Tuesday, September 30, 2008

Take A Deep Breath/Count to 10

Democracy's Cycle

By Don R Hays

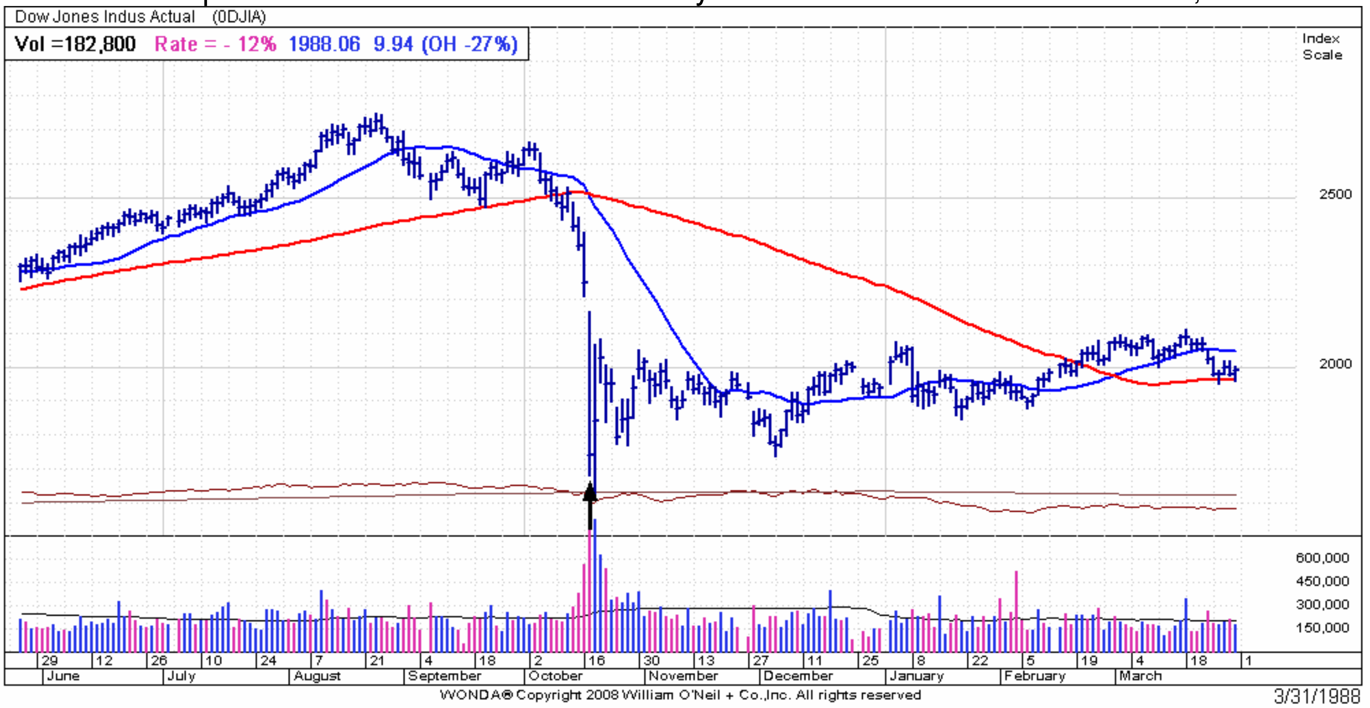
Summary: **As I've related on several occasions, I was the Investment Strategist for two different major regional brokerage firms for 20 years. This time interval takes us back to 1978 and covers a lot of ups and downs in the 1978 to 1998 environment. I've experienced the great upside days when I could cheer the troops on and celebrate our successes. That was easy and fun. But on the other side of the story I also had those days of unexpected climactic downside SHOCKS. On each of those "shocking" occasions", I did hold hands tightly as inter-day massive emotional and financial stress was being experienced, but at the closing bell if I had been forced to give my complete "wisdom" (such as it is) it would have been a huge mistake. It was always so necessary to "sleep on it." In truth, there was not much sleep, just a lot of tossing and turning, but when I finally interrupted the wee hours of the following morning with a fresh look it certainly helped to digest my wild emotional thoughts of the previous evening. I think yesterday was the worst financial day in my life except for that biggie on October 19, 1987. From a personal standpoint, the bottom line yesterday was much worse, but the emotions of that event 21 years ago were somewhat more climactic.**

So here I am—the next morning. The last thing I want is some "Jim Cramer" look-a-like to take me back into that emotional breech of yesterday. I want someone that provides logic, and reminds me of historical similarities, and gives me benchmarks to guide my thoughts. I've taken a deep breath, counted to 10, and explored available wisdom of sound analysis and mentors to provide logic. This is where I stand.

