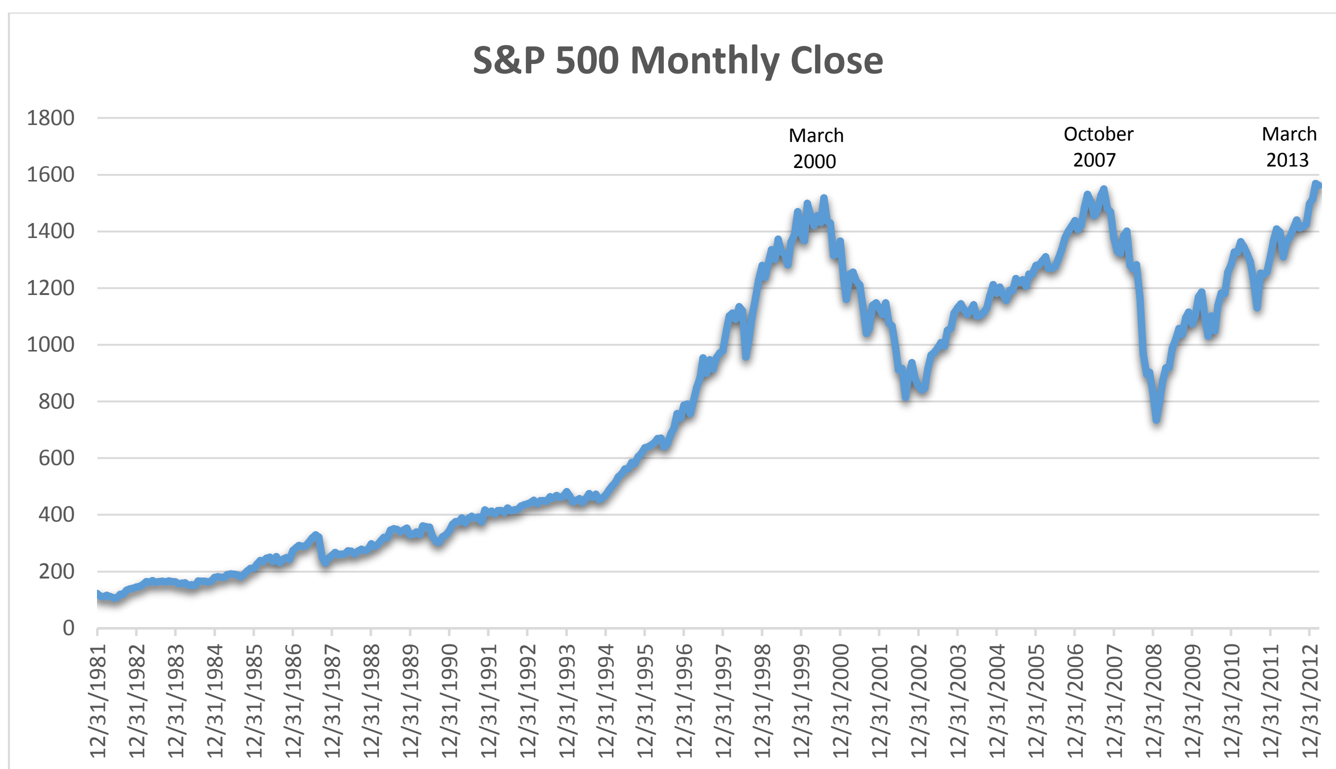
April 17, 2013

> "The essence of investment management is the management of risks, not the management of returns."
>
> Benjamin Graham, *The Intelligent Investor*

Now that the stock market, as measured by the S&P 500, has regained the price level of its two former peaks (March 2000 and October 2007), I think it is fair to say we are at a metaphorical crossroads. Peak Asset Management is definitely not in the short-term prediction business, but when the market does decisively break above this line, it will certainly mark a material change in character. As I have noted in past letters, stocks have historically experienced extended bull market runs (secular bull markets) followed by extended sideways markets (secular bear markets). From the World War II low in 1942, the stock market increased over 1000% to the 1966 high. From 1966 to 1982, its price level moved sideways (with a number of steep price declines and subsequent recoveries along the way). Once it decisively broke above the 1966 to 1982 highs, the market again rose over 1000% percent in the next 18 years to the March 2000 high. Even if history only rhymes, the coming of the next secular bull market definitely piques my interest!!! The obvious question is, "Is the stock market ready?"



