The Week

WACHOVIA SECURITIES

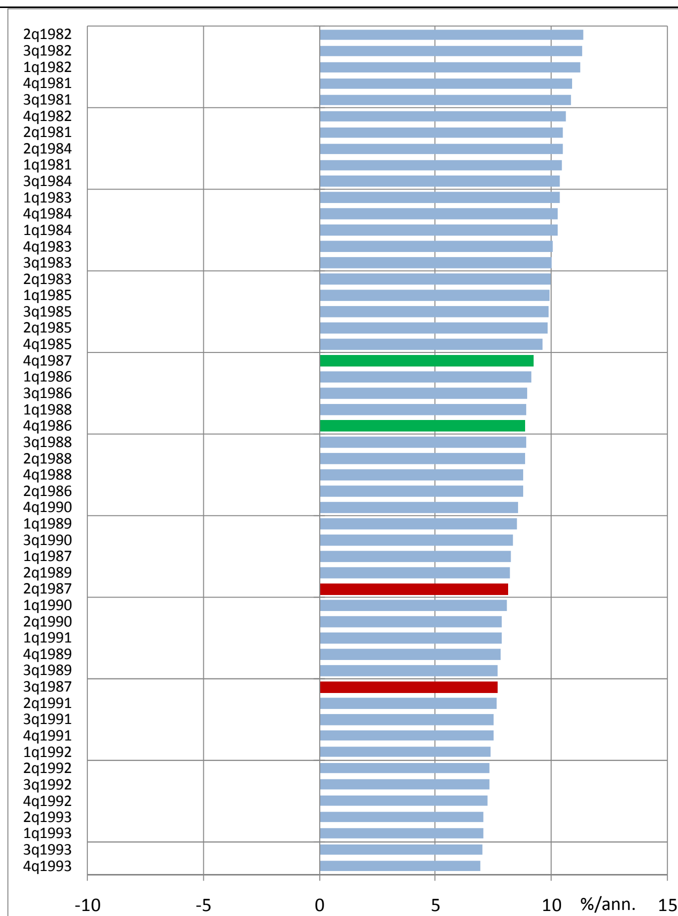
November 3, 2008 Tom McManus, Chief Investment Officer

