Ruminations – November 2014

H. Bradlee Perry
Marble Harbor Investment Counsel Advisory Board Member
Investment Consultant

How Should We Look At The Stock Market?

Following is the text of a talk I gave to a group of retirees on October 16th. Much of it is quite basic, but I think even experienced investors can benefit from reminding themselves occasionally about basic truths.

I have found that many individuals who own stocks devote a majority of their investment thinking to looking at the stock market and trying to figure out where it's going in the near future. But that's really very unproductive. So I want to talk to you about how you should look at the market, and get some benefits from doing so. Investing is a crucial activity for many people, because it's the foundation of their financial well-being. Making successful investment decisions requires a close focus on a few significant long-term certainties, and ignoring all the uncertainties that are mostly short-term in nature and thus of no lasting relevance.

In the long run, the stock market's main benefits to true investors are as an approximate scorecard of investment results and a measurement of stock valuations. But in the short run, the market fluctuates a lot above and below the fundamental values of companies and the long-term up-trend of those values. And because those swings are unpredictable, it is useless to try to do any sort of short- to intermediate- term market forecasting. But unfortunately, all of the market's fluctuations get reported every minute of every day, mesmerizing many investors and bothering a lot of them. This diverts their attention from the most important and most productive aspects of investing.

Illustrative of people's fixation on the stock market, almost invariably when I encounter friends who own investments and know I'm an investment manager, their first words to me are, "Have you seen the market today? What do you think it's going to do?" It's true that we are continually bombarded with stock market reports. We can't avoid them, and we do want to enhance our wealth. So I guess posing that question to me is inevitable. But the question does not address the key things true investors should be thinking about. Furthermore, it is unanswerable, because as I'll show you, no one knows where the market will go in the coming days, weeks, months, or even the next few years. The only certainty the market has is its long-term uptrend over decades as the economy grows and as most companies' sales, profits, and dividends grow, increasing the value of their businesses.

Let me start with an explanation of why stock market forecasting is a pointless activity. From day to day, the market is affected by two main things: news that could impact companies, mostly just in the short run, and investors' reactions to that news, whether it be in the economic or political arenas or relative to specific industries and individual companies. Obviously, the most useful company news relates to their products and positive or negative changes in their competitive positions, not to spot news and reports of quarterly earnings – which do contain short-term surprises from time to time.

All the news is factual, but as I said, much of it only has short-term impacts and thus should be ignored. Only a small number of news items have long-run significance, so investors should sort out the wheat from the chaff. Just listen to CNBC's all-day television investment reporting for a few hours and see how little news of long-term significance it presents. Yet many investors monitor CNBC all day.

People's reactions to the flood of news are the primary cause of stock price fluctuations, driven mainly by short-term traders. We may think we're all cool, calm and collected, but a great many investors are not – especially when their stocks are involved. The thrill of victory and the agony of defeat have as strong an influence on investors as they do on sports participants and their spectators. And investors' reactions to seemingly good or bad news often impels them to make quick decisions to sell or buy stocks at the wrong times. Speaking frankly, many investors are manic-depressive to a greater or lesser degree.

And a key difficulty with these stock market reactions is that the news that triggers them is almost always unexpected. So when we look at the broad market, we often see it acting in ways that no one had anticipated. Therefore, how can we forecast correctly what stock prices will do in shorter periods when we can't predict the stream of news that will come along in the next few weeks, months, or even several years?

For example, no one foresaw at its outset the great technology boom that occurred in 1996-2000, which caused tech stocks to rise 200-400-800% and produced a tripling of the entire stock market in that short five-year period. Nor did anyone, other than three people I know of, predict the housing crash that caused the devastating financial crisis and the ensuing Great Recession in 2008-2009, which together drove the stock market down 60% in a mere two years. And recently no forecaster told us that the super-aggressive monetary easing by the Federal Reserve – which has been aimed at boosting the economic recovery – would push stock prices up an unprecedented 30% last year, even though the economy was still struggling to advance at a snail's pace.