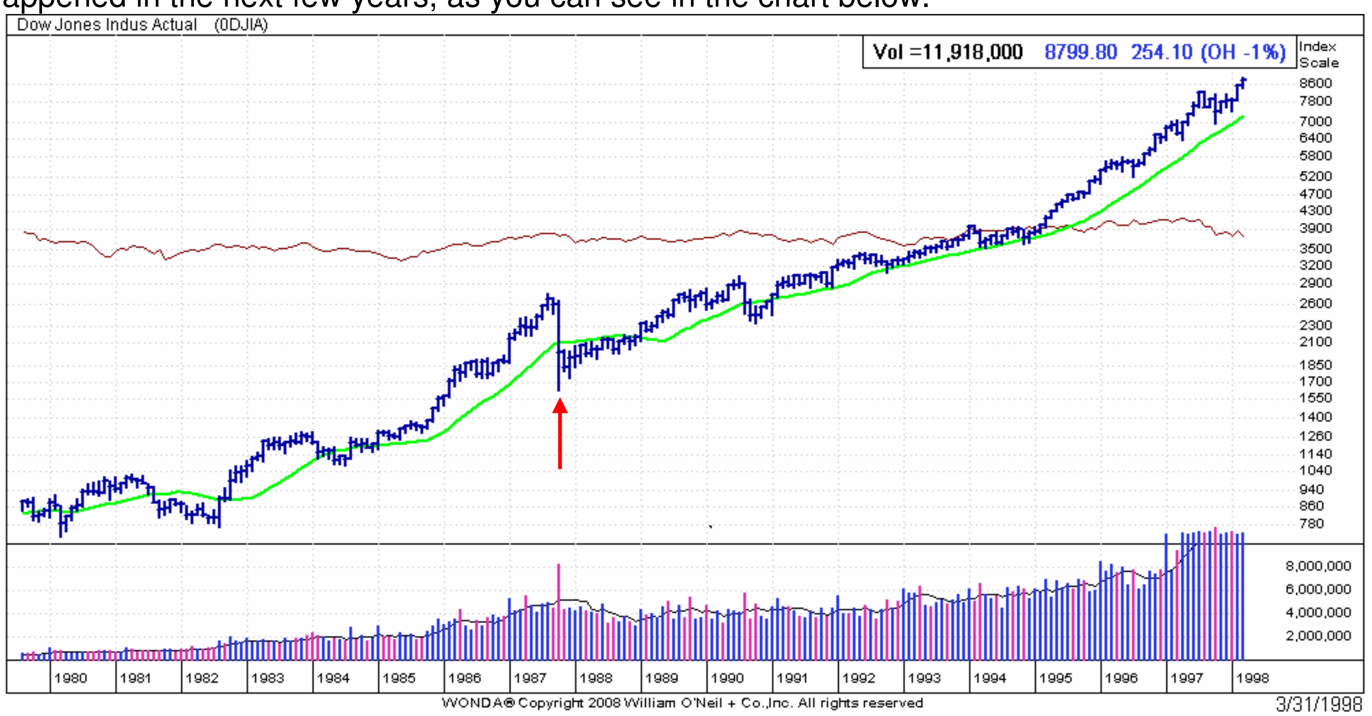
There have only been two days in my 40 years experience in this business with as bad a one-day downside market performance. One was that October 19, 1987 decline in the Dow by 22.6%. The other was the day the NYSE re-opened after 9/11, on September 17, 2001 and it dropped 7.1% in one day. Jason Goepfert tells me that if you look back to the beginning of the Dow Jones Industrial Average from 1897, you will find only 7 days when the Dow drops over 7% and makes a new low. Since the Federal Reserve did not really have the experience or the power until after that 1940 period, I discount those other 5 examples leading up to that date. But Jason says that even in that total universe of statistics, the bottom line is that "usually the market should not see more than another day of selling before another vicious rally attempt."

The CBOE option Volatility Index closed at 46.7 yesterday. It kissed the 48 level on an interday basis. Since its institution in 1986, it has only hit this level on 7 occasions, and each of those marked the peak of the wild oscillation by at least the next few days. The current VXO <u>OEX</u> Volatility Index (which I think in today's world might be even better than the VIX) closed yesterday at 51.84, and it has a very similar record at producing maximum volatility on THAT day and then calmer waters and at least for the short term very good upside bounces. Let's look at some charts.