# Should ‘Boomers’ Give Up On Stocks Now?

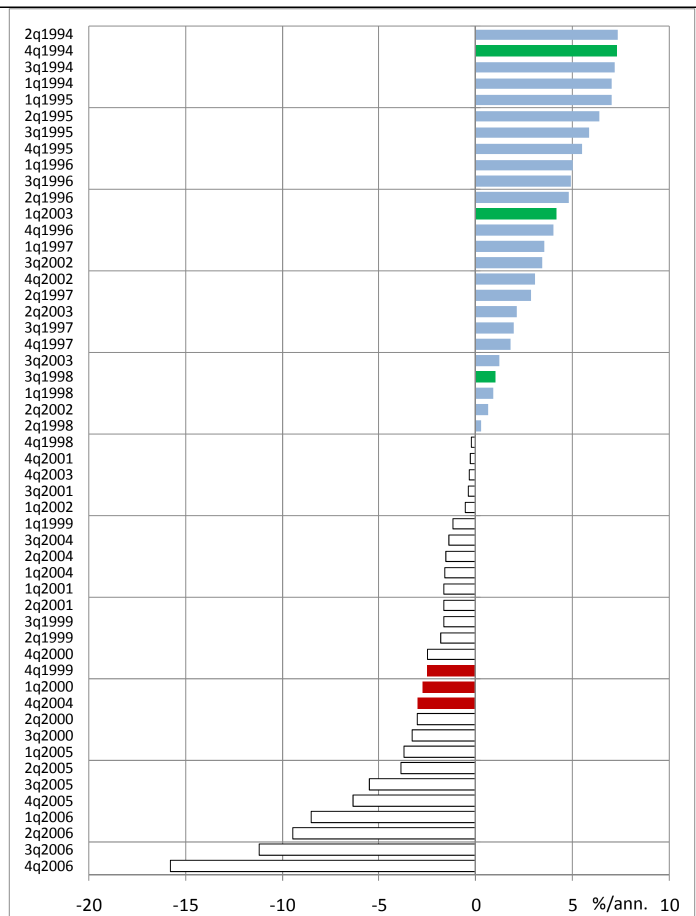
- Despite poor returns and deflationary risks, we believe the answer is no.
- The shock of loss is only beginning to set in; many investors have yet to come to grips with the merciless pounding their portfolios endured since August. Some – like ourselves – had begun to tiptoe back into equities on significant weakness earlier in the year. But all of us – no doubt – wish we had sidestepped the September/October plunge (or even better, positioned our portfolio “net short” equities before it occurred) that confiscated more than one-fourth of our equity in exchange-listed businesses around the world. In just two months, we sustained a similar-sized loss to that seen in the value of our homes over the past two years.
- Some observers are comparing the current situation to the autumn of 1987, when the S&P 500 shed −40% in seven weeks, including a mind-numbing loss of −25% in a single day. But investors were not hurt so badly then; in 1987, all they gave back were their earnings since the start of the year … as long as they did not allow the irrational exuberance of the spring and summer months to convince them to boost equity exposure or leverage. By contrast, this year’s losses aggravate and extend a period of unsatisfactory investor returns from stocks.
- If investors’ analysis of the driving forces of the 1987 stock market (Remember our “report card” dated October 20, 2008 evaluating the Economy; Valuation; Liquidity; and Sentiment?) had resulted in scores like A; D; A; D (respectively), as compared to D; A; D; A, which is our assessment today, then they might have reduced their risk of loss by reducing equity exposure.
- Timely shifts in equity exposure, investment style and even sector weightings can improve results by avoiding overheated areas at risk of a significant pullback. Investors were well-counseled to avoid growth stocks in general – and technology stocks in particular – toward the end of 1999. But by 2006, it was value stocks – specifically, the manufacturers, vendors and financiers of consumer discretionary spending – that were at risk.
- Over the years, we identified risks such as these, tried to help investors comprehend them, and suggested they attempt to protect portfolios by fleeing areas considered most vulnerable. This activity is called tactical asset allocation (TAA); we are confident that TAA will gain more credence as investors begin to sift through the rubble. If investors utilizing tactical tilts are successful in insulating their portfolios from loss, they might be more prepared to capitalize from the opportunities that arise. After all, history shows that U.S. stocks have eventually achieved new highs. But here, it is important to remember that past performance is not a guarantee of future results.
- But are tactical shifts sufficient in a much more difficult economic environment? *Business Week* has challenged the conventional wisdom that stocks are the best investment class for the long run, citing extended periods of unsatisfactory returns at the outset of the 20$^{th}$ century, lasting two decades in the U.S. and Britain, five decades in Japan, France and Germany, and seven decades in Italy. What might prevent stocks from achieving new highs anytime soon? The risk of “… a long, slow retrenchment in which consumers and businesses worldwide lose the wherewithal to buy, sending prices down for many goods” was portrayed prominently in *The New York Times* and *Business Week*. The specter of deflation poses two-sided risks to investors: first because the disease itself is harmful to growth, profits and credit quality; second, because of the inflation that central bankers may create to defeat it.
- After last week’s cut, the overnight rate on fed funds is back to 1%, a level it inhabited for a year ending June 2004. Some are concerned that – with all of the accommodation it has provided over the past year – the Fed is beginning to run out of ammunition to fight deflationary pressures emanating from falling home prices … and underscored by recent strength in the U.S. dollar and sharp declines in energy and other commodities. Now that the aura of financial crisis has encircled the globe, the risk that nations may pursue “beggar thy neighbor” policies has increased, according to straight-talking Bob McTeer, former President of the Dallas Fed, on CNBC last week.

## Annualized Total Return for S&P 500 Index for Each Quarter, through October 31, 2008

Calendar quarters from 1981 through 1993, ranked




Calendar quarters from 1994 through 2006, ranked




Note: Each observation shows the annualized total returns from a given quarter (month-end averages), through 31-Oct-08. Past performance is not a guarantee of future results. The S&P 500 is an unmanaged index and is unavailable for direct investment. Figures do not include fees, commissions or taxes which would have a negative impact on investment results. Source: Standard & Poor's.

On November 15, leaders of the Group of 20 nations will convene in Washington for a "Summit on Financial Markets and the World Economy," to discuss causes of the crisis, the progress of steps taken so far to resolve it, and its effects on emerging economies and developing nations. We suspect that a forum such as this one may provide an opportunity for policy makers and central bankers to air ideas for further *steps that may be needed if the crisis should worsen, especially if deflationary pressures continue* to increase.

