

Bear Market Outlook: Is the sky falling or is it time to invest?

By Mark J. Smith, CFP®, CPA/PFS, CIMA®
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Why Stocks Now?

- Many stocks are now trading at less than 8 times earnings and at levels below the cash balances on their balance sheet.

The Wall Street Journal
October, 2008

- Bearish investor sentiment at twice the historical level.

- Money market balances at all-time highs.

- Dividend yield of S&P 500 exceeds the 5-year Treasury yield.

- Warren Buffet stated that he is aggressively buying stocks since they are at the most attractive prices some investors may see in their lifetime.

The New York Times
October, 2008

- Oil prices plummet.

October 2008 will go down in the history books as the most volatile month in the Dow Jones Industrial Average's 112-year history. Shell-shocked investors wonder if they should run for cover or take advantage of buying opportunities. While the latter intuitively makes the most sense, the possibility of losing money and jeopardizing financial well-being makes such a decision very difficult.

The Dow's 40 percent decline since October 2007 makes this bear market particularly painful, since asset classes that can typically stabilize portfolios such as tax-free bonds, tangibles, and global investments, have also fallen. The only asset class that has performed well has been U.S. Treasuries. The fear in the marketplace has promoted a broad-based sell off of virtually everything. Investors are asking, "Should we flee for cover, or is this a once-in-a-lifetime opportunity to buy quality investments at deeply discounted prices?"

Those of you who have known me for any length of time already know what my position is. While I have always been an optimist in the long term, I am nonetheless greatly disappointed in the parties who created and perpetuated our current problems. There is plenty of blame to go around, from Congress, to Wall Street, to sub-prime loan borrowers. Rather than dwell on who caused what, it is more productive to examine the markets' outlook and where we are going.

When I look at today's cheap market valuations (see below), I cannot help but use a personal residence example of how foolishly the magnitude of this sell-off appears. Since most of us are homeowners, and because our home is generally the largest single asset we own, most proclaimed people can relate to my example.

What would you do if economic conditions deteriorated and headlines stated that owning a home was a bad investment? You would think those headlines were preposterous. In the same vein, I would say that any news that said owning a portfolio of high quality stocks was bad is also preposterous.

What would you do if many of your neighbors believed this news and began selling their homes in your neighborhood for any price they could get, even selling their homes at prices 40-50 percent lower than their value the previous year? My guess is you would not sell, and you would think that your neighbors were foolish for selling at such low prices. You would probably view your home as a long-term investment to provide you and your loved ones with shelter for many years to come. Similarly, a high quality portfolio of stocks should be viewed as a long-term investment meant to provide financial shelter and inflation protection for many years to come. Doesn't it seem surprising that so many people want to sell their high quality stocks?

Those of you who attended our Bear Market Seminar or Webinar recently gleaned some interesting facts about the markets. First, a high-quality and broadly diversified portfolio of stocks and bonds has never gone down and stayed down. Even during the 1930s, the decade of the Great Depression, profits were made when investors did not panic and sell out when the markets declined. Next, historically, when dramatic headlines and news about a dire economy and weak markets appeared, those have been excellent times to be a buyer, versus a seller, of stocks. And finally, when the markets do recover, the speed and magnitude of the stock market rally can be so great that any attempt to sit out on the sidelines until the outlook improves could result in missing much of the returns generated. Of course, past performance is no guarantee of future results.

Why Stocks Now?

Famous investors such as Peter Lynch, Sir John Templeton, and Warren Buffet have always said that the best time to buy stocks is when fear is the highest. I believe that five years from now, we will look back at these times as perhaps one of the greatest buying opportunities in our lifetime. To support this position, please look at the following facts:

- As reported by *The Wall Street Journal* in October, 2008, out of 9,194 stocks tracked by Standard & Poor's Compustat Research Service, 3,518 are now trading at less than eight times their earnings over the past year, or at levels less than half the long-term average of stocks! Furthermore, nearly 1 in 10, or 876 stocks, trade below the value of their per-share holdings of cash – an even greater proportion than that found in 1932 (the low point in stocks during the Depression)! As reported by Bloomberg, the S&P 500 is now trading at 12 times the trailing earnings and 10 times forecast earnings. Again, if compared to the historical average of 16, they are trading at close to a 40 percent discount to average valuations.
- Bearish investor sentiment is now at 60 percent and the average is 29 percent. History has shown that when sentiment reaches these levels, the markets are generally poised for a recovery.

- Money market balances are at an all-time high. This is important, because cash on the sidelines can support a major stock market rally once buyers come back into stocks.
- The dividend yield of the Standard & Poor's 500 has surpassed that of the five-year Treasury bond. My research, going back to 1970, shows that this has never happened before.
- In addition to the hundreds of billions of dollars that central bankers are injecting into economies around the world, oil prices have tumbled from over \$140 a barrel to roughly \$70 a barrel. This should greatly reduce energy and food costs in the future, and will provide additional relief to consumers.
- Warren Buffett, named the richest man in the world by *Forbes* magazine in 2008, is buying American stocks for his personal investments (holdings aside from those for Berkshire Hathaway). He says, "If prices keep looking attractive, my non-Berkshire net worth will soon be 100 percent in United States equities." (*The New York Times*, October 17, 2008)
- Warren Buffett also recently argued in *The New York Times* that those investors who hold cash equivalents should not feel comfortable. With a minimal return to begin with, the policies recently imposed by the government will most likely prove inflationary, and further decrease their real value in the long-term. However, the U.S. in the 20th century – experiencing world wars, the Depression, oil shocks and other financial panics – saw the Dow Jones Industrial Average rise from 66 to 11,497. Indeed, I agree with Buffett when he states, "Bad news is an investor's best friend."

In summary, I believe that the sky is not falling and that investors should view these turbulent times as opportunities to buy stocks at valuations we may never again see in our lifetimes. As always, we are here to assist you in addressing your concerns and can also help analyze what opportunities you may want to consider. Please call us for assistance.

Mark J. Smith is a Certified Financial Planner™ practitioner, a Personal Financial Specialist, a Certified Investment Management Analyst, and a Certified Public Accountant. In 2007 he was named one of the top 10 financial advisors in the U.S. by Registered Rep magazine; Barron's named him the top-ranked independent advisor in Colorado and number 22 in the U.S.; and the Winner's Circle, an independent advocacy organization, named him one of the top financial planners in the country. He and his firm have also been recognized by Worth, Financial Planning, Financial Advisor, and Boomer magazine. M. J. Smith and Associates offers fee-based services with a comprehensive financial planning approach which includes income tax planning. For more information call 303-768-0007 or visit www.mj-smith.com. Securities offered through Raymond James Financial Services Inc. Member FINRA/SIPC.