

## A RARE OPPORTUNITY: THOUGHTS ON THE CURRENT MARKET SITUATION

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Equities are the best asset class available to long-term investors interested in maximum total return or growth of capital. This statement takes into account all of the periods of falling markets or bear markets as well as the periods of rising markets. It naturally follows that buying during periods of declining markets adds to an investor's long-term investment returns. If an investor can find the discipline to buy equities after a significant decline in prices, obviously the long-term superiority of equities is enhanced. At such times the unpredictability of the short-term outlook is quite insignificant compared to the long-term advantage of investing new funds in equities. There is no way to know when the exact bottom of a bear market has been reached and it doesn't matter. It is enough to actually put cash to work when the market is down.

There have been four bear markets during the 20<sup>th</sup> century and the beginning of the 21<sup>st</sup> century that stand out from all the other bear markets during that period in both severity of decline and duration. Three of these took place in the 20<sup>th</sup> century and are now indisputable history and part of the long record of equity investment returns – returns that surpass all other asset classes. In each case, investment results for the five years following the last calendar year of decline were significantly above the long-term results of large-cap stocks for the period 1925 through 1999.

#### Average Annual Rate of Compound Growth for 5-Year Periods Following Past Major Bear Markets (last calendar year of decline)

	<i>Large-Cap Stocks</i>	<i>Small-Cap Stocks</i>	<i>Long-term Gov't Bonds</i>
Beginning of '33 to end of '37	14.3%	24.0%	4.5%
Beginning of '43 to end of '47	14.9%	35.0%	2.5%
Beginning of '75 to end of '79	14.8%	39.8%	4.3%

*Source: Ibbotson Associates SBBi Yearbook, 2003.*

*Note: These results understate the returns that would have applied if the inter-year lows or exact bottom of the bear market was used as the starting point of the 5-year holding period.*

Of the four most severe equity bear markets of the 20<sup>th</sup> and beginning of the 21<sup>st</sup> centuries, the 1973-74 bear market most resembles the bear market decline of 2000-01-02 as a correction of overvalued growth stocks. These two bear markets also have traced very similar profiles as to investor attitudes.

During 1971-72, US equity investors, impressed by the excellent long-term earnings records of a number of large-cap growth stocks, increasingly focused their attention on this sector of the market. The resulting phenomenon became known as the Nifty Fifty – 50 large-cap stocks trading at 50 times earnings and more. The record high P/E multiples of this group at that time contrasted sharply to the P/E multiples of many smaller companies with excellent growth records which were not as steady in their quarter-by-quarter progressions.

It was the attraction of steady growth with few short-term setbacks or “disappointments” that became the main justification for accepting the excessive valuations of the one-decision Nifty Fifty stocks. Growth at any price! Buy them and hold them indefinitely! This type of mentality created a self-fulfilling prophecy which seemed unstoppable, and for a time it was, then it stopped dead. In hindsight, such moves get labeled as unsustainable booms based on unbelievable folly. This, however, does nothing to restore the losses of investors who were willing to accept an imprudent justification for buying irrationally over-priced stocks simply because they couldn't resist owning stocks that were going up month after month and then year after year.

When one of these milestone extremes of market behavior peaks out and starts to correct, the historical pattern is for the changing direction to be resisted. Investors quickly react to the first significant correction by buying more of the past market leaders in the expectation that they will bounce back to resume their recent winning ways.

I believe that anybody who has paid reasonable attention to the fortunes of the US equity markets since 1997 will see the similarities between the 1971-72 Nifty Fifty era and the last years of the 1990s bull market. By 1998, and through to the early months of 2000, the magnitude of overvaluation, first of large-cap growth stocks and later of the entire high tech market, was much greater than the earlier experience with the Nifty Fifties in the 70s.

The correction of the discrepancy between the overvalued large-cap and the more reasonably priced small-cap stocks started at the end of the 1973-74 bear market. The similar discrepancy at the end of the 90s has followed a different timing sequence worth noting. Undervalued small-cap stocks began to outperform large-cap stocks during 2000, at the very beginning of the general bear market which has been raging for the past three years. This difference in timing in the overall process in a long bear market corrective phase will prove to have little effect on the final overall outcome of the correction. The excesses will be corrected and the stage set for a new bull market.

The general pattern of previous bear markets has been followed during this latest decline. Starting with a slow buildup to becoming disillusioned, and after numerous failed rally attempts, investors did finally become disillusioned. This quickly grew to a rejection of the entire concept of long-term equity investing for many. Finally, in common with the bottom area of all bear markets, there has developed an almost complete reluctance to put new money into equities – even by individuals who claim to be long-term investors. This certainly was true after the 1973-74 bear market.

In the mid-1970s investors gave up on equities and moved into money market funds. After all, short-term rates were high and moving higher, as was inflation. Today many investors are giving up on equities and money market funds. These investors are chasing after current returns from long-term bonds, lower quality credits and dividend income trusts. The move to money market funds in the 70s wasn't inspired, but the current move to long-term fixed income investments at a time when interest rates are at 40-year lows is just plain inexplicable folly.