Many observers were surprised by the extraordinary actions taken by the U.S. Treasury and Federal Reserve – in cooperation with their counterparts around the world – in response to the financial crisis. While central bankers may still perceive the *risks* of a corrosive deflation to be very small, its *cost* to economic progress would be so severe that they may be interested in pursuing an insurance strategy against deflation. That strategy could be an injection of inflation.

Inflation is the enemy of financial assets because it reduces the present value of a future stream of cash flows, earnings and dividends. But what may be less obvious is that inflation makes satisfactory operating results more achievable for entities whose creditworthiness is dependent on economic growth. In contrast, deflation increases the value of future cash flows, but it reduces the certainty of achieving them. Avoiding deflation is critical to the holders of stocks and bonds, especially for credit and growth-dependent entities.

All of the steps taken thus far to insulate the economy from the damage of falling home prices – whether involving fiscal or monetary policy, regulatory changes and extraordinary actions such as nationalizing Fannie Mae and Freddie Mac or injecting capital into banks to stimulate loan growth – are inflationary in nature and designed to offset the deflationary impact of the housing downturn and its negative impact on spending, income and employment.

If policy makers elect to pursue a more aggressive inflationary strategy to battle deflationary pressures, investors' principal in conservative assets – treasury obligations, money market funds, etc. –may suffer a loss of purchasing power. Such an approach would probably provide some relief to the markets for corporate bonds and stocks, as companies' debt service obligations would become less onerous.

The charts above show the returns achieved by "buy and hold" investors in the S&P 500 through the end of October. Of course, the amount invested during each period is crucial to investors' ultimate return, but it should be clear that very few of the quarterly periods over the past 27 years – indeed none of them since 1984 – have provided annualized returns to date that meet or beat the oft-cited long-term average of around +10% per year.

It should also be noted that there are some points (the green bars highlight a few outstanding examples) where the returns have been better than average, and others (red bars) where the returns are a good deal worse. Results such as these underscore the value of a tactical approach to asset allocation.

Keep in mind that small differences in the annual rate of return will make a big difference when compounded over long periods. While +9.2% per year may not seem much higher than +7.7% (see LH chart), a sum of $1000 invested in fourth quarter 1987 would be worth about $6,300 today (all dividends reinvested, excluding any taxes or fees), while the same amount invested in third quarter 1987 would be worth only $4,800 today.

The size of the bars on the charts and the shape of the curve (in particular, for the chart on the right) depend importantly on the ending market value. Given the extremely poor returns of late, it is beginning to look as if investing in the stocks has never been a good idea (or at least not since 1984).

It is useful to contrast the present situation – where buying the S&P 500 at virtually anytime over the past 20+ years seems like a mistake – to the attitude that prevailed in early 2000, when it was clear that the biggest mistake every investor had made was the fault of selling too soon. In our experience, extremes like these have a way of averaging out.

While an eventual recovery of the stock market would present an opportunity to boost the realized returns (push all of the bars on the chart toward the right), what will not change is the relative order of the bars. It seems to us that when stocks are fairly priced, investors could be amply rewarded for having assumed equity risk at appropriate times (when it paid to be brave), and suffer below-average returns for having held onto equities when the market underestimated their risk.

Perhaps sometime in our lifetimes, we will experience another era when selling will be seen as the biggest mistake any investor ever made. At a time like that, the difference in returns between investments made when economic prospects were dim and equity valuations were attractive and investment made when there was nary a cloud on the economic horizon will seem small and unimportant. Today, however, is quite the opposite; even those lucky and/or smart enough to be buyers of the S&P 500 at particularly attractive times (say, at the 2002-2003 lows) are not able to show a positive return on investments they made at the time.

The late, great Benjamin Graham once famously said: "In the short run, the stock market is a voting machine, and in the long run it is a weighing machine." Today's market appears overly depressed by valid concerns about economic growth and deflationary risks … including the risks of inflation that policy makers may accept to battle deflationary forces … and unwinding of excessive leverage used by consumers, businesses and investors. We believe the government may need to absorb an even larger amount of the leverage previously employed by the remaining economic segments in order to sustain growth, but that low equity valuations are providing ample compensation for investors to accept equity risk.

In our view, investors should consider employing a tactical asset allocation approach to try to protect their portfolios against damage from overheated sectors. Meanwhile, they should understand that central bankers may still need to take more extraordinary steps to deal with deflationary risks, and, while potentially painful, should be good for long-term economic growth.

*Tom McManus*

Past performance is not a guarantee of future results.

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