Waterstone Advisors, LLC
10 Brook Street
Walpole, MA 02081
vha@waterstoneadvisorsllc.com
www.waterstoneadvisorsllc.com

April 3, 2020

Imagining the Possibilities

Keeping A Long-term Perspective in a Turbulent Market

In the midst of a global pandemic, the health and safety of our loved ones, our friends, our neighbors, and ourselves is the priority - everything else pales by comparison, and it should.

As we suddenly find ourselves in uncertain times, it is only natural that our financial wellbeing is also on our minds. So, it makes sense to consider what we know and what we believe to be true about long-term investing. It makes sense to return to our foundational principles and to re-anchor ourselves during a difficult storm.

As in the past, once again I share with you the investing principles that I apply in managing your portfolios. They are straightforward and constant:

- Invest in well-run companies whose products and services have enduring value
- Invest for the long-term and be patient
- Focus on corporate earnings trends as secular drivers of share prices
- Seek dividend-paying stocks to enhance income and returns
- Pay attention to valuations, both high and low, and
- Minimize the risk of loss whenever possible.

Principles are fundamental truths or propositions that serve as guides to successful outcomes. In a volatile environment, they can help us to focus on what we know, and what we can reasonably count on to see us through the volatility.

In that spirit, I offer you a short exercise of the imagination, which I hope will serve to underscore the possibilities that lie beyond the current turbulence.

A Mental Exercise in Perspective

Imagine for a moment a world in which people are hungry, but refuse to eat. Imagine a world in which people are cold, but refuse to be warmed. Imagine a world in which people are ill, but refuse to be cured. Imagine a world in which people are bored, but refuse to be entertained. Imag-

ine a world in which people are uneducated, but refuse to learn. Imagine all human needs taken together, and imagine all things that we have collectively created in our businesses and companies over the years, and then imagine that no one would ever want to use those products and services to sustain and improve the quality of their lives.

As impossible as all of this sounds, this is exactly the message that worried investors have sent to us recently through the stock market with their dramatic fear-induced selling of stocks. As irrational as it may seem, investor behavior of-late has been premised on the highly unlikely notion that no one will ever eat at a restaurant again, no one will ever use energy again, no one will ever buy medicines again, no one will ever take a pleasure cruise again, no one will ever want to be educated again, and so on.

Indeed, we are witnessing the opposite of "irrational exuberance", the phrase famously coined by Alan Greenspan in 1996 during the Dot-Com bubble. Instead we are experiencing "mindless mayhem", a phenomenon in which people fall prey to the belief that humankind, with all our needs, will never again want to purchase the products and services our companies provide. I am sure you would agree that this makes no sense.

Let's apply a bit of perspective then.

One hundred years of rising living standards in the United States have left us better off materially than we have ever been before. If asked, most of us would agree that we would prefer to benefit from those higher standards than not. Aside from the pandemic itself, the stock market selloff is less an occasion for fear and more an opportunity for long-term bargain hunting as the companies that provide us with goods and services eventually rebound with a return in consumer demand.

Make no mistake, we are indeed in unprecedented times. Never in the history of the United States have we had virtually the entire country shut down for business, or be required to "self-isolate" to keep a virus from spreading. Fear is to be expected. Uncertainty is normal. Yet, looking beyond the pandemic, it is vital that we continue to invest as opportunities arise, and to stay on plan.

On several occasions I have quoted Warren Buffett's wonderful perspective on the stock market's long-term prospects. I offer it to you once more because it is helpful and because it is true. Buffett said *"In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497."* Some of this sounds very familiar today and is always great perspective.

When the pandemic is all said and done, broader consumer and business demand will return. Our economy will respond as it always has in the past, resiliently and dynamically with products and services that enhance our standard of living.

Why the Stock Market Fell Recently, and Why It May Fall Further in the Short-Term

As children, we have all taken a rubber band and pulled it taut to see how far it can stretch before snapping back. Sometimes the rapid snap-back would sting our fingers. After repeated trials, most of us eventually understood that stretching a rubber band wasn't such a good idea after all – it could hurt. An over-stretched rubber band can snap back fiercely.

It is the same with the stock market. An overstretched stock market where valuations and prices are far above their "resting" state, their long-term averages, could snap back easily and cause financial pain.

The trigger for the snap-back in the stock market is not the overvaluation itself, but rather a negative event that shatters investors' overly optimistic views of companies and economic conditions. Just as water seeks its own level, unrealistic investor expectations get easily washed away by waves of fear in overvalued markets until some balance is found. Fear of the unknown and fear that the global economy will collapse have taken center stage. In the current case, the trigger is the novel coronavirus/Covid-19 pandemic. Until we see statistics that point to the pandemic's mitigation and we see a return of the economy to some normalcy, we are likely to witness further volatility in the stock market, mostly to the downside.