The difficulty, and often the impossibility, of anticipating future events, large and small, shows up in the dismal record of stock market forecasting – even by the supposed "leading experts" on Wall Street, who earn salaries of millions of dollars to prognosticate to us. A study of their inadequacies was published recently by Birinyi Associates. Here are the figures:

January Stock Market Forecasts
By 18 Market Strategists

Years	Average Forecast	S&P 500 Actual Chg.	Actual Vs. Forecast
2013	+ 8%	+30%	+22%
2012	+ 7	+14	+ 7
2011	+10	0	- 10
2010	+10	+13	+ 3
2009	+ 9	+13	+ 4
2008	+11	-39	- 50
2007	+ 4	+10	+ 6
2006	+ 9	+14	+ 5
2005	+ 3	+ 3	0
2004	+ 5	+ 9	+ 4
2003	+13	+27	+14
2002	+12	- 22	- 34
2001	+21	- 12	- 33
2000	+ 4	- 10	- 14
14-Yr. Average	+ 9%	0%	±15%

Source: Birinyi Associates

It's really shocking to see how far from actuality the forecasts of these experienced observers were, by an average of 15% per year. That's two and a half times the 6% long-term average of annual stock market appreciation! And in four years they were wrong on the direction of the market, too. In the fourteen years the study covered, there were four market declines, about a normal number for such a time span. But the gurus predicted gains for every year.

Notably, in 2008-09 when the market crashed 39% – certainly a period when good guidance was needed – their January predictions called for a rise of 11%. Being off by fifty percentage points is unbelievable. And last year, when the market rose a surprising 30%, they were way behind – expecting a gain of just 9%. So ignore all the market forecasters. And don't make any decisions based on their shaky guesses.

Now, considering all the uncertainties about the stock market, especially its great volatility, what should we do? Well, the key is to be a true investor. That person tries to build wealth by buying and holding onto the shares of strong companies whose businesses are profitable and growing – most of them quite consistently increasing their sales, earnings, and dividends, year by year. Obviously, that trend gradually makes their shares more valuable over the long term.

Of course, even the most careful company selection process gets us into a few firms whose growth and profitability unexpectedly falter – and their shares become worth less, losing us money instead of making it. Nothing is a sure bet in the corporate world. Look at the demise of Eastman Kodak, one of the greatest corporations of the 20th century. But usually strong business fundamentals persist for long times. So the key always is to focus on good companies in good businesses.

Traders, on the other hand, focus primarily on stock prices, not businesses. Then, based on their rather superficial analysis of the short-term, they try to pick stocks that they guess will rise or fall in price much more than the market will move in those directions – either buying or selling short. Their goal is to get good rides in specific stocks for a few months and then switch to other promising candidates for quick profits.

But this is just a guessing game, because no one can be sure about short-term stock moves and the new events that may come along to cause them. Clearly, trading contrasts sharply with investing – where the goal is to be a successful marathoner, rather than the winner of many successive, frenzied sprints. No wonder that two programs on CNBC, the primary purveyor of short-term investment news, are named Fast Money and Mad Money.

It's an unfortunate fact that traders – mostly hedge funds and big investment firms trading with their own money, plus some misguided individuals – now account for more than 80-85% of all stock buying and selling every day. This includes "high frequency trading," whereby computers use complex mathematical algorithms to analyze the flow of news items, react to ones they consider most significant *in 50 millionths of a second*, and immediately place buy or sell orders for large numbers of shares. All this without any human intervention! It's the excessive stock price reactions all this trading causes that make the market so volatile in the short run. But the excesses caused by hyper traders and also by *investors'* occasional emotional highs and lows do get worked out eventually and fade into oblivion. The long-term trend ultimately rules.

