TAKE THE LONG VIEW

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The article began on an ominous note "...Observers are sounding warnings of overvaluations. Let's get out now and call it a year...."

Sound familiar? Actually, the article was published in the Investors Business Daily on August 3, 1995. It went on to describe a prevailing view at the time that the rise enjoyed by the stock market couldn't possibly persist. Valuations were far too high, the thinking went. A judicious program to protect one's gains was a common advisory. To his credit, the author counseled investors not to be swayed by near term concerns, and to take the long view.

It was sound advice then, and it is sound advice now. No one can predict the future, and emotional reactions to dire headlines are always a recipe for failure. Had one acted upon the advice proffered at the time of the article, he or she would have missed out on the ensuing 688% rise of 1996-2000.

For the investor the current times are charged with tension. The Federal Reserve Board has raised interest rates six times since last summer, most recently by one half of one percent. Furthermore, the statement accompanying its latest aggressive action contained thinly veiled threats of more increases ahead if economic growth does not moderate. The result was that most economists, taking their cue from the Fed, predicted further increases in rates. The prospect of rising interest rates is always unsettling to the stock market.

That initial reaction seems to have moderated. Recent economic data indicate that a gradual descent to a slower rate of growth is likely. As a consequence, fears of an even more assertive Fed have been pared back, at least temporarily. Rather than calming the markets however, the change in expectations has raised a different set of worries. Corporate earnings, not interest rates, now command attention and raise new concerns. Fears of negative earnings trends have caused extraordinary declines in some stocks, and heightened volatility in the market overall. Valuations are called into question in the present skeptical mood. The prevalent view now is that the stock market has limited upside potential until some additional light is shed on the trend of corporate earnings.

It is interesting to talk about but the truth is that no one can predict the short-term course of the stock market. Predictions of the direction of the stock market should never be taken seriously. To be continuously successful over a long period, an investor must have a strong anchor; a powerful conviction that transcends day to day news. Being dragged along by every changing tide is a recipe for endless frustration and failure. We believe that an investor needs to have some core principles to obtain the courage to stay the course when outside voices are yielding to panic. History has shown that good profit gains eventually generate solid stock market performance, and that above average returns come from patient investing. To base one's investment decisions on anything other than a conviction that this will continue, is to be rudderless in a raging sea.

True long-term investors understand that the stock market is subject to frequent corrections. Some prove to be lightning fast and nothing more than potholes. Others, like in 1973-74, are quite extended. Their common characteristics are that they are inevitable and unpredictable. They are also a major cause of procrastination, but there are other reasons. The market is too high, interest rates are going up, the trade deficit is rising. And what will happen to the market if foreign investors pull out their dollars?

Our intention is not to make light of investors' fears. There will always be worries. The market is, after all, an imperfect measurement of value, (especially in the short term.) Many of the problems deserve study and consideration so that one can be reasonably prepared for the future. In our view, to delay making a sound investment because of near term concerns however, or to sell sound holdings, may be momentarily pleasing but usually very wrong. Rather, such periods can be viewed as opportunities to add quality stocks at attractive prices. History supports this. In spite of corrections along the way, some of which were extended like in 1973-74, the U.S. stock market has risen three out of four years during the last century. Also, to date, following every one of the major declines in the last fifty years including the 1973-74 episode, the stock market regained its previous peak in an average of 13 months and went on to new highs.

The major and permanent loss of value in stock market investing is never caused by buying and holding quality individual stocks. It is caused by other factors. The much-publicized demise of some prominent hedge funds recently was not caused by declines in stocks, nor even by their missing the technology craze. The declines were caused by excessive dependence on debt as interest rates rose. The debacle in the dot com stocks during May of this year was caused by day traders, all playing the same thinly traded, unseasoned, over the counter stocks. The famous decline of October, 1987, the first time the stock market declined over 500 points in one day, was certainly exacerbated by widespread use of an esoteric device called portfolio insurance. Sold to sophisticated institutions, the product called for programmed sales of stocks as the market declined. It was statistically proven as a method to protect gains. The problem was that no one involved figured out that, in its execution, it was akin to pouring fuel on a fire. In these instances and several others, failed speculative strategies have been the cause of serious and permanent loss of value.

The great debate in the financial markets today is the divergent opinion about inflation. There is some evidence that supports those who believe that years of high growth at relatively full employment levels will cause a renewed bout of inflation. Others believe with equal passion that our domestic economy has achieved a higher threshold of non-inflationary growth due to the enormous gains in productivity in recent years. It is not our purpose to debate the issue here. The greatest risk all investors face is not the inevitable occasional correction in a long-term growth trend. It is inflation, which erodes the purchasing power of one's hard earned savings. It is easy to see why this is true. At an inflation rate of 6% a year prices double every 12 years. At 4% a year inflation doubles every 18 years, and at 2% the figure becomes 36 years. The only effective way to protect oneself against erosion is to own assets that appreciate in value. Bonds, however safe, offer little protection against inflation because ultimately their value and income stream are fixed. Stocks of successful companies whose earnings continue to grow over time are the most effective way to achieve asset protection and enhancement of earning power.

As prudent persons, all investors must be concerned about their and their family's well being and security. A sense of caution and inquisitiveness is healthy. The shorter one's investment horizon however, the more one is prone to unwise decisions. Investors should begin with an understanding of their financial situation and goals. In our view, once these are addressed, a person should form an investment strategy and stick with it, regardless of short-term moves. Doomsayers, no matter their pedigree, should be politely ignored. Our strongly held view is that persistence and discipline, and a long horizon, are virtues in the investment field, and the surest way to substantial wealth accumulation.

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