

## KFS November Update

Good Afternoon. I hope everyone enjoyed their Thanksgiving holiday and had an opportunity to spend some time with family and friends. Even during this difficult period, we all have a lot to be thankful for. I hope everyone took at least a few minutes to reflect on how lucky we all are to be Americans.

### Revisiting Our Mid-Quarter Update

A few weeks ago, I sent out our mid-quarter update which I summed up with a few sentences and five general thoughts. I wrote:

This has been a very tough few months. That said we believe the worst is over. Hang in there - you will eventually be rewarded for your patience. Let me reiterate our message:

1. We believe the worst is behind us. It occurred five weeks ago. Be patient.
2. There is plenty of cash on the sidelines. As the volatility levels decrease, cash will pour in.
3. Dips are followed by bounce-backs - most of which happen in the first two calendar years.
4. Diversification reduces risk...and in the past...has increased returns significantly.
5. We believe this is a stock pickers market...and we believe we have the best stock pickers.

I would like to clarify a few thoughts. First, I should have said, “we believe the worst **volatility** is over.” I don’t want anyone to think we were calling a **bottom** in the market. We were not. As you know, picking market bottoms is impossible and when “fear” is rampant... anything is possible in the short run. My only point was that the biggest drop in the market occurred five weeks previously. Second, last week stock market volatility dropped 24% as measured by the VIX (a volatility index). We noted that this was an important indicator which is watched closely by institutional investors. I want to note, this does not mean volatility is gone. Finally, as stock market investors we advocate being focused on the long run and using short term dips as opportunities. A few weeks ago, I provided some compelling evidence regarding the size and scope of stock market

bounce-backs after large significant dips. This week, Dr. Scott delves into bounce-backs even deeper. As long-term investors I think you'll all enjoy what he has to say.

#### **IRRATIONAL PESSIMISM? BY DR. SCOTT BELOW**

Desperate times call for desperate measures...or so the saying goes. But does this also apply to investing? The answer probably depends on how you define "desperate measures." Investors are a lot like snowflakes – each unique, with no two looking at things exactly the same way. Consequently, what seems desperate to one investor might simply be cautious or judicious to another. But in spite of wide-ranging opinions on the definition of desperate measures, you would be hard pressed to find anyone who disagrees that these are difficult times and that the economy and the stock market are both experiencing volatility that is unlike anything anyone has seen before. This makes things a little unsettling for even the most seasoned investor – and has put many less-seasoned investors into outright panic mode. This is extremely unfortunate, because the course of action an investor selects at times like this will likely define their success (or lack thereof) for decades to come.

#### **Uncertainty is Part of Investing**

Before we go further, it's important to stress that in investing, just as in life, there are few absolutes and no guarantees. And as in life, in investing the best way to deal with uncertainty is to gather all the relevant information you can, evaluate that information carefully and objectively, and then make intelligent, informed decisions based on facts rather than on feelings. Knowledge really is power, but many people are inclined to make impulsive decisions before gathering all the relevant facts. In investing, just as in life, impulsive decisions often turn out badly.

#### **Volatility, Emotions and Overreactions**

Academics and practitioners have studied stock market behavior for decades, and if there is one thing we know with certainty it is that the stock market overreacts ... in both directions! In other words, when things are going well investors tend to

extrapolate the good times out into the future. This causes people to take risks they ordinarily wouldn't take and can lead to short term bubbles. When things are going poorly, however, the opposite occurs. In bear markets like the one we're in today, investors tend to extrapolate the poor performance of the recent past out into the future, causing them to sell stocks in droves and put money in "safe havens" such as Treasury bills. Perhaps not surprisingly, we set an all-time record for mutual fund cash outflows in October and November looks likely to surpass it. Investors tend to get scared when the market behaves wildly and many eventually convince themselves all hope is lost. At that point, fear and concern turns to panic and they can't get out of stocks quickly enough, no matter the damage. This is emotional decision-making at its worst – and most destructive – and it happens to some degree every time we have a significant decline in the stock market. Because this decline has been so dramatic, panic-driven selling has reached (or perhaps even exceeded) levels we haven't seen since the 1930s.

### **We understand...People are Scared**

It's important to note that we understand why so many investors are so scared at this point. When you combine a 24/7 media with the difficulties we're facing in the credit markets, real estate, and the economy, it's no surprise stock market volatility has risen to levels we've never seen before. To illustrate how volatile it's been, I went back to the inception of the S&P 500 index in 1950 and counted the total number of trading days where the index fell by more than 5% for the day. I found 21 such occurrences over the nearly 59-year period (or more than 14,800 trading days overall). Remarkably, I also found that 10 of these 21 trading days occurred over just the past two months! This unmistakably indicates something unusual is going on, but to find just how unusual I needed to go back further in history. Since data on the S&P 500 index didn't begin until 1950, I turned to an academic research database called the Chicago Research in Securities Prices (CRSP) database, which goes all the way back to 1926. Using this, I again looked at the number of single-day declines in excess of 5% in the overall stock

market. The results appear in the table below (years with no declines over 5% are omitted) and show some interesting patterns.

