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Jun. 23, 2016

OBSERVATIONS ON THE MARKET

No. 300

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You hope you learn something after 25 years. One of my first lessons was to never make this letter more than one page, otherwise most people won't read it. Since this is issue #300, and I have not missed a month in 25 years (some might say I should have), I depart from tradition and will over-extend my welcome to two pages.

In June of 1991, the Dow Jones index was at 2,900. Since then the economy has had two recessions, and was just coming out of a recession in 1990. The stock market has had two declines of 50% and it has still advanced to 17,900. That is because earnings of the S&P 500 have grown from $20 to $86, and are projected to recover to $105 by the end of this year.

Lesson Number One: It does not pay to be too negative. Playing with the numbers a little bit suggests the market has grown by 7.5% per year since 1991 not including dividends. If growth slows down to 5% for the next 25 years, that puts the Dow at 60,000, not counting dividends. Here is a lesson that I wish I had learned much earlier in my career: If you add the dividend of 2.5% and assume that there is no growth in the dividend, that effectively adds 60% to the value of the market in 25 years. It implies that the Dow would effectively be at 96,000. At what rate did dividends grow in the last 25 years? Five percent per year. If you really want to be pessimistic and assume there really is no growth in the next 25 years, you can only assume interest rates will stay at 1%. Not a compelling alternative. Compounding is very powerful.

Lesson Two: Buy quality at a reasonable price and let management figure out how to deal with the next recession. If you are a long-term investor, it doesn't pay to guess where the market is going for the next few days, months, or years. There are several ways to make money and buying quality companies at a reasonable price isn't the only one, or, the best one, but you have to find the one that works best for you. Buying quality at a reasonable price is much harder than it sounds. Quality almost always comes at a premium, so if the premium is gone, that implies that the market is speculating that it is not a quality investment anymore. This is why you have a portfolio, because sometimes the Market is right, but most of the time it is wrong.

Lesson Three: More news is almost always a bad thing. It gives you a feeling of control, which is really an illusion. It is like trying to drink water from a fire hose. There is a lot of water, but you drink very little. In 1979, which is when I started as a stock broker, the news was printed on a roll of paper that you would go unroll several times a day to see if one of your companies had announced any news. Company information was found in a book from Standard & Poor's. The sheets where updated quarterly. It was all ancient information by today's standards. But an interesting observation is that market returns have not changed in the last 100 years. In fact, it seems that every investment guru out there is predicting slower growth. So maybe tons of information at your fingertips doesn't help. Personally, I am learning that watching one of the business channels is a determent to my investment results. Maybe by issue #600, I will be cured of this habit.

Lesson Four: I am not as smart as I thought I was, or hoped I would be. However, thanks to the power of compounding, which is sometimes referred to as the eighth wonder of the world, I don't have to be. The best decision I ever made regarding my investing career was completing the Chartered Financial Analysts program. The biggest take away after over 1000 hours of study was that this is a very hard game to beat everyone else at. Maybe if you steer for the middle of the road, you will end up beating most everyone else.

Lesson Five: It is those solid, boring core holdings that produce the extra money to speculate with. So why not just stick to the boring holdings? It is exciting to try and find the next big winner, the company that turns around and the stock price goes up 10 times. The problem is that the risk that an investor must assume is not proportional. This means that if you are hoping for a return that is double the markets' return, you are actually assuming more than double the risk or volatility. This was another benefit of studying financial theory. It is ok to occasionally speculate, but don't let it materially affect your long-term returns. This one took too long to learn. Boring is beautiful.

When I started as a stockbroker in 1979, the response to my less than stellar sales pitch was: Why should I invest with you when my money market fund pays 18%? Well, we all know now that that was the time to back up the truck and buy those lower yielding 12% 30-year government bonds and 5% dividend paying stocks which were the rule, not the exception then. In my economics class the big topic was stagflation. How do you curb inflation in a slow growth economy? You raise interest rates with the threat of killing everything. Fortunately, it worked, and it was a great time to invest. Today our problem seems to be the reverse.

Biggest Worry: Interest rates are at scary low levels. The British government recently issued 50-year bonds that yield less than 2%. There is now $8 trillion of global debt that earns a negative interest rate. Japan pays a miniscule .35% for their 40-year bonds (why hasn't the US been issuing these?). These are lousy long-term investments because one of two things will almost certainly happen sometime in the next several years. One, the economy finally returns to a somewhat 'normal' environment, and interest rates return to compensating investors for some degree of inflation risk. The second scenario is that at some point investors decide that governments are just monetizing their debt, and demand higher interest rates. Monetizing means that governments just keep issuing new debt to pay off old debt. In either case, it is not good for bond holders. There is no rule that says when investors should start to worry about debt monetization. It could be next month or maybe in the next decade. Hopefully, we never get there, but how this unwinds is anybody's guess.

There is always something to worry about, which is actually good because it keeps asset prices from reaching speculative levels. I remember walking to lunch on the 16th Street Mall in Denver during the 2009 stock market meltdown. The Dow was down another 200 or something points with no end in sight. The news media was predicting Armageddon. I noticed there was more than just me looking for a place to eat lunch, and thinking you still needed a house to sleep in, and a car to drive. At the worst of the 2008 recession, the economy declined by 8.2% in the 4th quarter. However, for the year 2008, the economy declined by 2.5%. It was basically flat in 2009, and was up by 2.7% in 2010. It felt like the end of the world, but in hindsight it was the best time to invest. I wish I had stopped listening to the financial media selling doom and gloom, and just looked at the people still going to lunch. The world does not stop, which you are made to believe. It just slows down.

In conclusion, these are challenging times, and it may become even more challenging for a while. However, the 8th wonder of the world makes it worthwhile to stay the course with reasonably priced quality companies. Here is my prediction for the market for issue #600 (25 years from today), Dow 60,000. Hopefully we all live to see another 25 years.