At the corporate level, public companies will be reporting their March 2020 quarter results over the coming days and weeks. During that time we are likely to hear that the pandemic has had a significant effect on corporate sales, supply chains, consumer demand, consumer sentiment, and earnings. CEOs may suspend financial guidance for the months ahead since the trajectory of the pandemic is completely unknown. This virus is, after all, "novel". The uncertainty will not sit well with Wall Street analysts who are likely to downgrade their ratings of companies or to suspend their ratings completely until they have further clarity. The general sense of uncertainty will feed into investors' sense of worry and lead to further stock market declines in the near-term. This is the scenario I envision, although other scenarios are certainly possible too.

Are We Now in a Bear Market? Is the 2009 Bull Market Finally Over?

Any neurologist or psychiatrist knows that "being paranoid" is not necessarily the same thing as being diagnosed with "paranoia". One is a term used in the vernacular to denote a feeling of suspicion, uncertainty, or fear, while the other is a legitimate medical diagnosis made by a qualified physician about a real mental condition. There is a significant and meaningful distinction which has become diluted as the term has become part of the popular lexicon.

This same kind of distinction applies to the term "bear market", which is often used incorrectly by over-anxious investors or media commentators to describe a 20% or greater decline in the value of stocks. Not only is this definition not correct from a technical standpoint, it does little to help guide investors as they seek to understand where they should invest their money longer term. It leads to confusion.

My own definition of a bear market is a bit different from the one that is commonly used, and may be more helpful for longer-term asset allocation. Asset allocation is the conscious act of de-

ciding where to invest money and for how long. From the perspective of long-term investing, I view bear markets as being multi-year pauses in the stock market's secular advance to newer highs. If *bull* markets typically last years, as most people would agree they do, then their opposite, *bear* markets, should be proportional and should also be measured in years rather than days, weeks, or months.

My definition is perhaps best exemplified by the chart on page 6. I have hand labeled the bear markets as being those from 2000 and 2009, the entire period from 1966 to 1982, and the period from 1929 to 1932. Granted, these examples would make bear markets relatively rare events, but at the same time they would help us to know when our money might be put to more productive use somewhere other than stocks.

By branding every 20% or greater downturn in stocks a bear market and stirring up panic, a disservice is done to investors. Such hasty labeling incites investors to sell now, only to have to make difficult decisions on "when" and "what" to buy in the future when prospects presumably look rosier. Perhaps this is partly why Dalbar, a Boston-based research firm, has determined that the average do-it-yourself (DIY) equity mutual fund investor has managed to eke out a return of only about 4% over the 30 year period to 2016 compared to 10% on average for the S&P 500 in that same period. DIY investors have a tendency to buy high and to sell low as they shift between greed and fear, rather than leaving their portfolios to benefit from compounding over long periods of time.

Back to the question at hand: Are we now at the start of a bear market?

The answer is, we may very well be at the start of a bear market – but, at this stage we are just as likely to be in the same stock market correction that started early in 2018 with the onset of the tariff wars. The broad investment picture has deteriorated in the last few weeks, for sure, as businesses and consumers have dramatically slowed or stopped their activities due to the pandemic. Unemployment claims have skyrocketed and the threat of an economic recession has become more real. While a deep recession is very likely in 2020, we do not know how long it would last. A short recession could translate into a stock market correction, while a longer recession could produce a bear market.

My own opinion for now is that we are likely to see a short, but deep recession, and a corresponding stock market correction. My basis for thinking this is that both the stock market and the real economy are being supported by the Federal Reserve's recently announced "unlimited" asset buying program, and the federal government's newly introduced and unprecedented $2 trillion economic stimulus package. Both programs would effectively inject cash into the economy, potentially enabling businesses and individuals to ride out at least part of the pandemic's financial turbulence.

Since the stock market is a leading indicator of the economy's health, typically leading it by six to twelve months, we could see a rebound in share prices before we see a rebound in the real economy, especially if news of the pandemic begins to improve.

In the Long-Run the Stock Market is Skewed in Favor of the Bulls

Over the past hundred years or so stocks have been a good place to invest compared to other asset classes such as bonds, real estate, and precious metals. During very short periods of time, such as one- or two-year rolling periods, stocks tend to be volatile and hence to lose money for their owners. Over longer rolling periods such as 5, 10 or 20 years, stocks tend to be profitable and to perform better than most other investments. On average, *after inflation* and over time, stocks return about 7% per year to their owners. By comparison bonds return about 4%, real estate returns about 2%, and gold returns a mere 0.7%. The chart on page 7 illustrates most of these relationships.

A final note: In the long run, the stock market is skewed in favor of the bulls, not the bears. Since 1932 the average bear market, using the popular "20%+" definition, has lasted about 18 months, while the average bull market has lasted over 60 months. Those are encouraging odds as we consider a more certain economic future where consumer demand is re-energized and where companies stand at the ready to produce, to sell, and to serve as they have through decades of ups and downs.

