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The Investor's Paradox

As I write this letter, the stock market is down more than 50% from its high in October of 2007. That wipes out all the market gains for the past twelve years. There has been a deluge of bad economic news, more scandals and the government response to date has been inept, at best. Little wonder that the stock market fell through its November lows.

The chance of a quick recovery from today's troubles appears to be slim. Unemployment is accelerating and unlikely to peak anytime soon. Unemployed workers threaten another round of loan defaults and weak consumer spending. We are dealing simultaneously with bankrupt workers, banks and counties; in a great deleveraging of the world's economies.

Deleveraging is a painful process. Bad loans have to be recognized from condos in Miami to shopping malls in Hungary. That stresses banks' balance sheets and government budgets to the point that some failures are inevitable. A single failure sends shock waves through the world economy exposing weaknesses we never dreamed of and causing a lack of confidence in the entire system.

There is little doubt that things are bad and getting worse. We all know that, but not many people understand "The Investor's Paradox." Simply stated, it is that at important turning points:

There is an inverse relationship between the short-term performance of markets and their long-term performance.

When easy money is being made, markets are most likely to crash and when there is "blood in the streets" you are most likely to make money. Or as Warren Buffett said: "The time to be fearful is when everyone is optimistic and the time to be optimistic is when everyone is fearful."

In retrospect, it's easy to see that market manias are rewarding in the short-term but dangerous in the long-term. At market tops every trade is a winner and the party looks like it will never end. There is a constant stream of good news that fuels prices ever higher. Of course, the paradox is that this is the most dangerous time of all for investors. At the top, valuations are at their extreme, euphoria must inevitably give way to disappointment and short-term returns have eaten up most of the long-term appreciation potential of the asset.

That's what happened when oil hit \$100 a barrel and was projected to hit \$200. It was clear that the tech bubble had to burst when the "new economy" promised endless prosperity. Gold was a no brainer in the eighties, except it took over two decades to break even when the mania ended.

The flip side of the paradox is less intuitive, but just as powerful. Market panics offer investors the best opportunity for long-term returns. The problem is that seeing opportunities in bear markets requires substituting greed for fear, and fear is a much more powerful emotion, at least for sane people.

How can a constant stream of bad news, markets hitting new lows and near universal pessimism be harbingers of superior future returns? It's the exact opposite of a mania. Valuations are low, the panic will eventually subside and markets have the most room to advance when they are depressed, even if they just go back to normal valuations. How can a market that has been going almost straight down for over a year now and faces the likelihood of more bad news be a good investment? That's the paradox! The best opportunities and the least probability of long-term losses occur in the worst bear markets.

Let's look at the numbers. Since 1950 there have been four major bear markets, in which the market went down 30% or more and two super bear markets, where the market went down 40% or more. After a 30% correction, the average return over the next two years was 10.7%. The average annual return for the stock market since 1950 was 6.3% with S&P at 700 today. Let's be fair and use 1000 for current S&P (half way between the recent high of 1300 and low of 700). That gives an average return for the period of about 7%. That makes the average return from bear markets historically 50% better than the returns in "safe" and "normal" times, when there is little to fear and the economy is doing well. Should super bear markets scare you? **Two years after a brutal 40% correction the simple average return was 15.6%. That's twice the market's historic average performance!**

Bear Market	30% Decline	Median Market Price	40% Decline	Median Market Price
2001-02	9/01	2003 -10%	7/02	2004 24%
1980-82	8/02	2004 59%		
1973-74	6/74	1976 18%	8/74	1976 38%
1968-70	4/70	1972 43%		
Average Simple Annual Return		10.7%		15.6%

But, couldn't we just avoid the near term pain and wait for some good news before buying stocks? Couldn't we participate in the recovery without having to suffer the pain of a bear market? Could we have just kept owning tech stocks at the height of the mania and waited for tech earnings to crash before selling Cisco and Yahoo? No, it would have been too late to sell if you waited for the bad news before dumping tech stocks; and, it will likely be too late to get the best part of the market's recovery, if you wait for the good news before you get back into the stock market. We have a pretty good idea of when there is a mania or panic, but we have a very limited ability to predict when they will end, other than to note they almost always end quickly and unexpectedly.

There are three commandments for equity investors.

