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OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

History has a way of not looking so bad after the event has slipped behind us by several years. Investing in the stock market is often presented as something that always works out if you just wait long enough. You are asked to look at the 'evidence' of a long-term chart, and those dips of the trend line are always followed by higher highs, and given enough time the pain is slowly massaged away. If you compare simple annual returns of the stock market for the two periods of 2000 – 2002, and 2007 – 2009 (see below), the period of 2000 looks worse if you just add up the annual losses. The experience of the two periods was completely different. The total decline of the two periods was similar, but in 2008, there were very few places to hide and virtually every asset class with the exception of treasury bonds was hit hard. The point of this exercise is that you have to take each investment period in the context of what's happening around it. Which leads us to today.

It seems intuitive that if you go 700 days and counting without at least a 10% market correction, and you know that it is the 4th longest streak since 1929, something may be about to give. However, no period in history has had as much Federal Reserve intervention as we have now. That changes the equation, we just don't know by how much yet. It is easy to say that since 1950, ¼ of all years have had at least a 10% market correction, but the market is up over 90 times in that period, so volatility is the price of admission. If you are fully invested, a 10% correction is not a fun thing to experience because we tend to think linear, 10% may turn into 20%. The key is not to be 100% invested if you believe in intuition. But then there is something called the 'gamblers fallacy'.

The gamblers fallacy simply states that the odds of a pair of dice coming up seven ten times in a row are very low. However, if you get nine sevens in a row, the odds of a seven coming up on the next roll are the same as the first time you roll the dice. This translated into investing language seems to be that each day deserves its own 'valuation'. However, you should not be investing with a one day time horizon. Greed and fear work over time to create both excesses and deficiencies in the economy. We have had excess liquidity from the Fed for several years now so a correction is out there somewhere.

Raising some cash seems to be the prudent thing to do now, not because a market downturn is imminent, but because when investing becomes less compelling, you should do less of it. The market is not cheap, stocks are at the higher end of their long-term valuation, fixed income investments offer little interest because everyone is chasing yield trying to earn something. You can guess that when the Fed stops stimulating the economy, something bad may happen. The examples of what should have happened in the last several years and what actually happened are too numerous to mention. One simple example is the Fed did start reducing the bonds they purchase monthly at the beginning of the year, but interest rates went down when everyone thought they would rise. There are many more. A balanced investment strategy appears to be to have enough cash to take advantage of opportunities that can present themselves at any time, but not too much cash that will severely drag down returns as the sevens keep coming up on the dice.

2000	-9.11%
2001	-11.98%
2002	-22.27%
Total	-40.36%

2007	5.46%
2008	-37.22%
2009	27.11%
	-37.22%