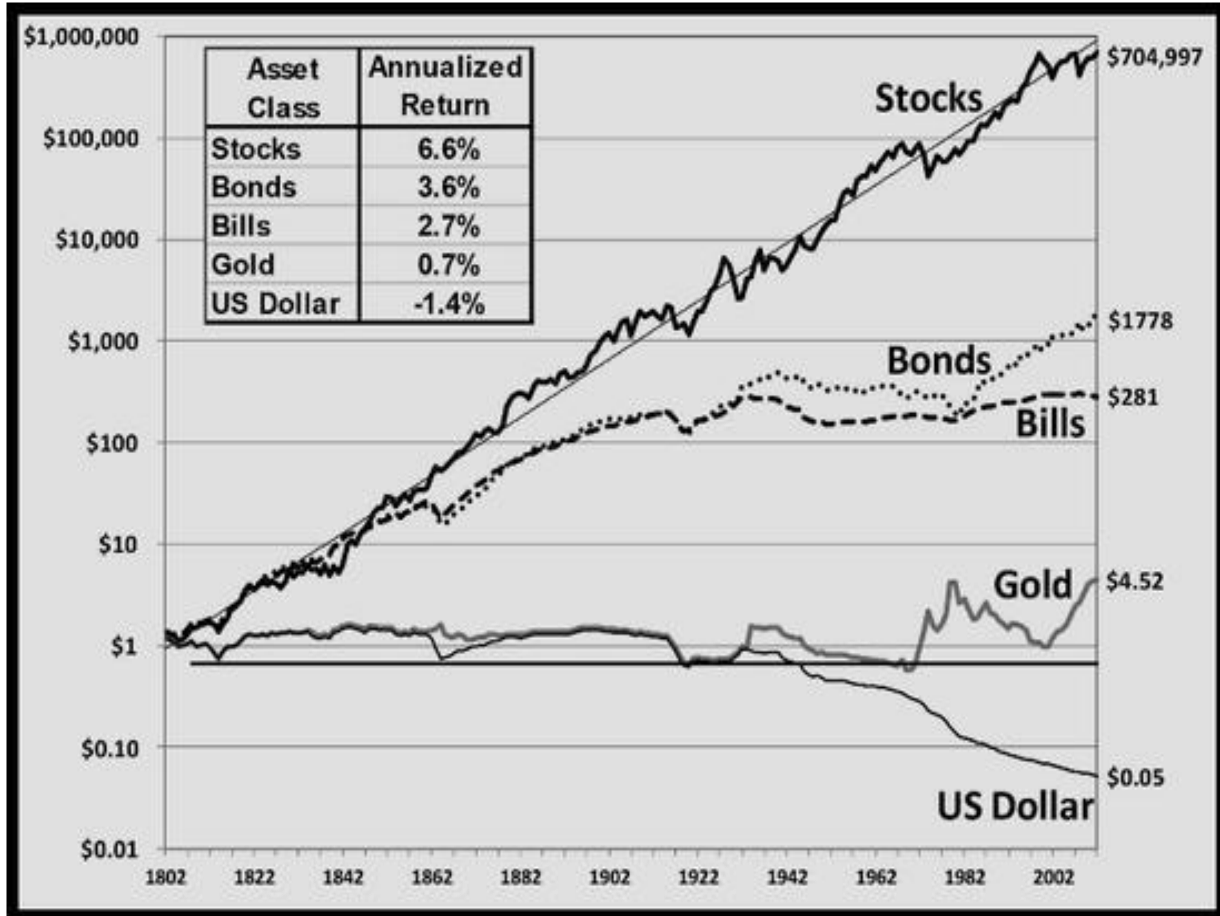
The human capacity to imagine is in many ways what the stock market is founded on: companies engaged in continual innovation to meet mankind's needs, to improve the quality of life, to create products and services that respond to a changing world. None of it would be possible without imagination.

As surely as the world will continue to change, we will continue to rely on investing principles that are proven and time-tested. With a dose of imagination on our part, we can more confidently stay the course even as we make our way through these turbulent and uncertain times.

V. Henry Astarjian

Dow Jones Industrial Average with Major Bear Markets (1915 – 2020)

Selected Asset Class Returns, Net of Inflation



Source: Jeremy Siegel / Gurufocus.com

Disclosures

The information and data presented in this investment letter have been compiled from publicly available sources that are believed to be reliable. However, their accuracy is not guaranteed. Waterstone Advisors LLC does not guarantee the performance of the securities or strategies discussed or analyzed in this letter. An investment in these securities or strategies may result in complete loss of capital. Past performance is not a guarantee of future results. Waterstone Advisors LLC and/or its officers may have positions in the securities and /or strategies presented.