

INSIGHTS ON FRONT STREET



BY JASON P. TANK, CFA
FRONT STREET INVESTMENT MANAGEMENT LLC

Today's Initial Conditions

MARCH 2010

Starting points matter. Back in 1982, John began his now nearly thirty-year investment career. Back in 1999, I began mine. The contrast of initial conditions on those dates couldn't be more pronounced. Starting points matter.

Back in 1982, John began his now nearly thirty-year investment career. Back in 1999, I began mine. The contrast of initial conditions on those dates couldn't be more pronounced.

From 1982 to 1999, John enjoyed the greatest bull market in modern history. So did an entire generation of investors. Over the ensuing seventeen years, the Boomers birthed a cult of stock ownership that fed optimism and economic prosperity. At the risk of being overly simplistic, aside from a few periods of tumult, staying invested in stocks was the way to build wealth.

From 1999 to 2009, I experienced one of the worst decades for stocks in modern history. Frankly, it took a lot flopping around to swim up stream. Sometimes we were forced to just sit on the sidelines to successfully get through it all. For sure, back-to-back periods of 50%+ market drops have a way of framing things. Given this contrast, it is with great relief that John and I are able to see eye-to-eye on most things.

After the past decade of boom-bust-boom-bust action, you would think that the cult-like devotion to stocks would have already died a digni-

fied death. It hasn't yet. It appears that many Boomers have long memories about the 80's and 90's.

Over the years the stock market has admittedly taken on a casino-like feel. I recently heard a comment about how truly odd it should feel to hear each major network's nightly broadcast note how the Dow closed that trading day, as if the daily gyrations should really matter. As John can certainly attest to, investing today has a very short-term feel to it. While not entirely bad, you can now "play" almost any tiny sliver of the global stock market or partake in any arcane investment strategy by just clicking a button. The casino operators know how to entice gamblers and apparently so does Wall Street.

As is widely known, in the real world of gambling the odds are tilted in the house's favor. In other words, the initial conditions of the game matter. To be fair, in the stock market over the long-run investors are destined to win. The odds are usually tilted in investors' favor, but not always.

At its lowest point in 2009, the stock market had underperformed long-term bonds over the

previous 30-year period. This unusual occurrence proved that the long-run can, in fact, be a long time.

That brings me back to 1982 and 1999. In '82, inflation was high and interest rates were even higher. The US was dipping and double dipping into recessions. As a result, stock prices were very low in relation to their underlying earnings power. Visit www.frontstreet.com to see an updated graph of how stocks have been valued over time. Pay special attention to today's valuation levels compared to history.

Back in '82, John and many professionals distinctly remember not being able to convince clients that stocks were a good place to invest. Investors naturally focused on the past, not the future. Returns earned in stocks from February '66 to July '82 were about zero after inflation was considered. Back in 1982, the cult of stocks was just a newborn. The ensuing run through '99 was legendary.

Comparing the conditions of '82 to today's initial conditions is not too comforting. The only valid comparison is that many professionals and individuals inherently believe that the last decade of zero returns indicates a new legendary run is now upon us. The concept of a things "reverting" to normal is almost a religious belief in our industry. In contrast, we still contend that today's initial conditions are not at all tilted in stocks favor.

Today, inflation and interest rates are low. They could go lower since they are yet Japan-like. Lower rates aren't likely as investors are already showing signs of starvation for income. Adding insult to injury, the stock market's dividend yield is only about 2%. Inflation needs to be truly dead for 2% to do the job. Further, the Shiller price-to-earnings ratio - a longer-term measure of the relative cheapness or dearness of the broader stock market - is now greater than all levels recorded prior to the mid-90's. We argue that the stock market, as a whole, is not historically cheap. These are only a few of the arguments that show that today's

initial conditions are tilted in favor of the house, not investors.

Yet still, anecdotal evidence points to a still serious bias toward stocks. For example, a recent released study by the Pew Center examined the current financial condition of state public employee pension plans. The study showed that plan trustees assume they'll make about 8% on pension assets over the long-term. Equally amazingly, most large public companies still expect north of 8% for their pension's long-term rate of return. Not surprisingly, the higher the assumed return or return, the lower the required pension contributions. If they keep investing the way they do, we think they'll be lucky to get 6% over the next ten years.

While it seems like a rounding error compared to the \$50 trillion underfunding of Social Security and Medicare, collectively these state-based pension plans are now underfunded by greater than \$1 trillion. Since states cannot simply print dollars to make ends meet, they may be forced to trim benefits, push out the retirement age and work to shift the funding burden to younger employees and taxpayers. Eventually, our federal government will have to take the same steps when/if the bond market forces their hand. Greece and Ireland are giving us a glimpse of what this means.

For individuals who live off their accumulated savings, they should view themselves as part of a single-beneficiary private pension plan. Since there is no federal bail-out coming nor is there some government sanctioned Ponzi-scheme to make up for the funding shortfalls, individuals' long-term return assumptions should be built with a margin-of-safety in mind.

We feel strongly that it pays to recognize today's initial conditions rather than making decisions based on the faith that since the last ten years were really bad, the next ten are destined to be pretty good. As much as we'd like it to be, it isn't 1982 all over again.