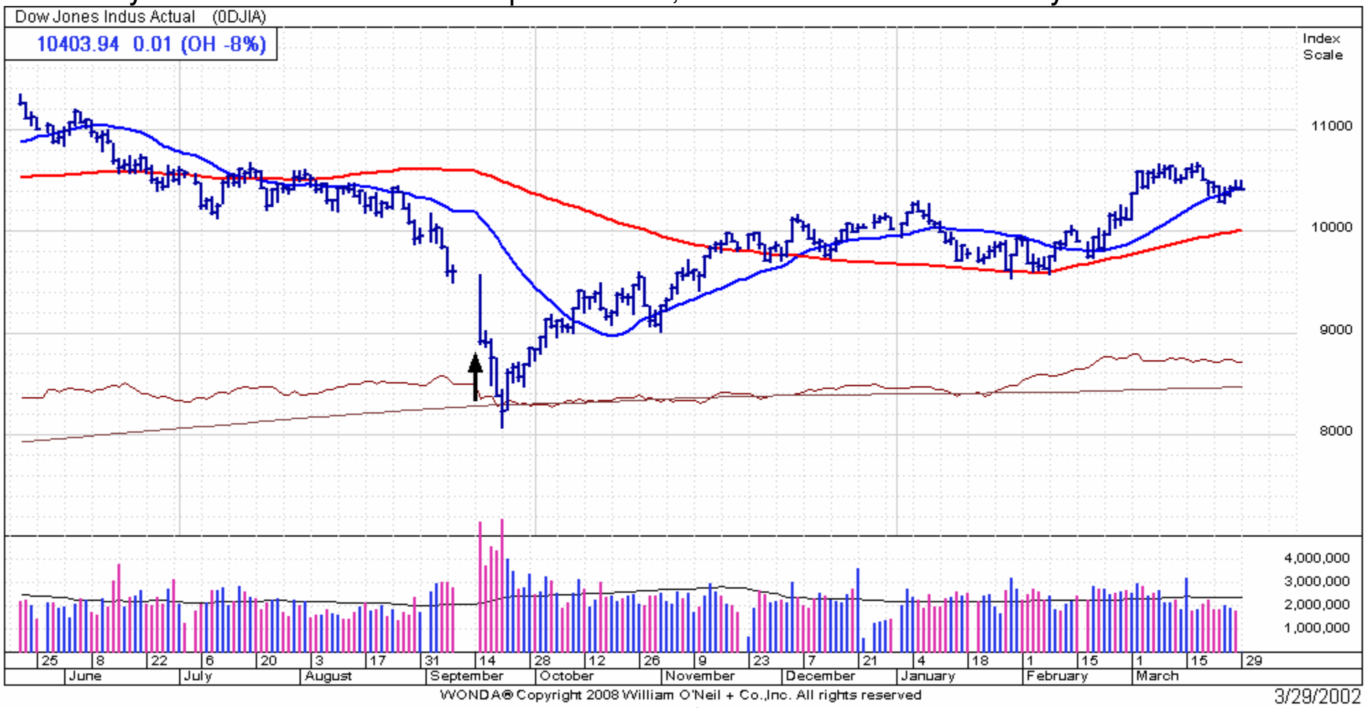
Let's begin by looking at the two previous times since the Federal Reserve really had a leading input on calming financial waters—1940, that the Dow Jones Industrial Average dropped to a new low and also experienced a 7%+ decline in one day. The first one was on October 19, 1987.



