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Speedy recovery will inflate stocks

by Stephen J. Butler

What a bummer. I was hoping the stock market would go up, but not this soon. Having just finished Warren Buffett's 900-page biography "Snowball," the main recurring theme is the extent to which he made most of his money by buying stocks when they were down — in many cases, really down.

Early in his career, this investment strategy was referred to as "picking up cigar butts." Then, we learn the extent to which Buffett managed to fold his tent when stocks in general were overpriced. There have been times when his annual stockholders' letter bemoaned the fact that he saw no values out there. This would have been when the rest of us were basking in the euphoric glow of irrational exuberance.

Growth

Well, "this time it will be different," for me at least. I have kept on investing methodically in stock-oriented mutual funds right through the downturn. I like the fact that the 401(k) deposits I made on Feb. 28th and March 15th, for example, were settling into mutual funds that were reflecting values of General Electric at $6 a share and Citibank at about $1. Citi has since tripled in a few weeks and GE has almost doubled. Stocks like that explain why many 401(k) accounts gained about 20 percent in just two weeks' time.

Hopefully, this isn't the beginning of another great bull market. I want the opportunity to keep buying in at these fabulous prices so I can reduce the average cost of all the mutual fund shares I own. The longer share prices stay down, the more I get to feel like some Warren Buffett clone.

A rule of thumb, if the last five crashes mean anything, is that the first few weeks of a major market updraft are critical. They make up a large part of what has been an average 38 percent increase in the first 12 months following the bottom of a crash. We have just seen what can happen in two weeks' time for those who need a reminder.

Positive future

For many reasons, the rebound this time around could be explosive and substantial. Unlike the '80s when interest rates and inflation were in the double digits, our current situation offers rates at 3-4 percent and inflation is in the negative. We have unemployment figures that are rising, but some of this number reflects a record number of people who are leaving the workforce for retirement. Most companies were overstaffed (especially financial services firms) during the recent fat years. Going forward, companies still in business after this unpleasant economic experience will have undergone much profitable course correcting.

For one thing, their CEOs will probably not be paid as much, and this has the effect of lowering compensation expectations all the way down the management food chain. It may take until 2013 before we actually reach the equivalent of 2007's peak, but what's magic about that number? In 2007, it represented the product of a 10 percent annual average return over a 20-year period, but we may not need that much going forward.

Stocks generally yield about 7 percent more than the rate of inflation, and inflation at an average of 3 percent contributes to that magic 10 percent. If inflation is next to nothing, we only need a 7 percent "risk premium" to meet inflation — adjusted retirement goals. But here's where the Warren Buffett magic comes into play. If stocks (mutual funds) in our 401(k) plan remain at half their 2007 prices for about two years and then slowly start returning to "full price" by 2013, our annual 401(k) deposits will be investing in cheap stocks with a weighted average cost of about two thirds the 2013 recovery price. The difference between two thirds and full price is a 50 percent return.

Meanwhile, our original Sept. 30, 2007, account balance that we all remember so fondly will have returned to its original value — plus five years of reinvested dividends (about 4% per year) that we had completely forgotten about.
If the market snaps back, we'll feel better sooner, but let's be careful about what we wish for. After all, a little foot-dragging on the part of what Buffett calls "Mister Market" would make us a lot richer by the time we really need the money.

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`Valley after the rally' looming?

by Stephen J. Butler

What next? While the stock market may be taking a breather, could another shoe be dropping soon?

Pick your poison — the next round of resetting adjustable-rate mortgages, a credit card default wave, small banks with mortgages on empty commercial property, still-rising unemployment — there's plenty of bad news if you just look hard enough.

Meanwhile, what's so is that every substantial rise in the stock market has been followed by at least some testing of the lows. It's the market saying, "Is this for real?"

Turning to some tea leaves, we can start with a look at history. The "Valley after the Rally," as pointed out by Paul Lim in The New York Times, has seen a lot of variation over the years. A rally after a bear market low always retests the low sooner or later. The market typically declines for awhile as part of a natural digestive process after gorging on a substantial gain. Practically speaking, it can be an exercise of profit-taking by investors who have had enough and who have been waiting to be made at least partially whole before throwing in the towel.

The easy money has already been made over the past eight weeks. Now comes the heavy lifting as the market lurches forward and possibly retests the market low. Regardless of what happens over the "summer doldrums" when a thinly-traded market traditionally slumps, we have history on our side. After any 10-year period when the market ended with a return of less than 5 percent, the following 10-year period saw average returns of anywhere from 7 percent to 13 percent. We are teeing ourselves up for a modicum of success by any historical standards. Money compounding at 10 percent doubles every 7.2 years, if that's any consolation; but even at a modest 7 percent return, your current account balance stands to double in about 10 years.

For crystal ball purposes, the VIX (Volatility Index) and the Baltic Dry Index (don't ask) are two forward indicators that can give us some idea as to how we might fare in the months ahead. The VIX is a measure of the amount of volatility in the options markets and it reflects the level of uncertainty on the part of professional investors. A high VIX (at 80) like we had last fall is usually followed by a decline in stock prices. Today the VIX is around 40. The VIX was at 20 during the rise in 2002.

Apart from the VIX is the Baltic Dry Index. This is the index that reflects the amount of shipping trade in the immediate future around the world. It is a measure of how much raw material is about to be shipped, and this, in turn, offers a glimpse into how much in the way of goods will be produced worldwide --- presumably to be sold at a profit. For what it may be worth, the Baltic Dry Index has quadrupled in value over the past few months. In lock step, Dreyfus Greater China fund has doubled since March 4th. Another 100 percent gain since March has been enjoyed at T. Rowe Price Emerging Markets Stock fund.

We don't need to torture ourselves by wondering why we didn't act more aggressively back in March when the world was going to hell in a hand basket. It takes nerves of steel to consider investing s in a plunging market --- it's like trying to catch a falling knife. However, the more risk we can accept, the greater the rewards will tend to be. Over time, the invisible hand of economic forces produces a "risk premium" that generates higher returns for investors who can live with more volatility. It stands to reason that human nature would behave this way, because otherwise there would be no money ever available for smaller companies or for promising ventures in the world's banana republics.

Considering that some of our retirement money will still be in play when we die, we can take the long-term view for at least some portion of our investments. If the renowned "valley after the rally" becomes a reality over the next few months, some of us might consider it an opportunity to shift a small portion of assets into something more entertaining and dramatic than the usual collection of bonds and blue chip stocks. At the reading of the will someday, our heirs will be amazed at our foresight.

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