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Voting With Their Feet… At the Worst Time?

On August 21st, the New York Times published an article titled "In Striking Shift, Small Investors Flee Stock Market". The article explains that over the first seven months of 2010, mutual fund investors have withdrawn more than thirty-three billion dollars from domestic equity mutual funds. The chief economist of the Investment Company Institute is quoted in the article saying, "This is very unusual. At this stage in the economic cycle, $10 to $20 billion would normally be flowing into domestic equity funds." However, I disagree with him, this is not unusual.

It's not unusual because, on an aggregate basis, no one has made any money investing in U.S. stocks over the past 10 years! The S&P 500 index peaked at a high of 1552.87 during the day on March 24th, 2000. Since then the stock market has sorely tested the patience of every long-term investor by staging a few substantial rallies that were later followed by more significant declines. Psychologically, the bear market of 2008-09 was so scary that it destroyed any remaining confidence that we might have had in the idea of 'long-term investing'.

In her book On Death and Dying, Elisabeth Kubler-Ross posited that there are five stages through which people progress as they deal with grief and tragedy. Looking back over the past decade, it is quite apparent that equity investors have been transitioning through their own version of these five stages.

The first stage was 'denial'. When the stock markets began to decline in 2000, most of us believed that it was just a short-term correction. We were 'correcting' some of the mistakes caused by the mania of the late 90s.

The second stage was 'anger'. Just when we thought that the correction might be reaching an end, we were brutalized by the events of September 11, 2001. We couldn't hide in denial any more. The world had changed. We were at war with an unknown enemy. Our fear about our safety and our future sapped us of all optimism. The stock market continued its steady decline until late 2002 when the S&P 500 hit a low of 800.

The third stage of grief was 'bargaining'. After a few false starts, the stock market began to rebound in March of 2003. We reduced our unreasonable expectations of high returns; we were willing to earn just reasonable ones. We began to believe that we had survived the worst. Finally by October 2007, the S&P index had risen back to 1576. All was right with the world again.

The fourth stage was 'depression'. Just when we thought that we were out of the woods, we discovered that there were cracks in the economic recovery, that housing prices had risen to unsustainable levels, and that the financial masters at companies like Bear

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Stearns had loaded their balance sheets with illiquid complex assets whose appraised values over-stated their true worth. We became depressed as we watched our financial system collapse under the weight of over-leverage and hubris.

The fifth and final stage is 'acceptance'. Our financial system completely collapsed in 2008 and the stock market followed in late 2008 and early 2009. In early March 2009, the S&P index imploded to 667 - a level not seen since the mid 1990s. Seemingly, all investors now 'accept' that the last ten years have been miserable. These investors now accede that stocks are a losing proposition. Their faith in 'the cult of equities' is now dead.

So, I believe that it's not unusual for small investors to 'flee' the stock market. I am old enough to remember when this happened before in the late 1970s. The stock market peaked in 1968. For the next ten years, we struggled with miserable markets, a moribund economy, a war without end and surging inflation. By 1978, small investors were, indeed, in full flight out of the stock market. The current flight of small investors is not unusual. But it is irrational. As it always is!

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In this past Sunday's New York Times, noted financial author Roger Lowenstein wrote about today's gloomy stock market in an essay titled "Taking Stock". He cites the same statistics showing investors "withdrawing money from U.S. equity funds for the third straight year." And he remembers that in 1979, Business Week magazine proclaimed on its cover, "The Death of Equities". Three years later the stock market began a decade-long rise, and the "cult of equities" was born.

This begs the question, "Where are we today?" Is the stock market trading at a discount to its intrinsic value? One of the simplest ways to value stocks is to calculate their earnings yields. According to Lowenstein, the S&P 500 is currently trading at "only 12 times the expected earnings of the underlying stocks over the next year. Inverting that ratio, stocks have an expected earnings yield of 8.5%." This earnings yield is extremely attractive when compared to current bond yields, exemplified by the 10 year U.S. Treasury note that returns "a dismal 2.58%".

Southeastern Asset Management published their own analysis of the current earnings yield data, in their first half letter to shareholders of the Longleaf Partners Fund. In their analysis, they adjust the earnings yield of the S&P 500 for the 'approximately $100 of cash imbedded in the S&P." The adjustment raises the 'operating earnings yield' to 10.4%. They conclude by writing, "If earnings grow organically from today's depressed levels at only 5% per year (a rate that does not require the reinvestment of earnings because of current excess capacity), and even if the P/E ratios remain below long-term averages, *an investor's five year average annual return will be in the mid-teens* (italics mine)."

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One of the great investment adages is Benjamin Graham's, "In the short term the stock market is a voting machine, in the long term it is a weighing machine". Today's small investors are 'voting' with their feet as they exit the domestic stock markets. This is a normal type of behavior (not unusual) considering the last ten years. As Roger Lowenstein writes, "the ethos of confidence in long-term investing has disappeared."

After ten dismal years, it's normal to be angry and depressed. But don't vote with your feet. The best ten year returns inevitably follow the worst ten year periods. The lousy stock market of 1969 – 1978 produced an annualized return of +3.2% in the S&P 500. The next ten years from 1979 through 1988 generated an annualized return of 16.3%! Now that we have suffered a 10-year annualized negative return of (-1.0%), aren't future returns apt to be quite good? Rather than 'vote' your emotions, shouldn't you 'weigh' the likelihood of significant positive returns from stocks over the next ten years? Or, are you excited about the 2.58% return on a ten-year U.S. Treasury note? Ending his essay with a prophetic warning, Lowenstein writes, "It would be a sad twist if people were to mirror their recent excessive risk-taking with excessive caution now."