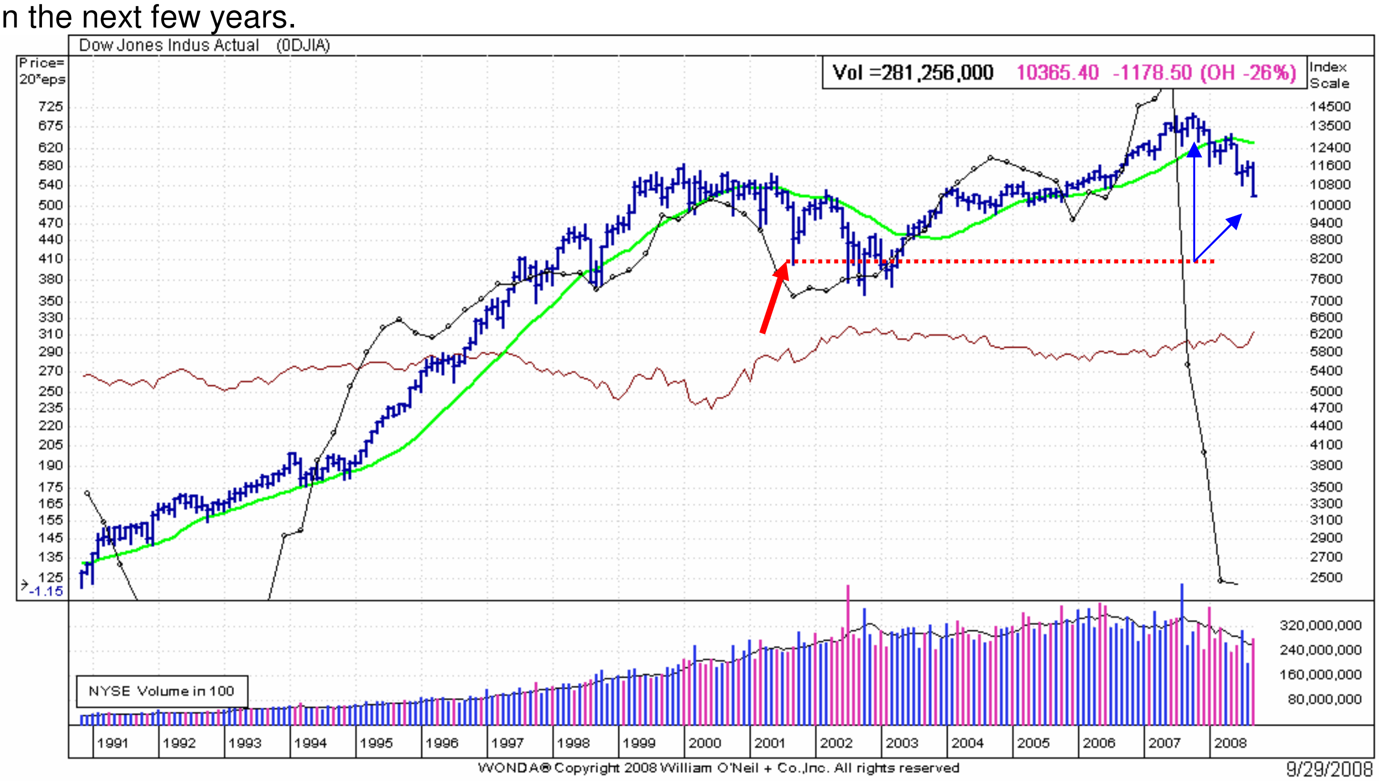
The above chart shows you the one-day volatility that proved to be the worst day of the decline. You can also see that in the next six months the Dow moved from that 1738 panic close to the 2100 level. It doesn't look that extensive, but amounted to a 21% gain. But more importantly what happened in the next few years, as you can see in the chart below.



That October 1987 was a major event that forced action and changed the investment pattern on the Portfolio Insurance excesses and the marketing "guarantee" that led to the peak in August 1987. It was a huge and important cleansing of the "easy money" investment philosophy that was growing at that time. Now, the other one was equally climactic since the entire fiber of American Democracy had been attacked on September 11, 2001. Here's that one-day action.



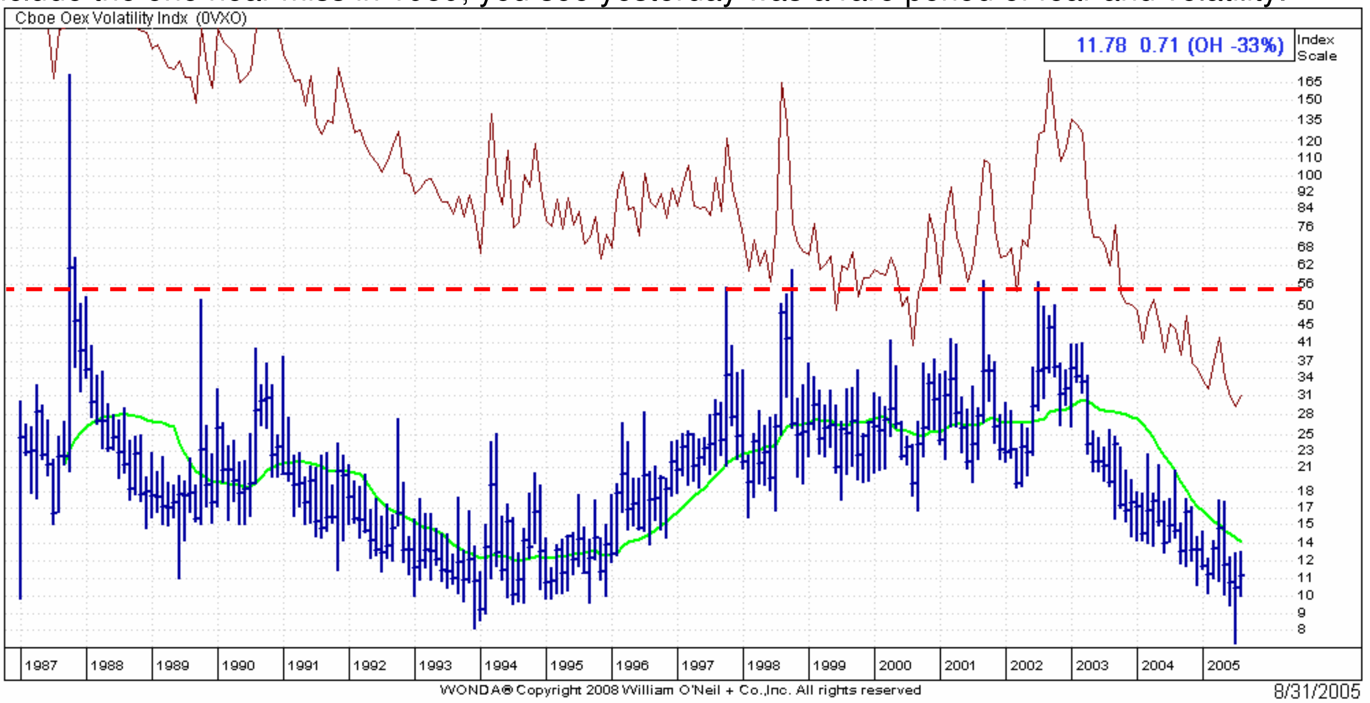
The bottom day did not end on that September 17th day, however. The next day did very little, but in the following three days after this opening plunge, the Dow fell sharply to end the plunge on 9/22/2001 down another 7% from the low of 9/17/2001. You can see that even in the next six months, the Dow moved from that first low on the 17th to a high of 10,700 for a gain of 20%, but once again we would like to focus on what the results of this historic one-day plunge history were in the next few years.



