THE PSYCHOLOGY OF A BEAR MARKET

“The stock market is a business, not a gamble. Business progresses not in an even, orderly fashion, but by a series of booms and depressions. Depressions pave the way for business revivals, revivals develop into booms, booms breed crises, and crises run into depressions. We have been proceeding in this manner for generations and there is no reason to believe we will ever do otherwise.”

-Jonathan Bell Lovelace
founder of the Investment Company of America

That quote dates back to the late 1920s, back when the term depression referred to depressed spending, sales, revenues, and earnings, rather than the decade of despair that we think of today when we hear that word. Jonathan Lovelace, or JBL as he was often called, was the founding father of The American Funds Group and portfolio manager of their first and still largest fund, the Investment Company of America. He steered the portfolio through the first of the three secular bear markets we’ve had, the unimaginable decline during the Great Depression of 1929-1937 and the “depression within the depression” from 1937 to 1942. In that second leg down, the market dropped 60% from its 1937 peak.

Referring to that difficult time, Jim Fullerton, chairman of the parent company of The American Funds Group, offered some perspective in 1974, which proved to be the middle of the second secular bear market in our nation’s history. He said, “Courage! We have been here before. Bear markets have lasted this long before. Well managed mutual funds have gone down this much before. And shareholders in those funds have survived and prospered.” He went on to explain that each economic, financial, and market crisis is unique but they all share the commonality of apparently insolvable problems and reason for pessimism about the future for many investors. It was his belief that a return to reality had always occurred allowing for two facts to hold true. One, despite the gloomy outlook, solid U.S. corporations would survive, and two, those companies were indeed more valuable than their stock prices indicated at the time.

This is where we find ourselves today, in the midst of the third secular bear market which many economists believe began back in 2000. Fear is at an all-time high, the problems of the hour seem insurmountable or the costs of the potential solutions seem catastrophic (or both), and the general feeling is that we are witnessing the end of the free market, or capitalism, or the ability to invest and earn money in the capital markets. Don’t give in to what psychologists call the illusion of terminal uniqueness. When events overtake us, we tend to suffer from this mental phenomenon that renders us unable to put events into historical context, or to even remember history itself.

In the late 1970s inflation was rising, incomes were declining, an Iranian revolution led to gas prices skyrocketing, and government price controls produced lines at the pump. Organized labor led hundreds of work stoppages involving more than one million workers, and in 1980 the misery index – the sum of inflation and unemployment – was over 20 percent.¹ BusinessWeek magazine ran their famous (now infamous) cover that decried “The Death of Equities” and poverty rates were increasing. By the early 1980s, gold was at $850 per ounce² (about $2,000 in today’s dollars,) the 30-year Treasury was

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yielding over 15%, and unemployment was just under 11%. Most of us do not remember how the economic crisis was solved, but the important fact is that it was solved. Just as I believe today’s problems will be. Terminal uniqueness – don’t fall into the trap of thinking this time is different.

I heard the late Sir John Templeton speak early in my career. John Templeton was not only a very successful investor, but also the founder of the Templeton Fund family, and widely regarded as the father of international investing. He frequently said that you want to buy at the point of maximum pessimism, and one of his most famous quotes is “The four most dangerous words in investing are ‘this time it’s different.’” My ardent belief is that no one can consistently time the market, so the only way to capture the full long-term return of the stock market is to be willing to ride out the full temporary declines, no matter how steep they may be. If you allow the prevailing wisdom of the hour from the teleprompter-readers on TV to cause you to lose faith in the corporations you own and liquidate them, you cannot, by definition, capture the returns you see most often advertised to you on that same TV.

In order to stay the course, it often becomes necessary to remind ourselves of the difference between security prices and intrinsic business values. Security prices reflect what a buyer is willing to pay for a given business today, and often those prices are way too high because of unfounded optimism by ill-informed investors. Somewhat less frequently, those prices are far too low, driven there by an equally ill-informed panic on the part of the investing public. In the dot-com bubble, people were willing to pay stratospheric prices for companies that had no actual earnings. Today, we are in such a time of fear that indiscriminate selling has driven down prices of companies that have strong balance sheets, and have annual profits in hundreds of millions (if not billions) of dollars. The question to continually ask yourself is, does the fact that share prices have dropped dramatically mean that those businesses have become permanently less valuable? A business’s true value is the sum of all future cash flows. One or two year’s earnings represent only a small portion of a corporation’s cumulative earnings power and, in many cases, the large declines in today’s security price changes do not accurately reflect the small changes in long-term earnings power of well-run corporations. There are certainly some instances where the long term earnings power has been significantly impaired – the banks and automakers come to mind – but to assign that level of decline in security price across all manner of companies in every sector of the economy may well prove to be a huge opportunity for those who add to their portfolios at this time, or at least that stay the course.

In the next edition of the newsletter, we will further discuss the previous secular bear markets and investment opportunities during them, as well as the much talked about “lost decade” in Japan. The assumption that investors could not have made money in these periods of “flat markets” is just as incorrect as the idea of terminal uniqueness will prove to be.....

Sources:
3. Bloomberg