This is why if you look at the wealthy people in any community, you find that most of them have been successful investors – either starting and building a good company on their own, or for the rest of us, by investing alongside those businesses-builders by purchasing the publicly traded shares of their companies. And these successful investors – insiders and outsiders – have held onto their shares for a long time to get a big payoff, not trading in out and out of the stocks. You and I weren't as smart and capable as Ken Olsen in the glory days of Digital Equipment, or Henry Termeer of Genzyme more recently, but by climbing into their canoes we got a great ride with them.

I'm sure most of us here are true investors, not traders. And acting as investors, how should we look at the always-jumpy stock market, which in one role is the scorecard of our decisions? First, we must recognize that the volatility of the market makes it an ever-fluctuating scorecard that at times deviates significantly from accurate valuations of the companies that we're holding for the long term. But experienced investors can see and understand those variations. So, instead, they look at long-term trends of stock prices – drawing trend lines in their minds at least, between the interim highs and lows.

And the stock market can help us greatly beyond that scoring function – by showing us the valuation of the businesses that underlie stocks. And the averages of their fluctuating valuations tell us what normal, sensible valuations are for those businesses. Those norms are the key to making successful buying and selling decisions on stocks. The primary measuring stick for valuations is the price-to-earnings ratio. The more a business earns – in total and for each share of its stock – the more it is worth. So as earnings per share rise, a stock becomes more valuable.

Over a long time, the stocks in the Standard & Poor's 500 stock index have had an average price/earnings ratio of 14½. So that has been the normal valuation of the stock market. Naturally, within that broad group, the shares of the strongest, most rapidly growing companies have justifiably sold at higher multiples, often twenty times earnings or above – because those businesses' inherent values have been increasing faster. Conversely, weaker and slower-growing companies have sold at lower price/earnings ratios – ten or less – because their businesses are not becoming much more valuable over time and they have the risk of becoming worth less.

At any time when we're appraising individual companies, or the market as a whole, it's simple to determine whether stocks are realistic values relative to their earnings or not – based on the historical range of valuations. Such analysis is key to making good buy and sell decisions. For example, at the market low in early 2009, when the S&P 500 index was around 700 (it's now near 1900), its stocks had an average price/earnings ratio of 11½ on the depressed earnings at the moment (due to the slumping economy). And versus the S&P's peak earnings in 2007 (which were quite likely to be re-attained in a few years, once the economy recovered) the 2009 P/E ratio was 8 times 2007 earnings – the lowest valuation level in more than 50 years.

Compared to the S&P's historical multiple of 14½ in the prior half-century, stocks – in the lingo of investors – were "a screaming buy" in the winter of 2008-2009. But most investors were too fearful to buy stocks at that favorable point. In fact, 15% of all Americans then owning stocks looked at the big collapse, ignored the fabulous valuations, panicked, and sold all their stocks – bailing out right at the extreme lows. Thus, they missed the near-tripling of stocks that subsequently occurred. When emotions derail rationality, the result can be devastating.

So valuation is critical, and the stock market is the sole source of measurement for that. Hence, it's always crucial to know what valuations are and how they compare with long-time norms. In the short run, we can't predict where the market is going – even though we know it will rise in the long term. And we should buy stocks only when their valuations are reasonable – or if we are lucky, they are cheap, as they were five years ago. Buying at high valuations minimizes future gains and often it leads to big losses.

And we must recognize that if we are true investors, to reiterate, we will be buyers of businesses, not stocks. Stocks are just intangible things with fluctuating prices. It's the businesses behind those stocks that are crucial. We must understand the businesses well and appraise them sensibly when we invest. Let the traders fool around with stocks and try to guess their short-term price moves. That may be exciting but generally it doesn't produce good long-term performance – even for the highly touted hedge funds. Despite all their managers' supposed brilliance and great skill, most of these funds have had poor performance in ten of the last eleven years (and so far in 2014) – because they've been trying to do what is virtually impossible.

So don't let the jumpy stock market bug you. Just enjoy the comfort and success of owning pieces of really good businesses. In the long run they'll do well for you.