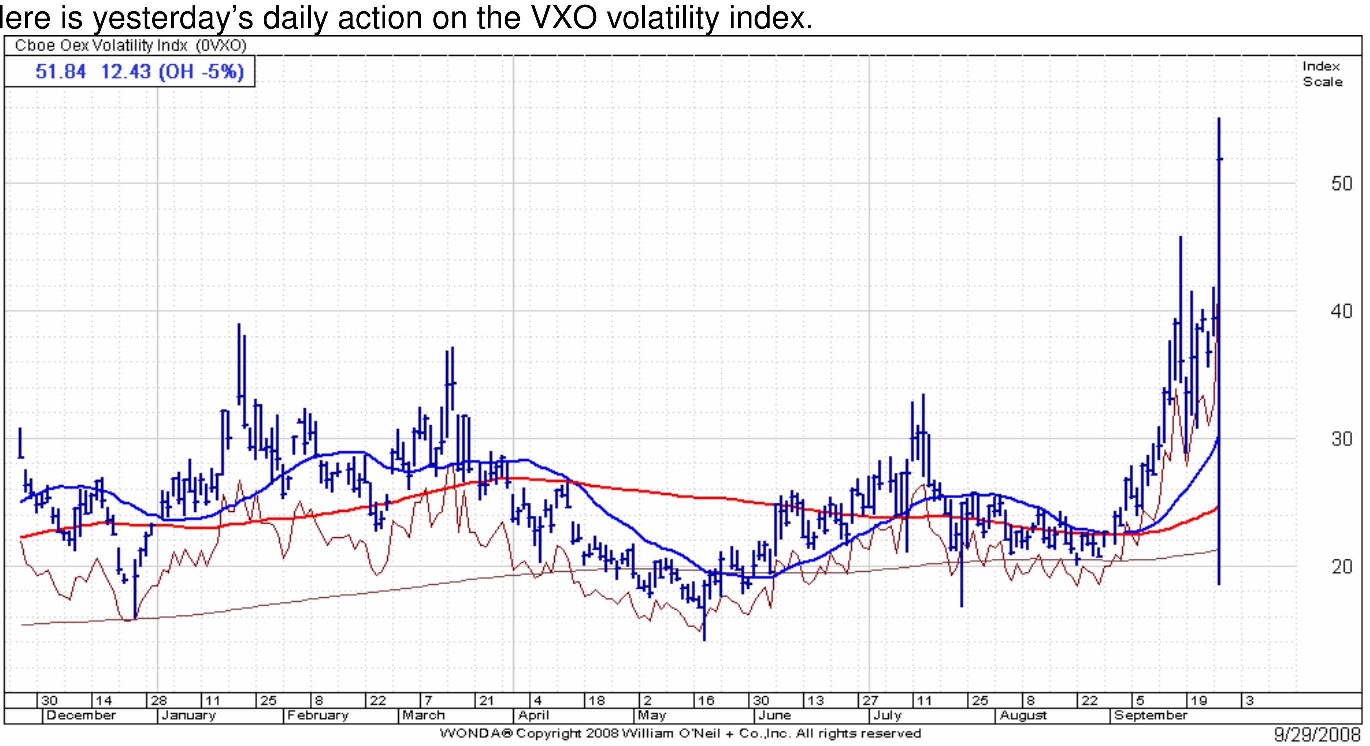
This was not the same happy ending one year later, as the initial rally off the panic low did have to pull back once again to make an even lower low as the final stage of that bear market evolved in

2002. BUT, even with that knowledge, you can see how a longer-term investor that rode through those tumultuous days benefited in the following few years, not only at the eventual top last year, but even considering the damage of the last one year's decline.

