of equities' permanent return is to ride out all of equities' temporary volatility. (That said, significant declines are always an opportunity for the patient accumulator of equities to enhance his lifetime return by acquiring disproportionately large numbers of bargain-priced shares.) As demanding and strenuous as buy-and-hold must surely be at times, it remains the only way to be sure of getting the full permanent returns of equities.

If we start, as advisors, with this bedrock philosophy, we can turn all dread—focused or unfocused—aside. The simple fact is that ***dread can never be an investment policy, because the action dictated by dread—fleeing the market—can never be a valid investment strategy.***

The impulse to flee the market in advance of, or even during, a significant market decline is both very human and very irrational. (This goes a long way toward explaining why the advisor's job is not portfolio management but behavior management.) Its irrationality is rooted in three incontrovertible truths:

(a) The decline one is trying to flee from is temporary—as are they all—and will in due course give way to a resumption of the permanent uptrend, as corporate earnings, cash flows and dividends ultimately carry equity values on to new (and often undreamed of) heights. **Fleeing a decline that you know is temporary makes no sense.** You don't have to know where or when (or even why) a decline will end—and you can't. You just have to know ***that*** it will end—and be followed by a resumption of the permanent uptrend *which is usually about as sharp as was the prior decline.*

(b) Moreover, getting out of the market demands that an investor have a plan for getting back in when the permanent advance resumes. Unfortunately, that resumption cannot be timed, any more than the decline can. This is academic, because the person surrendering to dread and fleeing the market isn't even thinking of getting back in, much less developing a strategy for doing so. Thus, getting out isn't really a strategy; it's more in the nature of an impulse, and a thoroughly irrational impulse at that. ***There is never a sound reason for liquidating a lifetime/multigenerational portfolio in reaction to a decline in its market value.***

(c) Thus, the only argument that can be advanced in favor of fleeing the market is a current events-driven contention that "it's different this time." And in a short-term sense, this argument is always right, inasmuch as the particular circumstances driving a major market decline are often just unique enough to blind the panic-prone investor to its essential timelessness. ***But in the long run, the market cycle is never different; it is an irregular pattern of excessive optimism followed by excessive pessimism and back again, cycling around a secularly rising trendline.***

Rather than reacting to each crisis as it comes along, we advise you to build a portfolio that incorporates the amount of risk you need to achieve your own clearly defined goals, diversify your holdings domestically and internationally to comfortably spread the risk and hold fast to that tiller when the winds of change blow. Because out there, beyond the horizon, your desired destination awaits, if only you stay on course. We thank you for your continued trust and business. WS Investment Advisors, LLC.