

A Correction Is Not A Trend: Lessons from 1987

Since this year marked the twentieth anniversary of the stock market crash of 1987, much has been written comparing and contrasting the financial markets of today versus those of the past.

Some commentators have used the historic date to insinuate the market is somehow “due” to have another fall. While desiring to avoid financial declines is perhaps human nature, the focus on the same can create a certain myopia which detracts from the bigger picture.

One person who keeps up with such predictions is Mark Hulbert, the founder of *Hulbert Financial Digest*. Mark’s company tracks over 160 financial newsletters to see which ones have the most favorable track records.

Mark’s finding: the newsletters that were the most accurate in forecasting the 1987 crash have been among the poorest performers since that time. The newsletters that did the worst in 1987 have since been among the best performers.

This is not just a matter of style or exposure to risk. The newsletters that did well in 1987 did not sidestep the far steeper correction in 2000-2002. The newsletters that did not do well in 1987 performed better in this time period and most time periods since.

What this suggests is a certain choice of time frames by the newsletter authors. The shops that called the 1987 decline were (and are) more short-term oriented and thus more focused on the here and now. The better performing firms over the entire time frame have a longer investment orientation which permits them to see beyond the current turbulence to the potential of the future.

The data also suggests that even when an organization can foresee one correction, its talents may not permit it to forecast another one. Finally, the data implies that those who have a pessimistic view of the world and its future tend not to expose themselves to the potential of things turning out better than they forecast.

The best performing newsletters tend to focus on specific investments rather than the market in general. They also have a time frame of one to five years in terms of investments rather than short-term trading opportunities. Finally they are not overly diversified. Such newsletters seldom have more than fifteen to twenty buying positions.

This is not to say money cannot be made trading short-term. However, those who are successful at short-term trading tend to devise their own strategies and realize that it is a game of percentages or probabilities. Technical information is paramount in such a situation. Longer term investors tend to focus more on fundamentals and changes in the investment environment. There is an old adage on Wall Street that a long-term investor is a short-term trader with a losing position and an ego that will not permit him to sell. This makes for poor performance both short term and long.

In another paper published last week Hulbert polled the newsletter writers with the best track records for the past ten years on a risk-adjusted basis to see how they felt about the current stock market. On average the best performing letters were recommending an 83 percent exposure to stocks. This is in contrast to the worst performing newsletters over the same time frame on a risk-adjusted basis which recommend at this time an average of 9 percent equity exposure.

The bottom line for both the market and any given stock is not how you feel about the near term but how you feel about the long term. One should not avoid corrections any more than one should avoid being rained on if your intent is to capture long-term gains. When Peter Lynch managed the Fidelity Magellan Fund he was fond of reminding people that the stock market declined by ten percent or more an average of one year in three and two years in five. The implication was that such swoons were not in themselves reasons to sell and head for the sidelines.

On the other hand, if you feel the market is going to decline and not come back in the foreseeable future then by all means be out of the market. However such a call is not to avoid a correction but the perception of a catastrophe.

Warren Buffett once wrote that the stock market is in the short term a voting machine but over the long term is a weighing machine. By this he meant that day to day prices are set by buyers and sellers. Not always are they set rationally. Over time the prices are ultimately the reflection of the fundamental worth of the company. If you look at a company as a business and not as a stock the presence or absence of value becomes more apparent.

The Economy

A retraction in consumer spending is in turn causing the rate of economic growth to decelerate. Retailers are looking at a subdued holiday selling season at best. Energy prices are pressuring a number of family budgets. The housing market is almost frozen in some areas as people cannot buy the home they want because they cannot get someone to buy their home in turn and are afraid of carrying two mortgages.

The current bright spots in the economy center on either foreign demand in the form of exports or government demand typically in the form of health care and retirement expenditures. Hopefully by spring the housing market will be fluid enough to accommodate more transactions which will in turn give consumers more confidence to buy. While the concept of housing as an investment will take some time to recover, the appeal of housing as shelter continues to exist. Once housing markets are restored consumer spending should recover.

Interest Rates

The $\frac{3}{4}$ percent decline in Federal benchmark loan rates has had some problems filtering into the economy. Bank loans tied to the prime rate have been impacted as well as the home mortgage market among those who can meet loan qualifications. For others the cut has been a bit more fleeting. Credit card interest rates have not declined, nor have auto loans been impacted.

There has been a great deal of discussion as to whether the Federal Reserve will cut interest rates again before year-end. At this point it does not seem likely. The current financial dislocations of the market have more to do with the terms of credit rather than the cost of credit. As such the Federal Reserve is not receptive to a further reduction in interest rates at this time.

Inflation

Inflation is accelerating, due to rising energy costs as well as the consequences of the falling dollar.

As interest rates have declined, investors who once purchased dollar securities have shifted their focus to other countries whose interest rates are higher than those offered in the US. The resulting fall in the value of the dollar against other currencies which are in greater international demand causes prices to go up in dollar terms. Most of the increase in the price of oil is the result of the fall in the dollar. In terms of euros or pounds the price of oil is almost the same as it was six months ago.

We look for an inflation rate of between four and five percent per annum by next year. This will be a significant increase from the past few years.

The Stock Market

The overall indexes have been in sharp gyrations for the past six months. After hitting one set of highs in early summer, the market came close to correcting ten percent before again hitting new highs in October. Since that time the overall indexes have declined to being almost ten percent down.

The overall numbers have hidden a number of cross-currents. Financial stocks, which make up around 20 percent of the Standard & Poor's Index have declined in the double digits this year. The rest of the market is up enough to keep the Index in the black by three percent or so year to date. This rotation out of financial stocks into exporters and the like will likely continue for another few months, exaggerating volatility in the process. By next year the new investment themes of exporters, health care and capital goods will emerge as the new leadership.

Warren M. Barnett, CFA
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