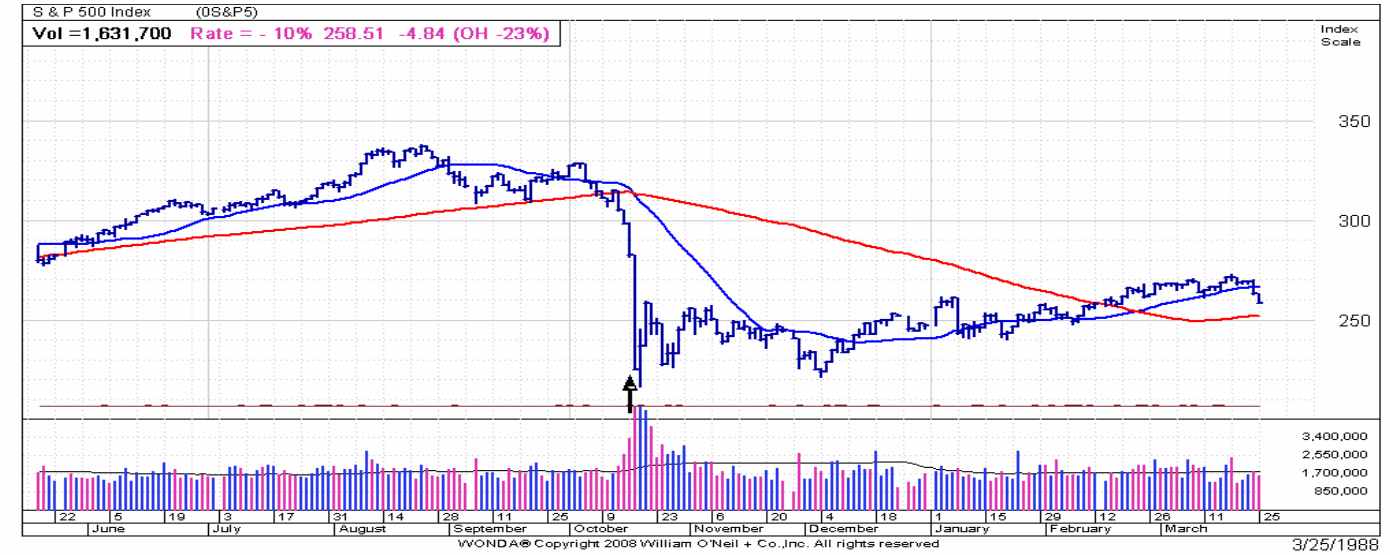
I'll get back to the long-term in just a moment, but now let's review the action of the markets in each case after the VXO OEX Option volatility index. Here's the overall chart from its birth in 1987 to 2005. I'll show you yesterday's peak level in the following chart, but in this historical review, you can see that yesterday's peak level of 55.10 has only been hit on 5 previous times. Even if we include the one near miss in 1989, you see yesterday was a rare period of fear and volatility.