Year	Number of Days < -5%
1929	7
1930	1
1931	2
1932	7
1933	5
1934	1
1937	4
1938	2
1940	3
1946	2
1950	1
1955	1
1962	1
1987	2
1988	1
1989	1
1997	1
1998	1
2000	1
2001	1
<b>2008</b>	<b>10</b>

As you can see, the only other period where we've seen more than two 5%+ down days in a single year was during the Great Depression, which ran from 1929-1940. But even then there were just seven such days in 1929 and seven in 1932. In other words, the highest number of 5%+ down days found in a single year during the Great Depression was seven...compared to the ten we've seen in a period of just two months this year! The undeniable conclusion is pretty clear – no one has seen volatility of the sort we've experienced thus far in 2008, making this a year for the history books. Unfortunately, it isn't exactly the type of history we want to make, and this obviously has investors very unsettled.

### **What's Driving This Volatility?**

Since we've never seen volatility of this magnitude before, even during the most difficult of economic times in the 1930s, it is clear something unusual and unique to this time period is driving it. The most logical culprit is hedge funds, although it may be a year or more before we have access to the data we need to know for sure. Even so, in October, investors pulled a record amount of money out of hedge funds and hedge fund managers, many of them holding highly leveraged portfolios, have been selling at a frantic pace in order to meet the redemptions. Hedge funds are a relatively new invention, of course, and were not around during earlier bear markets, which may help explain why this bear market is seeing such wild intraday swings in the stock indexes. Another probable cause of increased volatility is the 24/7 access to financial news via cable TV and the internet. Never before have investors been able to access so much news so quickly, and never before have so many different news outlets been competing so relentlessly for a finite amount of advertising dollars. Remember, sensationalism sells and investors are emotional beings – put the two together and, well, you get the picture...

### **A Longer Term Perspective**

Now that we've documented that this is indeed an unusual period in history, the logical next thing to investigate is the performance of stock investments following difficult periods in the past. In October of this year the S&P 500 index was down 16.8%, and through November 20 the index was down 22.3% for the month. This made me wonder what happened the last time we saw back-to-back months with double-digit declines in the overall market (little did I realize I would need to go all the way back to April/May 1932 to find the last back-to-back double-digit monthly declines). What I wanted to find out was how investors who maintained their long-term focus and stayed in the market back then had fared. What I discovered is encouraging. In the twelve months following April/May 1932, the overall market rose a whopping 125%, and in the five years following that period the market rose more than 358%! **The lesson is that even during Great Depression, investors who maintained a long-term focus were rewarded!**

### More Evidence

Even though much of the recent decline happened over a three week period in September and October, it should be noted that the overall stock market has been drifting downward since October 2007. In fact, through the end of November the S&P 500 index had fallen 39.49% from its level just twelve months earlier. Fortunately, declines of this magnitude are rare, with just 20 twelve-month periods since 1926 where the overall market declined by more than 35%. Having just come through one such period, it is only natural to wonder how the market performed following the other 19 periods. The results displayed in the table below are both instructive and quite encouraging.

<b>Market Performance Following a 35%+ Drop over a Twelve Month Period</b>		
	Over the Following 12 Months	Over the Following 60 Months
Average Annual Return	14.45%	18.76%
Best Average Return	157.02%	35.63%
Worst Average Return	-60.71%	-3.05%

### Short Term Returns

The results indicate that in the one-year period following a 35%+ twelve-month decline, the overall market averaged a return of 14.45%. The best one-year period following a big drop saw the market gain 157.02%, while in the worst twelve months it lost 60.71%. This suggests that during the year following a large drop in the market there can still be significant volatility and the market can remain unsettled. That said the average result has obviously been very good. Things get even better when we analyze the five-years (60 months) subsequent to a large drop in the overall market.

### Long Run Returns

The average annual return over the 60 months following a major decline was a very impressive **18.76% annually!** Over five years, the cumulative average return is 236%! In fact, even during the height of the Great Depression there was just one 60-month period (October 1930 through September 1935 for those who are curious) following a 35%+ drop where an investor would have lost money (and just 3.05% annually at that). The best subsequent 60-months following a major drop saw an average annual return of 35.63%, which ranks as the single best 60-month period in history! Once again, the evidence shows that large dips are typically followed by large and sometimes even stunning bounce-backs. Furthermore, the evidence indicates there is much less downside risk (looking forward) for those who remain committed to the long run.

### **Why do we keep preaching a Long Term Perspective?**

This analysis should make it pretty clear why we advocate maintaining a long-term focus even after major market declines. The evidence that strong bounce-backs occur in the periods following steep sell-offs is overwhelming and it's clear that the investors sitting on the sidelines during these periods tend to miss out on some of the biggest returns in history. In other words, reacting to feelings rather than facts can be very costly. As we've long emphasized, investment decisions not based on evidence are ones that should never be made.

So going back to our original question, do these desperate times call for desperate measures? If by desperate measures you mean sitting tight, rebalancing your portfolio, maintaining rational perspective and then waiting for the inevitable bounce-back...then yes, absolutely!

### **A Final Note**

We hope you enjoyed this update. As always, we appreciate your comments, questions and feedback. As we go forward, we remain committed to continuing to refine and improve our proactive investment strategies. As always, our goal is to provide each of our clients with the best possible mix of assets given their particular situation. If you need anything or your goals or time horizons have changed, please do not hesitate to

call or drop an e-mail to set up an appointment. We are here to serve your financial needs, whatever they may be. We thank you for your comments, your kind referrals and your feedback regarding our updates.

**- Joe and the Gang at KFS**