

What do you believe? Part II

“Every Crowd has a Silver Lining.”

Phineas Taylor Barnum

In November 1999, we wrote a piece titled “What do you believe?” The point of that commentary was to highlight how the enthusiasm of the day was resulting in ridiculous prices for certain stocks and a get rich quick mentality by many. Investors most susceptible to the future losses that occurred were those without a clear and simple statement of philosophy on investing.

Nearly three years later (and several thousand points on the NASDAQ) investor moods have shifted from jubilation over how fast their portfolios were rising to one of shock over how fast they are shrinking. With stocks posting the worst six-month period since 1974 and a bear market now 2 ½ years long, we thought it timely to put a new spin on our original piece.

The following is what we believe.

The crowd is often wrong. Many investors are now painfully aware that a good idea (e.g. the Internet) can be taken to disastrous consequences in the stock market. Investors should not forget two critical lessons from this experience. First, it doesn’t matter what causes the market to enter a speculative period. History is replete with examples of market bubbles not only in stocks but many other assets as well. What matters is the simple truth that when too many people believe the rewards far outweigh the risks the chance for disappointment increases significantly. The second point relates to when crowd sentiment swings in the opposite direction. **Too much pessimism can push valuations to extremes that represent extraordinary opportunity.**

A critical mistake by many investors is letting the market make decisions for them. By contrast, one of our basic beliefs is that the fair value on a stock is often different than the current price. We establish buy and sell targets for each stock and determine independently what we believe a stock is worth. This has been a vital step in our discipline for more than 30 years. Our valuation process is more important than ever before as surprisingly few large investors today have considerable influence on individual stocks. For example, 50% of the net assets invested in large growth and funds are concentrated in just 31 mutual funds and the top 15 shareholders of the stocks in the Dow Jones Industrial Index control on average 34% of the outstanding shares. This level of

concentration convinces us it is key to have a valuation discipline especially when the sentiment of the crowd appears extreme.

The most profitable decisions are frequently the hardest ones to make. Having a sound yet simple set of investment beliefs is needed most when the markets are in extreme periods. The closer the market reaches a turning point the more one-sided and convincing become the arguments. Investors who successfully navigate through the turbulent times are aware that the hardest decisions are often the most profitable ones.

Judging by recent flows in mutual funds, the hardest decision by many investors is to stay committed to stocks. In July alone, investors pulled a record \$53 billion from equity funds. **We believe selling stocks today will prove to be a mistake.** Consider the following facts. There have been 10,583 trading days over the 42-year period from 1960 - 2001. The S&P 500 Index price return without dividends was 7.3% annually. Missing the 10 biggest up days in percentage terms reduced the annualized return down to 6.0%. Missing the best 30 days in the index would have lowered the annualized return to 4.0% and **missing the biggest 88 days would reduce the annualized return to 0.0%.** Investors who decide to abandon stocks today in favor of safer havens in the short run should consider the long-term impact of missing a better market environment.

Market history is a useful guide. The inherent volatility of stocks leads investors to placing too much weight on what is going on today and not enough weight on the historical pattern of stocks. For example, most investors are aware that the long-term return from stocks has been around 11% annually. What is far less clear to many is that this record is made up of good years and bad years with few years in between. For example, over the past 76 years there were 38 years when the market return was over 15%, 25 years when the market return was negative and only 13 years when the market return fell within the “normal” range of 5 to 15%.

For the 5 years ended 9/30/02 the S&P 500 Index return was roughly -2% per year, the first negative 5-year return since 1978. This most recent period marks the 29th time (out of 288 periods) dating back to 1930 but only the 5th since 1950 when investors lost money in stocks. What should investors expect for the next 5 years? Based on market history investors should be optimistic. Every 5-year period since 1930 that followed a losing period generated a positive return. The median return was almost 15%, well above the long-term average. Importantly, the median return in each year of the subsequent 5-year period was positive with the 1st and 2nd years producing the highest returns. Of course, these past patterns of stock returns do not guarantee the next 5 years will hold true to form. However, we believe investors who make decisions without this historical knowledge will more likely make mistakes on asset allocation that could prove quite costly.

Stocks DO beat bonds in the long run. Similar to the points made above, stock returns relative to bond returns have been dismal. This comparative performance has been due not only to falling stock prices but to bond yields declining to 40 year lows, allowing the

bond investor to enjoy both income and capital appreciation. Does this recent relative performance undermine the historical record of stock returns beating bond returns? Absolutely not in our opinion. In fact, **we believe from this starting point in bond yields the case for stocks are stronger than ever.**

The 5-year Treasury note ended the 3rd quarter of 2002 with a yield of 2.56%, the lowest yield since May 1958. The dividend yield on the S&P 500 Index ended the 3rd quarter at 1.95%. **Stock prices therefore have to appreciate less than 1% per year over the next 5 years to equal the total return of an intermediate term Treasury.** Since stocks managed to exceed this hurdle rate 87% of all 5-year periods since 1930, it would appear to be a reasonable expectation they will do so over the next five years.

The circus is in town. We sense an important parallel has developed between the current market and the one of three years ago. A large and vocal majority of investors have accepted the view that stocks are not worth the risk. The supporters of this pessimistic forecast are just as strident in their views as were the bullish herd of three years ago. The world of course is never that black and white (including the investing world) and we strongly suspect the truth lies somewhere in between. If we are right in our perception, stock returns will surprise on the upside sooner than most investors think.

Which brings us to the quote at the top of this letter from Phineas Taylor Barnum (better known as P.T. Barnum). Barnum saw money making opportunities in large crowds and so do we. We acknowledge that P.T. had an easier road since there are no circus animals or clowns with which to entice investors to buy stocks again. However, a clear perspective on market cycles, the long term record of stock returns and a willingness to go against the crowd makes the decision for us to stay committed to stocks an easy one.

So, what do *you* believe?

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