Similar to the last 13 years, the sideways period in the stock market from 1966 to1982 was full of global and economic challenges. There was the Cold War and the Vietnam War. There was an oil embargo, stagflation, President Nixon's attempt at wage and price controls, an Iranian Revolution, a hostage crisis and another oil shock. Ronald Reagan defeated incumbent President Jimmy Carter in the 1980 election. He inherited double-digit inflation and a stagnant economy. In his first year in office, he supported and signed the Economic Recovery Tax Act of 1981 (a.k.a., the Kemp-Roth Act), which lowered the individual income tax rate in the top bracket from 70%

to 50% and in the bottom bracket from 14% to 11%.[1] It also lowered the long-term capital gains tax rate from 28% to 20%. On the spending side, he instituted aggressive cuts to non-defense discretionary spending and ramped up defense spending. Simultaneously, the Federal Reserve, led by President Carter's appointee Paul Volcker, took the Federal Funds short-term interest rate up to 19.1% to try to break the back of the inflationary cycle that had developed, and the economy fell into a recession. By 1982 it had deteriorated into the worst recession since the Great Depression (at least the worst prior to our recent 2008-2009 "Great Recession"). Headlines included double-digit unemployment and farm foreclosures -- and out of the mire, a new secular bull market in stocks was born.

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I am now 26 years into my career as an investment advisor. In the first 13 years, the S&P 500 moved up over 500%, from 1987 to early 2000. In the second 13 years, early 2000 to date, the S&P 500 ended up right where it started (though, as the chart above nicely illustrates, sideways does not mean that nothing happened!). During both periods, I have found the Benjamin Graham quote I used to open this letter to be the single greatest investment management principle. It may seem obvious that we can only manage risk and not control returns, but fear and greed are powerful forces (certainly the intrinsic value of corporate America was not as volatile as the S&P 500 was in the last 13 years). Effectively, if you don't manage your risk, you might not earn the returns. Or, as one of my early mentors liked to tell me, "To make money, you have to be in the game." While there are some standard risk management techniques that all investors can employ (such as security selection and asset class diversification), there are also aspects of risk management that will differ widely from person to person. If you have accumulated enough assets to provide financial security for yourself and your family for the rest of your lives, loss of purchasing power through material asset losses or inflation are key risks to manage. If you do not have enough assets to provide financial security for yourself and your family, underinvesting/not saving is a key risk to manage. Similarly, if you are currently living off of your assets now, your risks are different than if you are living on employment income. Financial markets move up and down, and the management of risks allows you to benefit from both.

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I do not know if the stock market is ready to start its next secular bull move. To paraphrase Yogi Berra, it is easier to predict the past than the future. Even though I prefer to take the contrarian side as an investor when I see too much fear or greed, I doubt that I could have envisioned the birth of a ten-fold bull market in stocks in either 1942 or 1982 (maybe I will feel differently in 2022?). Even though I am a glass half-full person, I recognize that it is easier to identify current problems than to accurately foresee their resolution. For example, it is easy to see that our federal government (and many state and local governments) has over-committed benefits to seniors and pensioners, but it is hard to conceive of how our world will change, even in the next decade, with the exponential trajectory of computer technologies and the biosciences. In 1982, could we have comprehended what the internet has become today? I do know the future is coming. And I do know the stock market will make its next 1000% move up when it is ready. In the meantime, there is plenty of life to be lived!

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If you know someone that could use our assistance in the management of investment risks, please let us know. We would be happy to contact them. We appreciate your business.

John McCorvie, CFA

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[1] President Reagan had to partially reverse course on tax policy in response to a rapidly growing budget deficit, starting with the Tax Equity and Fiscal Responsibility Act of 1982 that tightened tax loop holes and rescinded some of the phased in provisions of the Economic Recovery Act of 1981. Under Reagan's two terms, federal tax collections averaged 18.2% of the US Gross Domestic Product (GDP), slightly above the 18.1% average from 1960-2010, and US debt as a percentage of GDP more than doubled. In 2009, federal tax collections as a % of GDP hit the lowest level since 1951 at 15.1% and moved back up to 15.8% of GDP in 2012.