

March Newsletter

“No worries, mate. She’ll be right.”

When my wife Anita and I left on a trip to Australia on February 18th (to see our daughter who has chosen to live there), the stock market as measured by the S&P 500 was at about 800, down 11-12% for the year. Disheartening, after last year’s 37% decline. 2 weeks later, when we returned, the S&P had declined by another 15-20% hitting a low of 660. Scary, downright scary. Yet in our first 2 weeks back, in the midst of all the fear and loathing, the market has recovered all of what it lost while we were away. Now that’s the kind of volatility that characterizes a bear market. As we go through these gut-wrenching days, I certainly hope that our new Aussie friends prove correct when they say “No worries, mate. She’ll be right”.

But when? This is the question. How do we know we are at the bottom? I’d argue that we can’t know precisely because as the oft-quoted portfolio manager Jeremy Grantham puts it “a bear market ends when it’s totally black, just a little less so than the day before”. Given our inability to predict the bottom, we tend to develop a state of “terminal paralysis” in bear markets, which always leads us to conveniently finding a good reason for not investing in the stock market.

My job is to help you avoid terminal paralysis. So, in this edition of the newsletter, I am going to tell you why I believe that an environment characterized by fear and uncertainty, such as the one we are experiencing today, could create enormous opportunities for long term investors.

First the bad news. Even if the market improves significantly over the balance of 2009, it is very likely that the 10 year period ending this December will be the worst decade for investors ever. Since the stock market has (already) lost approximately 4% per year for the last nine years, compared to the 2% loss it experienced in the 10 year period between 1928 and 1938, my prediction is hardly a wild one.

Yet, if you look at the history of the stock market carefully, you will find some good news too. Data published by Davis Advisors shows that it has *always* been profitable to invest in the market after a decade of poor returns. Specifically, they point out in their most recent quarterly update for the Davis New York Venture Fund that there have been ten rolling 10 year periods since 1928 when the market returned less than 5% per year. In every case, the 10 years that followed produced good returns averaging approximately 13% per year, ranging from a low of 7% to a high of 18%.

Why are the bad years followed by some good ones? In my last newsletter, I quoted legendary investor Shelby Cullom Davis, who said that “you make most of your money in a bear market, you just don’t realize it at the time.” While this statement sounds counterintuitive at first (because prices go down in a bear market), it starts to make sense when you envision investors as *buyers* who welcome lower prices for the simple reason that lower prices may increase future returns. In bear markets, prices are driven down by

fear and forced selling. Forced sellers are not asking what a business is worth; they are taking whatever they can get. The irrational selling you get in bear markets can allow patient investors (buyers) to buy great businesses at distressed prices.

“But it just doesn’t feel right!” While many of the investors I talk to are indeed able to recognize the opportunities I point out to them with their head, their stomachs often have other ideas. As former Fidelity portfolio manager Peter Lynch put it, “The key organ for investment success is your stomach. Everyone has the brainpower, but not everyone has the stomach for it.” In today’s bear market, some investors are racing for the exits. Cash is pouring into short-term U.S. Treasury securities with next to no yield. Although this choice feels good, it could prove costly in the future given the high likelihood of a return to inflation. Meanwhile, the purchase of high quality common stocks, which feels like a terrible choice right now, could prove to be very profitable over the next decade.

Warren Buffett wrote an important editorial for The New York Times last October. In it, he noted that “The financial world is a mess, both in the United States and abroad. Its problems, moreover, have been leaking into the general economy, and the leaks are now turning into a gusher. In the near term, unemployment will rise, business activity will falter and the headlines will be scary. So... I’ve been buying American stocks.” He continued, “Over the long term, the stock market news will be good. In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced President. Yet the Dow rose from 66 to 11,497.”

While we cannot predict the direction of the market over the next month or the next year, we do know that it will move higher before the headlines become more reassuring. If investors wait until things seem better, they may pay higher prices. I believe that today’s prices reflect the most attractive valuations I have seen in my 40 year career and that it is part of my job to show you examples of what I mean, which I promise to continue to do. “No worries, mate. She’ll be right”. Talk to you soon.

The Standard & Poor’s (S&P) 500 Index is an unmanaged index that tracks the performance of 500 widely held, large-capitalization U.S. stocks. Individuals cannot invest directly in an index.

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