

Winter Newsletter: Lessons from a “Lost Decade”

2009 is in the books. While it was pretty scary back in March, investors who hung in there were rewarded as the stock market as measured by the S&P 500 recovered nicely from its lows to finish with a 23.5% gain. However, the sobering reality remains - 2009's gains were only a partial recovery of the losses incurred over the course of a particularly painful decade for the S&P, which was down 24% for the 10 year period. So why after these disappointing results, should investors remain committed to the stock market?

A look at history may help answer the question. The record shows that the stock market tends to do well in the decade following a period of disappointing results. According to Davis Advisors (research published in their January Newsletter), 10 year returns following disappointing periods (defined as those 10 year periods from 1928 to 2009 where the market returned less than 5% per year) averaged 13% per year. Certainly there is no guarantee that stock market returns will be better in the next decade, but history does suggest that investors should not abandon stocks after a period of poor returns.

What is perhaps more compelling is a comparison of the market's valuation as measured by its “earnings yield” at the beginning of this decade versus 10 years earlier. “Earnings Yield” is defined as the Earnings Per Share (EPS) for the S&P 500 divided by the S&P 500 Index itself. 10 years ago the forecast for the EPS of the S&P was \$48 and the index was at 1456 resulting in an earnings yield of approximately 3.3%; at 12/31/09, the forecast for S&P EPS was between \$60 and \$70 and the index itself was 1115, producing an earnings yield of 5.8% (using the midpoint of \$65 for EPS). Again, there is no guarantee that stocks will do well in the coming decade, but having close to a 6% earnings yield on the market at the start vs. 3% 10 years earlier (and a 10 year U.S. Treasury Bond yield of 3.60% currently) is another reason that investors shouldn't abandon stocks at this time.

So what can we learn from the “Lost Decade” just concluded? Three lessons stand out for me:

1. “It's the Fed, Stupid!” I learned that the Fed wields even more influence than I had previously thought. Its willingness to engage in a massive and continuing stimulus effort, which played an enormous role in “thawing out” a global economy that was freezing rapidly, provided enough moral hazard to the stock market (“we will do whatever it takes”) to help engineer a 60% rally off the lows of March. I also learned that the Fed is capable of getting out of touch with the real world – “what housing bubble?” Given the unprecedented extent of its involvement in the financial markets currently and its growing global influence, Fed watching becomes even more important than it has been.
2. “There is a new world order.” I learned that the developed countries, including the U.S., are past their prime compared with developing countries. As a result, I need to continue to explore investment opportunities that provide exposure to the developing market economies.

3. “There is more to investing than a BUY and HOLD strategy.” I learned (actually re-learned) that having a disciplined tactical investment approach (a willingness to adapt to changes in the market) is an important element of protecting client portfolios. Traditional asset allocation plans got caught in the last 10 years, overweighting the worst segment of the worst performing asset class (Large Cap U.S. Stocks). As it turned out, there was no investment segment that offered the best performance year in and year out, nor was there any consistency in terms of the worst performing asset class each year. The need for flexibility and adaptability and a rules-based approach to finding the asset classes that are in favor has never been greater.

So what about 2010? Of course, we can't know how the stock market will perform over the balance of the year. We do however know that the market was down in January confirming that the strong upward momentum witnessed through October of last year has been breached, at least temporarily. I am suggesting to my clients that they:

1. maintain a higher than usual level of cash, not as an earning asset (cash returns remain unattractive at 1/10th of 1%), but as a tactical weapon should an unusually attractive buying opportunity emerge.
2. emphasize quality in selecting investments.
3. look for dividend paying stocks.
4. take partial profits when appropriate.
5. buy on pullbacks in the market.

Most importantly, I believe that investors should not reduce their exposure to stocks despite the disappointing performance of the market in the last decade. While we cannot know for sure what the next decade will hold, it may be far better than what investors have suffered through in the last 10 years. 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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