Having said that, where do stocks stand today? Using the essential measuring device of valuation, they are moderately overpriced – by about 15% – because their current average price/earnings ratio is 16½, versus the long-term norm of 14½. That's not a big differential, but recently common sense has been telling us that at some point the market could experience some sort of setback – because the U.S. and much of the rest of the world are faced with more big, and seeming unsolvable, problems than any of us can ever remember. These include widespread financial weakness (especially in parts of Europe), economies still very sluggish or even declining again in various nations, dysfunctional governments everywhere we look, large government deficits and rapidly rising debt burdens in almost every country, possible deflation, and numerous geopolitical conflicts, including outright wars.

And, lo and behold, an upset did develop just last week when one of the problems started to worsen: The very weak economic and financial condition of Europe. Collectively, it's the world's biggest economy (6% larger than the U.S. and China) and thus it is very important to all nations around the globe. And at the same time, earlier declines in oil prices started to accelerate – reflecting persistent economic weakness in many nations and rising U.S. petroleum output.

These two news items spooked what had been a complacent, really optimistic American stock market – quickly pushing it down 8%, in just a few days. Most of this was due, as usual, to trigger-happy short-term traders. We can't predict the outcome of Europe's current, deep-seated difficulties or future moves of oil prices – or of the other problems I mentioned – but at their current moderately high valuations it seems sensible to be cautious about stocks now.

One more important problem with stocks today, for retirees, is their low current dividend yields. On the S&P 500, current dividends provide an income return of only 1.9% – just about the lowest in history. That's partly the result of companies using more of their profits to re-acquire their shares in order to increase earnings per share on the reduced number of shares they'll have left outstanding. So corporations are paying out a smaller portion of their profits in dividends: now about 30% of their earnings, versus 40-50% prior to the late 1990's.

And at the same time that stock yields are near record lows, bond yields are by far the lowest in history – ranging from well under 3% for the highest quality issues to 4%-plus for issues of lower quality. Past average bond yields have been 5½ -7½% in low-inflation years. Realistically, there's no safe way for people needing good current income to get much of it today in any investment sector. Bonds are the highest-priced they've ever been, thanks to the Federal Reserve's aggressive easy money policy, and their prices will fall sharply if interest rates return to more normal levels, as they certainly will someday. So the best approach now is to carefully seek more income from stocks, which are much less overpriced than bonds. Some good-quality shares of companies with moderate growth trends are reasonable values now, and they have current dividend yields of 3½% or a little more. That's not great but it provides 80% more income than the 1.9% average yield on the S&P 500 stocks as a group.

But while many people struggle today with low investment income, we can all be happy with the superb rebound in stock prices from the awful period of five years ago – a near-tripling as I said earlier – and a quadrupling of stock prices from their highs of 20 years ago. We've really been quite lucky with the stock market up to now.

And actually the current outlook isn't all uncertain and gloomy for American investors. First, we are benefitting from a successful financial rescue and recovery program, carried out by our federal government and the banks. It has been more effective than in any other nation. Second, we've been experiencing a stronger economic recovery, sluggish as it has been, than in most other countries. Third, our development of hydraulic rock-fracturing and horizontal well drilling has greatly boosted U.S. reserves and production of oil and gas (two key commodities in the modern economy). Fourth, our continued success in research and development is providing the innovations that can help create good productivity gains and economic growth. So the U.S. has more strengths than most other nations, as we confront the large problems that will be difficult to overcome.

Finally, to keep your peace of mind, don't get mesmerized by the short-term swings in the stock market, and certainly don't let them worry you. I can assure you that I don't, even though investing is my profession and the sole source of my livelihood. Focus on the companies you own, not their jittery stocks. Good companies, in aggregate, always do well for investors in the long run.

*   *   *

Marble Harbor Investment Counsel, LLC
101 Federal Street, Suite 2505
Boston, MA 02110
617-956-6710
www.MarbleHarborIC.com