December 3, 2012

Achieving Success while climbing the Wall of Worry

This is a letter that I would ask you to put aside in a place you can easily find. Then, when needed, you can pull it out and re-read it as the stock market has inevitable quick pullbacks on its way to much higher prices.

It is our conviction that we are entering a major bull market where prices will continue to rise for at least a decade and possibly much longer. Here is what we <u>believe</u> is going to happen: The popular averages such as the Dow Jones Industrial Average and the Standard & Poor 500 will push through to all-time highs and just keep climbing. They will do this even though fear and skepticism will be the prevailing mood. When downward corrections do occur, they will be quick and sudden and reinforce the fear. They will not erase the total gain, but will take away a good part of it quickly. The averages will once again advance and will break through to yet another all time high. This is the long-term multi-year pattern of a major bull market. Later in this letter we will give you our reasons for being so very positive.

<u>Conditions prevailing at the beginning of a major multi-year advance in the stock market</u>

1. General business climate is poor, or not showing significant enough improvement that is visible or evident to most people.
2. Prevailing attitude of pessimism or outright fear. This is due to economic or political worries or both.
3. A stock market which has drifted or gone nowhere for at least 9 to 13 years reinforcing the belief that stocks are generally poor place to invest.

If this sounds backward or illogical, consider the conditions surrounding the birth of the last major bull market which started in 1982 and ran for almost 18 years until a major top was made in 2000.

In March of 1970, the Dow Jones Industrial Average was trading around 800. Twelve years later in August, 1982, it was also about 800. It had been both higher and lower, but, in effect, it had gone nowhere for 12 years. Investors were discouraged and business news was not good. The cost of loans was excessive because interest rates were so high. (Today people can't get loans because banks are fearful). In 1982, the unemployment rate hit 10.8%, the highest since 1940. In addition, six months earlier, air traffic controllers had gone on strike and were all fired by President Reagan.

Amid this mess, the stock market started higher and Dow had moved from 800 to over 1,000 by year end, breaking into new all-time high ground. For the next 17 years, the market continued its huge upward climb culminating at a high of just under 12,000. For that seventeen year period the Standard and Poor 500 logged **<u>an average gain of over 18% per year</u>**. Keep in mind this was the <u>average gain of the largest corporations in the country</u>. Many companies experiencing growth spurts did far better (a $2,700 investment in Microsoft, when it went public in 1986, was worth almost $800,000 by the year 2000).

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During the first ten to twelve years of this major bull market, the majority would not buy. They were unbelieving, bewildered and dumfounded. How could this be happening while the reported economic and political news was only slightly better? Finally, in 1998 and 1999, the mainstream mass got the message that the stock market was the place to be. They entered just in time to catch the dot com bubble and the end of the great bull market. 1999 was a great year to open new accounts in our business. Does this have a familiar ring – i.e. the housing market of 2005-2006?

There were other multi-year bull markets in the last century, and they all had one thing in common. They arose from the ashes of pessimism and outright fear.

Why does this happen?

As mentioned earlier, before 1982 there was a long period of time, 13 plus years, when the market produced almost zero gains. During this time, individual companies became leaner and more efficient. Not only did they pay down debt, but the efficiencies of doing business were vastly improved. This all was happening quietly in the background, and most people either didn't recognize the changes which were occurring or were oblivious to them.

We have a good friend, a very successful advisor with a large company, who has been in the investment business for many years. In a recent conversation he detailed a few of the powerful developments and advances which have transpired over the last dozen years. These would include computer technology and the growth of mobile computing, the gradual emergence of large segments of population (as in China and India) into the middle class, and a possible major energy revolution with new energy development in the United States.

The reasons we are so positive in our outlook:

- Explosion of advances in computer technology. This would include the ease of communication and rapid transfer of information. Visual conference calling to almost anywhere in the world is now cheap and easy. My phone or iPad will talk back to me, and transcribe my spoken instructions into notes, appointments or reminders.
- Ease and efficiency of doing business. In virtually all industries it is far easier to service clients and keep track of business trends and money flows.
- Numerous companies have paid down debt and cleaned up their balance sheets. Most of the companies we own in our portfolios either have zero or very low long-term debt.
- Stock valuations have dramatically improved over the last 12 years. Shares are much cheaper relative to sales and profits. In early 2000, the price/earnings ratio on the S&P 500 was 29; today it is a little over 15, about half.
- The cost of money is extremely low, with interest rates as low as they have been for over 60 years.
- Taxes are historically low. While we believe they are likely to be increased, individual tax rates are currently the lowest they have been for over 40 years
- Enormous amount of money on the sidelines. The government has created a huge amount of money over the last ten years. According to Forbes, the 400 wealthiest individuals in America hit a new record this year: 1.7 trillion which is <u>five times</u> the

wealth they held in 1992. As one of my smartest clients recently said: "Liquidity trumps all."

There is a monumental amount of money in savings earning well under 1% per year. Leaving funds parked at this rate is a terrible long-term investment plan, and eventually it will move into equity asset classes. Some of this will gravitate to the stock market in search of growing companies. The U.S. is still one of the best places in the world to start and operate a business.

There is an old, but true, saying in Wall Street: *"A bull market climbs a wall of worry!"* It is one of those adages that one needs to experience before becoming an actual believer. There are many worrisome items in the news and that can keep people from owning a well-run company with a great product, unique service and excellent fundamentals. Clients who have money sitting in a bank earning less than ½% interest have told me, they did not want to invest until things became more certain. I have been in the investment business for over thirty-five years and I can truthfully state I cannot remember a single day when I could say, "Today things are certain! I can invest with utmost confidence and nothing will go wrong." Unfortunately, when it comes to the stock market, that's not the nature of the beast!

This powerful optimism is a radical departure from letters we wrote to clients 5 years ago. Take the time to read "Bumps in the Road" written August 29, 2007 (this can be found on our website, www.sara-bay.com, and clicking the tab labeled Newsletters). When markets enter major bull cycles, they tend to ignore bearish news and continue to rise. The all-time high in the Standard & Poor 500 is 1579. As we write this, the figure stands at 1416. We fully expect the old high to be surpassed. Watch for this to happen!

Sincerely,

Mike Ben Andrew

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