### GIVING UP ON EQUITIES IN THE MID-70s WAS A HUGE MISTAKE

You may have read recently that after the 1973-74 decline, a new bull market did not really start until 1982. Before we comment on where on earth this notion comes from, please consider the following:

	<i>Large-Cap Stocks</i>	<i>Small-Cap Stocks</i>	<i>Long-Term Gov't Bonds</i>
1975	37.2%	52.8%	9.2%
1976	23.8%	57.4%	16.8%
1977	-7.2%	25.4%	-0.7%
1978	6.6%	23.5%	-1.2%
1979	18.4%	43.5%	-1.2%
1980	32.4%	39.9%	-4.0%
1981	-4.9%	13.9%	1.9%
Cumulative Returns	150.6%	750.8%	20.9%

*Source: Ibbotson Associates SBBI Yearbook, 2003.  
Cumulative returns calculated by North Growth Management Ltd.*

Stocks were very reasonably priced at the beginning of 1975 and most investors just didn't care. They had been burned badly and they were fed up with equities. While it may be easy to understand the emotions involved here, the reality of low P/E multiples and the availability of companies with good prospects for earnings growth was a much better basis for making investment decisions.

1982 might have been the beginning of a secular bull market, but to say that a new bull market did not begin following the 1973-74 sell-off until 1982 isn't a very astute observation. In fact, it was a terribly erratic period, impossibly frustrating for trend followers and market timers. Many managers did poorly in this environment. Many individuals ignored the market so completely that they probably don't remember it as a bull market. Nevertheless, large-cap stocks were up 150.63% during 1975 through 1981, and small-cap stocks were up an amazing 750.78%. No serious long-term investor can afford to write off such a period because they feel emotionally uncomfortable. Also of interest is the fact that long-term government bonds had a cumulative return of only 20.90% during this period!

Mid-1982 was the beginning of a secular bull market that lasted through to 1999. Obviously, it too was a good time to be invested in equities. It was also a major bond market cycle as interest rates, both long- and short-term, witnessed a major decline from their peak levels in 1981.

The following table documents the great secular “bull market of the century.”

#### Stock Market and Long-term Bond Market Returns 1982-1999

	<i>Large-Cap Stocks</i>	<i>Small-Cap Stocks</i>	<i>Long-Term Gov't Bonds</i>
1982	21.4%	28.0%	40.4%
1983	22.5%	39.7%	0.7%
1984	6.3%	-6.7%	15.5%
1985	32.2%	24.7%	31.0%
1986	18.5%	6.9%	24.5%
1987	5.2%	-9.3%	-2.7%
1988	16.8%	22.9%	9.7%
1989	31.5%	10.2%	18.1%
1990	-3.2%	-21.6%	6.2%
1991	30.6%	44.6%	19.3%
1992	7.7%	23.4%	8.1%
1993	10.0%	21.0%	18.2%
1994	1.3%	3.1%	-7.8%
1995	37.4%	34.5%	31.7%
1996	23.1%	17.6%	-0.9%
1997	33.4%	22.8%	15.9%
1998	28.6%	-7.3%	13.1%
1999	21.0%	29.8%	-9.0%
Cumulative Returns	2,029.6%	1,012.9%	678.5%

*Source: Ibbotson Associates SBBI Yearbook, 2003.  
Cumulative returns calculated by North Growth Management Ltd.*

A great period to be invested! The best period in the century for bonds! Still, bonds did less than half as well as large-cap stocks during this period and also lagged small-cap stocks.

#### THE CURRENT SITUATION

The current market is extremely oversold by past historic precedent. This suggests that there would have to be something extraordinarily different about the present situation for this not to be a highly rewarding time to be investing in equities. In fact, based on fundamental analysis of individual companies, which is the main driver of our investment decisions, and on major economic variables, which are consistent with the beginning of a recovery economic cycle, the outlook is extraordinarily positive. The fundamental picture reinforces the likelihood that past stock market patterns will develop and that risk in terms of a further year-to-year decline is small and that an advance of a number of years is not only highly likely, but likely to provide returns that will continue to support the observation that even after taking into account periods of bear markets, equities are by far the best long-term investment available.

Any other conclusion has to be based on emotion rather than logic. Consideration should be given to the fact that the market is always fluctuating between extremes of excessive optimism and excessive pessimism. 2000 witnessed the most extreme optimism seen since 1929. Now that the market has been correcting since March of 2000, the market mood is no longer optimistic. It is my judgment based on successfully handling 11 bear markets, including being fully invested in reasonably priced stocks with good earnings growth prospects near the end of each of those bear markets and at the beginning of every bull market since 1962 – **this is as clear a time to be bullish as investors ever see.**

	<i>Large-Cap Stocks</i>	<i>Small-Cap Stocks</i>	<i>Long-Term Gov't Bonds</i>
2000	-9.1%	-3.6%	21.5%
2001	-11.9%	22.8%	3.7%
2002	-22.1%	-13.3%	17.8%
Cumulative Returns	-37.6%	2.6%	48.4%

*Source: Ibbotson Associates S&P Yearbook, 2003.  
Cumulative returns calculated by North Growth Management Ltd.*

Many investors prefer to wait until there is general agreement that the economy has established an up trend and that business is good for most companies before committing money to the market. That is OK if that is the best one's emotional make-up will allow, and it will even work out well if those investors become long-term investors. It will, however, reduce their long-term results from what they could have been if they had bought at the beginning of a bull market. Anyone who buys late then gets nervous and sells during the next period of market weakness will not realize the long-term advantage of owning equities.

Now is the time to buy equities. There will always be uncertainty – that's life. While the very short-term is always unpredictable, especially during a major war, buying equities after 3 years of declining markets has historically been a low risk/high potential proposition.