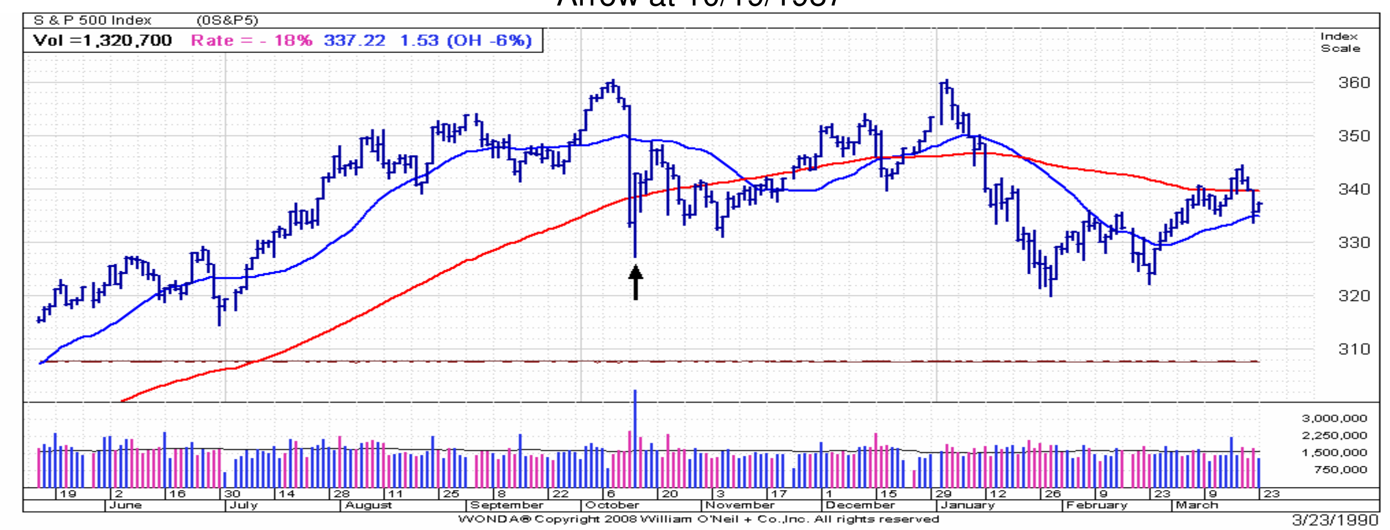
Here is yesterday's daily action on the VXO volatility index.



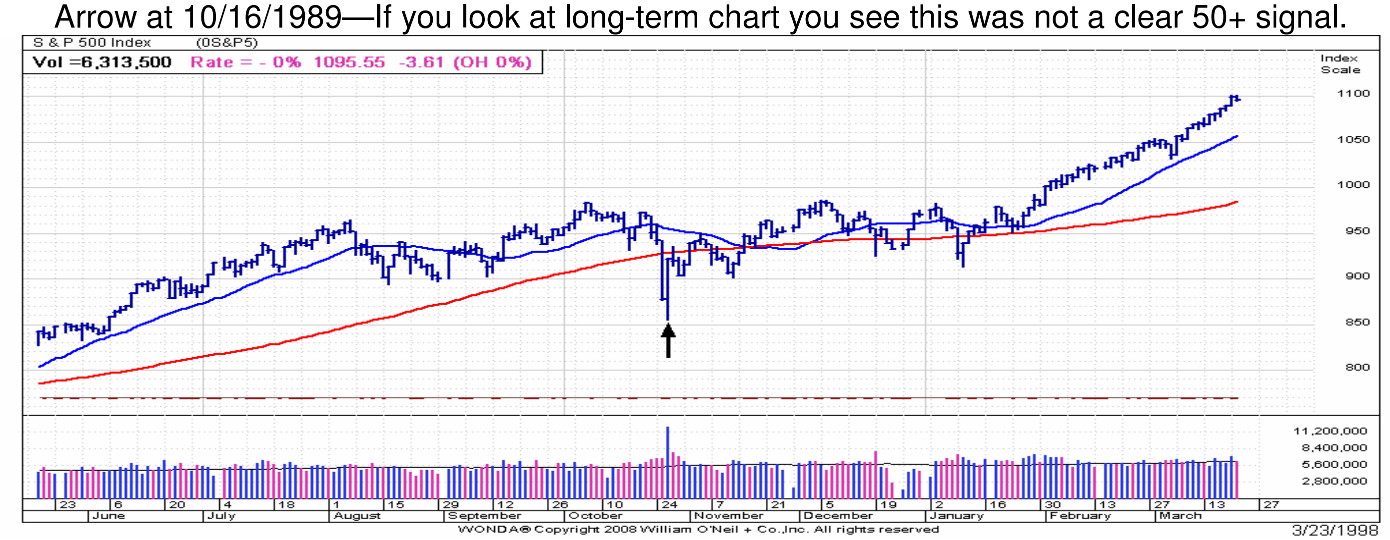
This may be more than you want, but let’s look at the S&P 500 on each of those previous 50+ violations in this index.



