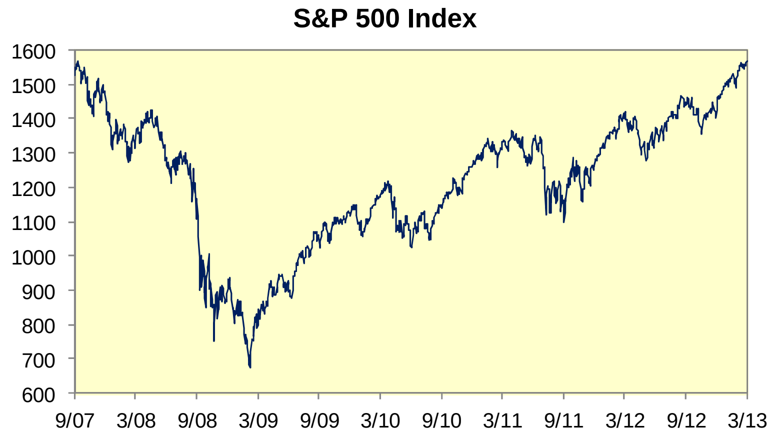
April 2013

Stay in the Game

> The Dow Jones Industrials advanced from 66 to 11,497 in the 20th century, a staggering 17,320% increase that materialized despite four costly wars, a Great Depression, and many recessions… Since the basic game is so favorable, Charlie [Munger] and I believe it's a terrible mistake to try to dance in and out of it based upon the turn of tarot cards, the predictions of "experts," or the ebb and flow of business activity. The risks of being out of the game are huge compared to the risks of being in it.
>
> Warren E. Buffett, *Berkshire Hathaway 2012 Annual Report*

On October 11, 2007, the S&P 500 Index registered an all-time intraday high of 1576. At that moment, the economy seemed to be in good shape, and corporate earnings were forecast to hit a record high in 2007. But the stock market rolled over that month and began its descent. At first, the decline was gradual, but the market generally looks ahead one or two quarters. It was again prescient in this case, sensing that the huge bets that U.S. financial institutions had made on residential mortgages (especially CDOs) would end badly. By the end of 2007, the S&P 500 had dropped 6.8% from its peak to 1468. But the approaching collapse of venerable Bear Stearns in March, 2008 accelerated the stock market's fall. By September, the U.S. financial markets were in a state of panic. There is not time or space to chronicle the Panic of 2008, but the bankruptcy of Lehman Brothers ushered in the most desperate financial conditions in the U.S. since 1933. The S&P 500 finished 2008 down 37% – the second worst year in the stock market since 1825. And the bottom was only reached on March 6, 2009 when the S&P 500 traded intraday at 666, ending a gut-wrenching 57.7% descent. Few investors who lived through it will ever forget it. Yet, on April 11, 2013, the S&P 500 Index closed at 1593 – 1% above its previous all-time high reached 5½ years earlier in October, 2007. And the Dow Jones Industrials are currently trading in a 14,600-14,800 range – their highest level ever. The chart below shows the path of the S&P 500 during this highly volatile period:

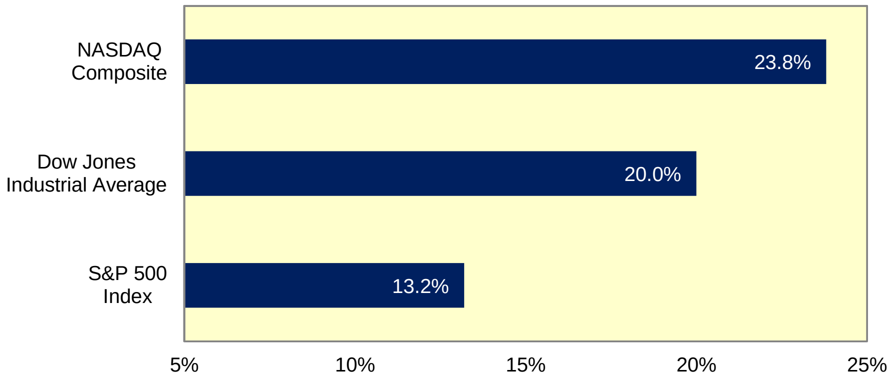


Source: Bloomberg

U.S. Stock Market Performance
2007 – 2013

Despite the many challenges that have faced the U.S. since 2007, the markets have bounced back strongly. Bailing out of the stock market during the worst stages of the Panic was disastrous, with losses of 50-60% not uncommon. But investors who stayed in the game with quality stocks have actually made money during this volatile period, as the chart below shows:

Investment Performance*
October 7, 2007 – March 31, 2013

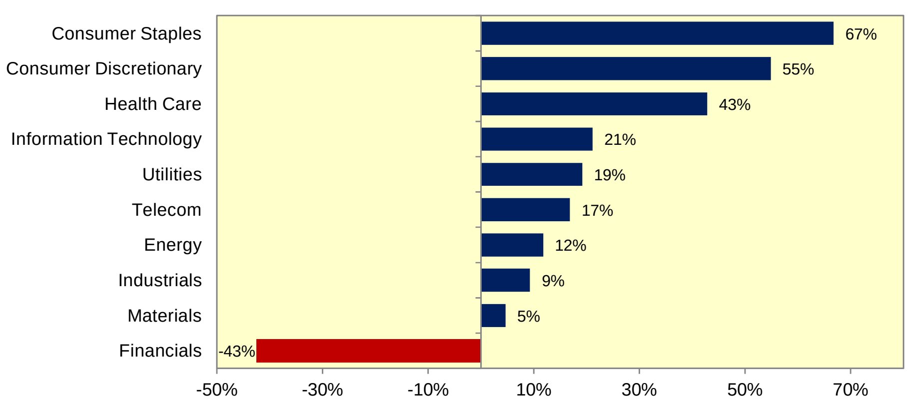


*(Including Dividends Reinvested)

Source: Bloomberg

What sectors fared the best and which underperformed? As would be expected during such a volatile and risky period, the so-called "defensive stocks" were the best place to ride the bear market out. Defensive stocks generally have relatively high dividend yields and are shares of companies whose products and services are resistant to economic downturns. They include consumer staples companies, low-priced retailers, and health care/pharmaceutical corporations. The worst-performing sector was the financial sector, with Citigroup and Bank of America leading the parade with total returns of -90.0% and -74.2% respectively during this period. The chart below shows the performance (including dividends) of the various S&P sectors:

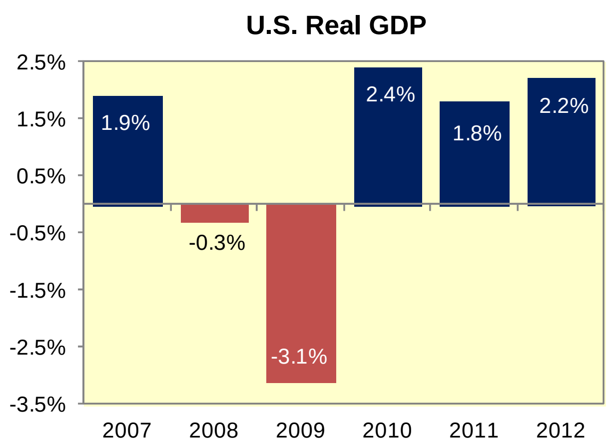
Investment Performance by S&P 500 Sector
October 7, 2007 – March 31, 2013



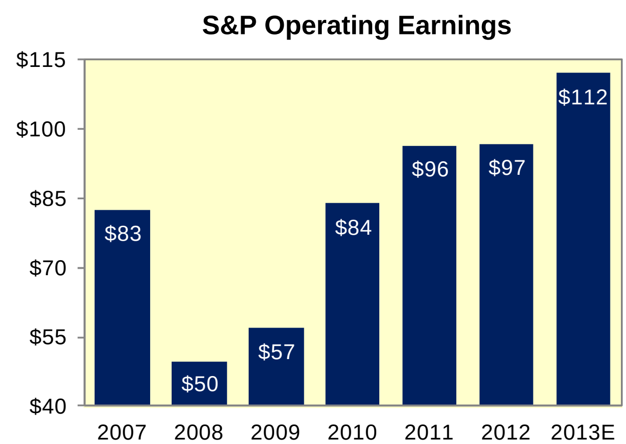
Source: Bloomberg

Are Things Better Now Than in 2007?

As both the S&P 500 Index and the Dow Jones Industrial Average notch all-time highs, it is useful to determine if there are sound reasons for the market's bullish action or whether the market's exuberance is built on a house of cards. Are economic and political conditions here and abroad at the moment better than in 2007? In looking at the big picture, it is clear that individuals and companies, or the consumer and the corporation if you will, are in significantly better shape financially than in 2007. First and foremost, the U.S. financial system is back on sound footing. Most U.S. banks have boosted their capital ratios significantly. They have cleaned up their balance sheets, shedding non-performing assets and shutting down off-balance sheet SIVs (special investment vehicles). TARP was successful and even turned a profit for the U.S. Treasury (with the exception of General Motors and Chrysler). The U.S. consumer is also in much better shape with the lowest household debt ratio (which includes mortgages and consumer debt) in three decades. The 2000-2006 housing bubble has been burst with housing prices having bottomed in late 2011. Housing prices are up 8.1% year-over-year (January, 2013) for the 20-city index in the latest Case-Shiller report. U.S. corporate earnings are strong with the S&P 500 operating earnings for 2013 projected to hit an all-time high of $112. U.S. crude oil production is skyrocketing, and various think tanks have even forecast that the U.S. will be energy independent within several decades. The charts below track the path of the U.S. economy, and while the economic recovery has been anemic, both U.S. GDP and corporate earnings have recovered the ground lost during the 2007-2009 period:



Source: Federal Reserve (St. Louis)



Source: Standard & Poors

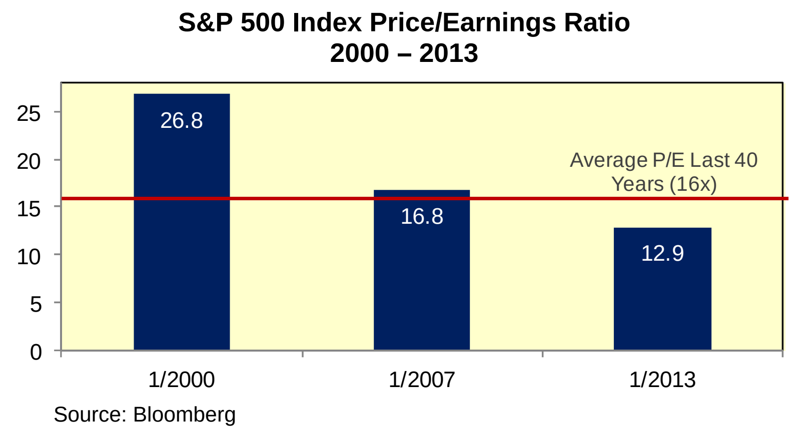
Things That Are Worse Now Than in 2007

Unfortunately, the U.S., the body politic, is in worse financial shape. Many of the steps which Washington took to get the economy back on track, to bring unemployment down, and rebuild the balance sheets of the banks and the consumers, have had a deleterious effect on the nation's finances. The Federal Debt in 2007 was $9 trillion. The Debt/GDP ratio was 62.9%. The Federal Debt currently is $16.7 trillion with the Debt/GDP ratio at 105%. The annual Federal deficit has exceeded $1 trillion each of the past four years, and in 2013 – almost four years after the recession officially ended – Washington is borrowing one out of every four dollars that it spends. The nation has lost its AAA credit rating. The level of participation in the national labor force of 63.3% is lower than at any time since 1979, and there are still 2.8 million fewer Americans employed than at the end of 2007. Finally, there has been a massive transfer of wealth from the people who have saved for their retirement in favor of debtors. In short, the ship of state is in a mess financially.

In geopolitical terms, the current situation is fraught with peril. North Korea is threatening the U.S. and South Korea with nuclear war. Iran proceeds with its plans to weaponize the nuclear bombs which it will be able to produce by the end of next year. The Arab Spring has sown chaos and war throughout the Middle East with the radical jihadists gaining power in many countries including Syria. China is flexing its military muscles with its neighbors. And, finally, Europe is far from resolving the financial problems in at least five countries that are part of the Eurozone.

U.S. Stock Market Valuation

The problems and challenges facing the U.S. and other countries are not lost on investors. Investor anxiety continues to be very high and is reflected by the massive movement of funds out of U.S. equity mutual funds and into bond mutual funds over the past four years. These worries are also mirrored in the current U.S. stock market valuation. The chart below shows P/E ratios at market highs since the turn of the century:



Summary

The most important lesson is to stay in the game. As Warren Buffett wrote in Berkshire Hathaway's 2012 Annual Report referred to above, "*The risks of being out of the game are huge compared to the risks of being in it*." The key to successful investing is time – not timing. It is important to emphasize that the unstated assumption of Buffett's assertion is that investors in the stock market need to have a long-term perspective. Most professionals write that investors in the stock market should have a time frame of five years, if not ten years. This gives the investor the time and patience to wait out the difficult conditions and bear markets and let the remarkable benefits of democratic capitalism reassert themselves both in the society and in corporate life. Another unspoken assumption in Buffett's quote is that broadly diversified portfolios are needed so that one sector or several stocks do not cause outsized harm to the portfolio. In fact, during bear markets triggered by economic contractions, the wise investor will overweight defensive stocks and avoid stocks with high correlations to the economic cycle. At Bradley, Foster & Sargent, Inc. we see it as an important part of our mission to help our clients counter their impulse to sell during the bad times and stay in the market until conditions improve.