1. **Thou shall sell manias.** You don't have to sell everything. You just have to avoid expensive stocks. We got through the first two years of the 2001-03 bear market relatively unscathed because we sold most of our tech stocks before the bubble burst. Selling a lot of energy stocks while oil was over \$100 a barrel didn't hurt our returns either.
2. **Thou shall buy panics.** You don't have to put new money in the market, but you can get aggressive with the money you have by moving into stocks with better long-term reward potential. Balanced portfolios should sell bonds and buy stocks. Cash should be kept to a minimum.
3. **In all other times, thou shall keep a conservative portfolio allocation.** Investors need to understand that the market is unpredictable, but is capable of offering a superior long-term return.

There have been two other super bear markets in the past 100 years. The last bear market that even approaches today's carnage was in the seventies and early eighties. Back then, we had 11% unemployment versus about 8% today, a hangover from the Viet Nam war, hyperinflation and stocks had to compete with bond and money market yields in the high teens. The top tax bracket was over 50% and capital gains were treated as ordinary income. Three quarters of the world was living under communism, their markets were closed to us and their governments were vowing to bury us. Still, if you were unlucky enough to buy the market when it was at its high in 1973, it took you seven years to get even but you doubled your money twelve years later.

To find anything like the miserable absolute market performance of the past twelve years, you have to go back to the great depression and World War II. Could things really be that bad? The 26% unemployment rate reported during the great depression probably greatly underestimates the real numbers; and, those people didn't have unemployment insurance or today's welfare programs. When your bank went bust, you lost all your money because there wasn't a FDIC. The government didn't do much to stimulate the economy until years after it tanked. Instead they compounded the problem by passing protectionist trade policies. Any hope for an improvement in the investment climate went up in flames with the outbreak of World War II.

Unless the economy is in much worse shape than it was in the early eighties and nearly as bad as it was in the great depression, the stock market should have a normal recovery that would wipe out recent losses in short order. In fact, the economy is in much better shape than it was in the seventies and we are doing much more to fix it than we did then. To have the problems we had in the seventies, we'd probably have to see unemployment increase from less than 8% to over 11%, top income tax rates go to over 50%, inflation go to over 15% and China close its markets. **We could begin to make some comparisons between our current problems and the great depression if unemployment tripled, the FDIC stopped guaranteeing bank deposits, Europe and Japan started trade wars, most of the rest of the world defaulted on their debt and we went to war with Russia.**

The problems we face today are not nearly as dire as what we have faced in the past, but there are significant challenges and worse yet, the solutions appear to be misguided. We can't seem to throw enough money at the problem to make it go away and every crisis seems to bring a new bandaide but no cure. The fact that the new administration has been unable to solve the world's problems in a matter of

weeks isn't surprising, but the market says they are off to a bad start. Mr. Market wants results and unless he gets what it wants, there will be hell to pay.

The administration has a short period of time to clean up this mess or their legislative agenda will be toast and they will lose their majority in the next election, just a year and a half from now. That may not be fair, but it's the way it's always been and why our country has prospered. We try almost everything and we keep trying until we get it right.

The investor's paradox doesn't depend on our government being geniuses or the effectiveness of short-term bailouts. It doesn't require that investor confidence is suddenly restored or that we turn the economy around overnight. It just requires that the economy eventually heals itself in the same way it always has. It's tempting to say this time is different. Yes, it is different, but it probably isn't worse. But what you really want to know is:

How much worse will this market get and when will the pain end?

That is a question of volatility, not risk. Volatility is unpredictable because short-term events can cause just about anything to happen. Risk is more measurable. Risk is what is likely to happen over the next few years and as I have shown, and common sense would indicate, the odds now appear to be heavily weighted on the side of investors.

Volatility only presents risk for investors if they let it. Look, if I told you that the market would have an average annual return of between 0 and 12% over the next five years (risk) but that the average annual percentage change from top to bottom (volatility) would be 50%, instead of the "normal" 20%, should you care? That's equivalent to a market that drops every year by the same amount it did last year. Would it break you? It might break your spirits, but as long as you either didn't sell in the dips or took a fixed percentage out when the market was up and down, it wouldn't hurt you financially. You'd just get whatever the average yield was over those five years, regardless of how bumpy the ride was.

The way to get really hurt is to sell low and buy high. If you sell when the market is low, either by design or because your emotions got the best of you, you can transform volatility into risk. Stop loss orders, market timing, various options strategies and just plain selling to stop the pain are all examples of actions that feel good in the short-run, but expose investors to risks they didn't have to take. **It is part of the investor's paradox that trying to avoid short-term market losses can expose investors to additional risk.**

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