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From Caution to Courage

> *By this, he seemed to mean, not only that the most reliable and useful courage was that which arises from the fair estimation of the encountered peril, but that an utterly fearless man is a far more dangerous comrade than a coward.*
> *– Herman Melville from Moby Dick*

Caution has been our theme in recent years. Alpine clients have benefited from our caution – if "benefit" is an appropriate description for a modest decline in stock account values compared to the massive decline suffered by others.

In our opinion, today's market calls more for courage than caution. Ironically, when stock prices were 40-50% higher, courage was abundant and caution scarce. Today, when stock prices are 40-50% lower, caution is abundant and courage scarce. The history of financial markets is one of misplaced courage.

Courage does not mean caution is abandoned. For the investor, as distinct from the speculator, caution is never abandoned. Caution comes first, and courage must be based upon an objective analysis of economic facts.

So why courage? And what are the facts?

First, stock investing has never been for the faint of heart. Over the past eighty years, the stock market has declined 15-25% in five years, 25-35% in two years, and over 35% in three years. That is a lot of heart thumping volatility for one lifetime.

But there is a reward – higher long run returns than bonds. Stock returns of 5-6% after inflation versus bond returns of 1-2% after inflation are reasonable long run expectations – when a fair price is paid upfront. Few can afford to live on 1-2% bond returns, so stock ownership is a necessity for most, and with it the courage to stomach the ups and downs.

Courage is also needed to weather current economic conditions. This includes the worst economic contraction since at least the 1980s, and the possibility of even lower stock prices in the short run. The economy was terrible in the 4th quarter of 2008, and it may get worse before it gets better.

The all-important factors required for success in difficult times: a portfolio of companies that have the business and financial strength to weather an epic economic contraction, and the intestinal fortitude to avoid bailing out at low prices.

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Most importantly, courage is needed to buy because values are compelling. By our estimates, a carefully selected portfolio of companies can be bought at a price less than 10 times a conservative estimate of their net earnings. Some companies are selling for less than 5 times their net earnings. These are excellent prices. Note that the overall market is selling for about 15 times net earnings, near the historical average over the past eighty years.

One might still ask – what if things get really bad? What if our worst economic fears become reality – another Great Depression 1930s style? Would you invest in the stock market today knowing the Great Depression shoe was about to drop?

The market today is already down 47% from its peak. The question proposed is what to do next, assuming we are entering the 1930s Great Depression. Let us say you invest $10,000 in the stock market in 1931 after it had declined by 47%.

$10,000 invested in 1931 after a decline of 47% would have grown to $23,710 by the time the market fully rebounded in 1936. Put another way, if today was identical to the 1930s, your return in the stock market from here would be 19% per year over the next 6 years, far better than an investment in your mattress or in bonds.

There is no reason to believe the current economic contraction will turn into the next Great Depression. Our thinking on future economic conditions can be segregated into three possible scenarios.

1. Probable – Significant contraction with 10% unemployment and stocks near bottom.
2. Possible – Major contraction with 10-15% unemployment and stocks 10-20% lower.
3. Unlikely – Epic contraction with 15-20% unemployment and stocks 20-40% lower.

Clearly we hope the probable scenario comes to pass, but no one really knows. The point is that even in the event of the unlikely scenario, stock returns from today are still likely to be quite good over the next five to seven years.

The last reason to call upon courage today is to ward off worry and fear. Come what may, worry robs us of enjoying today's gifts, and fear undermines the courage necessary to act and capitalize upon opportunity.

Nick Tompras
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