Asset Class

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Uncertainty is Our Friend

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As I wrote last month’s Asset Class article “America Is a Value Stock,” I recalled an article I had read many years ago. Writing about the excuses professional investment managers make to avoid stocks during market environments similar to today’s, a wise man once wrote:

A second argument is made that there are just too many question marks about the near future; wouldn’t it be better to wait until things clear up a bit? You know the prose: “Maintain buying reserves until current uncertainties are resolved,” etc. Before reaching for that crutch, face up to two unpleasant facts: The future is never clear; you pay a very high price in the stock market for a cheery consensus. Uncertainty actually is the friend of the buyer of long-term values.

Fans of Warren Buffett will recognize this passage from an article he wrote for Forbes magazine 32 years ago, titled “You Pay a Very High Price in the Stock Market for a Cheery Consensus.” In his folksy, sarcastic style throughout the article Buffett skewers professional investment experts for their “schizophrenia,” “Pavlovian response,” and “puzzling behavior” of buying high and selling low. He starts out with this observation:

I’ve written about this behavior in previous Asset Class articles as being particularly puzzling when displayed by investment advisors who should know better. They market their value proposition as being the strong, disciplined tree that won’t be swayed by short-term market winds—until a client gets wobbly during a falling market. The advisor then turns into a weeping willow, not only refusing to rebalance back to the portfolio target allocations “at the client’s request.” This is how fee-only, full-discretionary investment advisors become order-taking stockbrokers in a flash.

Thirty-two years after Buffett’s brilliant article, we continue to see the same behavior from advisors and their clients. The chart below shows the flow of assets out of stock mutual funds since 2008. Note how the outflows (orange line) coincide with a decline in the S&P 500 market index (gray area). When stocks exploded (unexpectedly*) starting in early March 2009, we see barely a blip in positive stock fund flows before investors and

*Last 10 yrs. returns are ended 12/31/10.

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advisors got wobbly again and moved out of stocks. Although we don’t show it here, much of this money found its way into bond and money market funds—despite close to 0% yields. In contrast, assets devoted to a disciplined asset class strategy using the DFA funds steadily rose over the period (blue line).

Buffett’s comments in 1979 were directed at decision makers at pension plans. These included the corporate executives who hired the professional consultants who recommended the professional money managers—all seemingly highly intelligent, highly experienced and certainly, highly paid experts. Clearly these professionals were no smarter or better behaved than the mere mortals whose retirement money they were entrusted with protecting and growing.

Wisdom and Patience Win Out

In the August 1979 Forbes article, Buffett asks the question “Can better results be obtained over, say, 20 years from a group of 9 1/2% bonds of leading American companies maturing in 1999 than from a group of Dow-type equities purchased, in aggregate, at around book value and likely to earn, in aggregate, around 13% on that book value?” Good question. Here’s the answer (in terms of investment return):

<table>
<thead>
<tr>
<th>Table 1: 1980-1999</th>
<th>Annual Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500 index</td>
<td>17.9%</td>
</tr>
<tr>
<td>5-Year Treasury Notes</td>
<td>9.5%</td>
</tr>
<tr>
<td>Long-term Treasury Bonds</td>
<td>10.8%</td>
</tr>
</tbody>
</table>

Of course, even the great Buffett had no idea that stocks would do as well as they did over that period and essentially peak at the end of 1999. He was simply using “20 years” as a reasonable long-term time period to match the long-term investment horizon of pension plans. So let’s be more realistic by including the last 11 tumultuous years (and add large and small value stocks to honor Buffett’s and our value preference):

<table>
<thead>
<tr>
<th>Table 2: 1980-2010</th>
<th>Annual Return</th>
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</thead>
<tbody>
<tr>
<td>S&amp;P 500 index</td>
<td>11.4%</td>
</tr>
<tr>
<td>DFA US Large Value index</td>
<td>13.2%</td>
</tr>
<tr>
<td>DFA US Small Value index</td>
<td>15.9%</td>
</tr>
<tr>
<td>5-Year Treasury Notes</td>
<td>8.3%</td>
</tr>
<tr>
<td>Long-term Treasury Bonds</td>
<td>9.7%</td>
</tr>
</tbody>
</table>

Kind of scary how clear thinking, independence from Wall Street, and a disciplined adherence to sound principles pays off, right?

Then and Now

The market environment that influenced Buffett’s article was very similar to what we’re experiencing today. Buffett went through a severe bear market (1/73-9/74, S&P 500 down 42.6%), followed by a steep recovery over a short period of time (up 55.1% in nine months). The market bounced along after that, providing a meager 2.5% annual return from the beginning of 1973 until Buffett wrote his article. After another short, steep climb in 1980, the market fell again until the big bull market started in earnest in late 1982.

From 11/07 to 2/09 the market fell 50.9% and then returned 65.5% over the next 14 months (through April 2010). Since then, the market’s bounced around, with volatility increasing significantly of late as economic uncertainty in the U.S. and Europe has increased.

The seven years before Buffett’s article and the two years afterward offered exceptional opportunities to buy stocks cheap. There should be no question that our own “lost decade” and these current uncertain times are creating similar opportunities to buy stocks at exceptionally high expected returns—especially compared to what we can get from bonds.

It’s appropriate then to close this article with Buffett’s last words thirty-two years ago:

Amen. Now, Mr. Buffett, that thing about raising taxes during a recession...

* Unexpectedly for some, not Equius Partners. See our February 2009 Asset Class article “Past Declines & Their Recoveries.”