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History is but a lantern to our stern

Learning from past experiences will help investors navigate the U.S. economy's choppy waters

"If men could learn from history, what lessons it might teach us! But passion and party blind our eyes, and the light which experience gives is a lantern on the stern, which shines only on the waves behind us!"
– **Samuel Taylor Coleridge**

SUMMING IT UP

William Rutherford

As we pick our way through the detritus of the last few years, it is very tempting to look at history for explanations. Just a few months ago, after the collapse of Lehman Brothers, it appeared that we were on the verge of another Great Depression. Much was said, and much was written that the end was near. And yet, it did not occur. It does appear that we are experiencing the "Great Recession," one larger than any we have experienced before.

The prologue to this debacle is well known. The Federal Reserve, led by ex-chairman Alan Greenspan, traded one bubble, dot.coms (which burst), for another, housing. We found ourselves in an inflated cycle of borrowing that elevated asset prices but was unsustainable. The collapse has been far more devastating than perhaps anyone thought, because no one in government or business was aware of how much leverage was in play. Now we are going through the "Great Unwinding" in which the leverage is being unwound and asset prices are dropping. As good as it felt on the way up, the way down has been relatively more painful. Unfortunately, the process is not over, and lives and fortunes have changed in ways that we may not even yet understand. To be sure, much has changed, and much of that change has been permanent.

No longer do people look at their assets, 401(k)s and home prices, and feel secure about their retirement, savings for their children's college education and their own consumer habits. No longer do we discuss the great generational wealth transfer that is about to occur, because now baby boomers are worried about supporting their parents.

The U.S. government, in an effort to cushion the fall, has gone on a massive borrowing and spending spree that will almost certainly have implications for the future. Not only has the U.S. debt risen to levels never before imagined, but also other nations, which have supported our debt in the past, have raised questions about the value of our debt and our currency. Our Federal Reserve has devoted its attention to economic stimulus, debt unwinding and deflation, but in the next few years it may face inflation. Will we simply inflate our way out of our debt, or devalue or currency? If so, what are the implications for future generations, the U.S. government, and particularly our investment portfolios?

As legendary investor Shelby Davis once said, 'You make most of your money in bear markets; you just don't realize it at the time.'

By now, you may know that my mantra is diversification. This means not only diversifying among asset classes, such as equities, fixed income, real estate, international investments and others, but diversifying within asset classes. The reason for diversifying investments is to decrease the probability of large losses and increase the opportunity for gain.

History may be only a lantern to our stern, but it is also a prologue from which we can observe and maybe even learn. For instance, after every 10-year period where the market gain was less than 5 percent, the returns for the next 10 years averaged 13 percent, with a range of about 7 to 17 percent. However, those numbers won't show up for 10 years, so patience is required. As legendary investor Shelby Davis once said, "You make most of your money in bear markets; you just don't realize it at the time." Warren Buffett has made similar comments.

Why should one think that money can be made now, especially after the big run-up? Just as markets have suffered big falls after high valuations, they have had big gains following low valuations.

There is a great deal of money on the sidelines. The value of money market funds exceeded stock funds earlier this month for the first time in 16 years. In the summer of 2007, by comparison, the value of stock fund holdings was more than three times that of money market funds.

Private sector cash holdings, a combination of U.S. household and nonfinancial companies, recently reached 70 percent of U.S. gross domestic product, a postwar high according to Wells Capital Management. As this money flows back into the market, it should raise market valuations.

Equities are a call on the growth of the U.S. economy. If you believe the U.S. economy will grow over time, then you should be an investor, especially when the prices of solid U.S. companies' are down. Of course, prices can go lower, and have, but will they stay there? It's unlikely.

In the Great Depression, the market crashed in October 1929, and did not recover its highs for 25 years. But if you had invested $10,000 in January 1929 and invested $10,000 for the next 25

Continued on next page

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Continued from previous page

years, or a total of $260,000 when the market regained its 1929 highs, 25 years later, you would have had $1.2 million.

On the other hand, if you missed the best 30 up days for the market in the last 20 years, your returns were zero. This self-inflicted investor behavior penalty is more damaging than either market or manager behavior.

Review your objectives with your investment professional. Get your asset allocation right because 90 percent of your returns will be decided there. Diversify. If you are uncertain what to do, try averaging as in the 1929 example. Invest carefully and patiently. In time, you should be rewarded.

William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the leading separate account managers in the country and recipient of a four-star rating from Morningstar. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com.