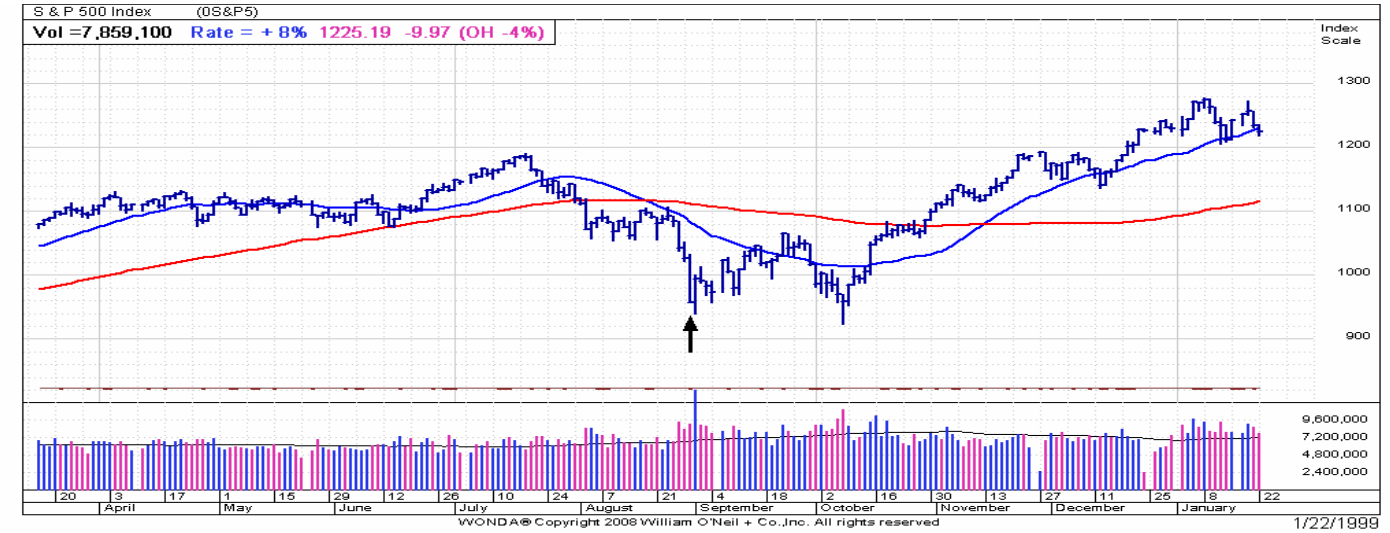
Arrow at 10/19/1987



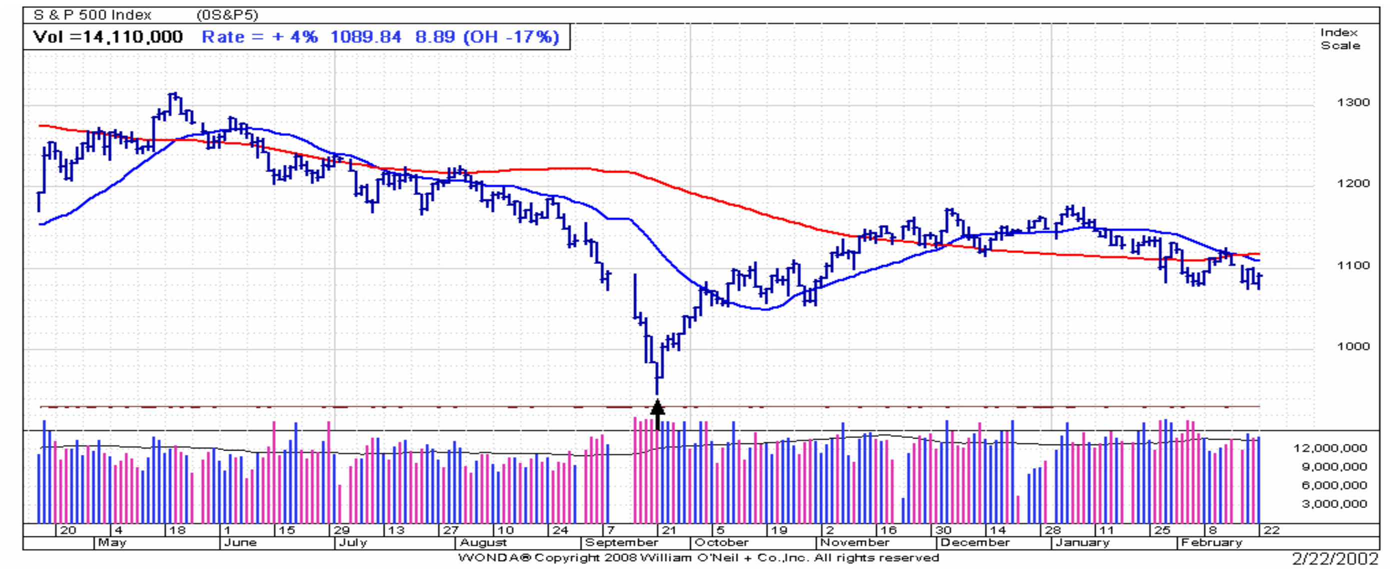
Arrow at 10/16/1989—If you look at long-term chart you see this was not a clear 50+ signal.



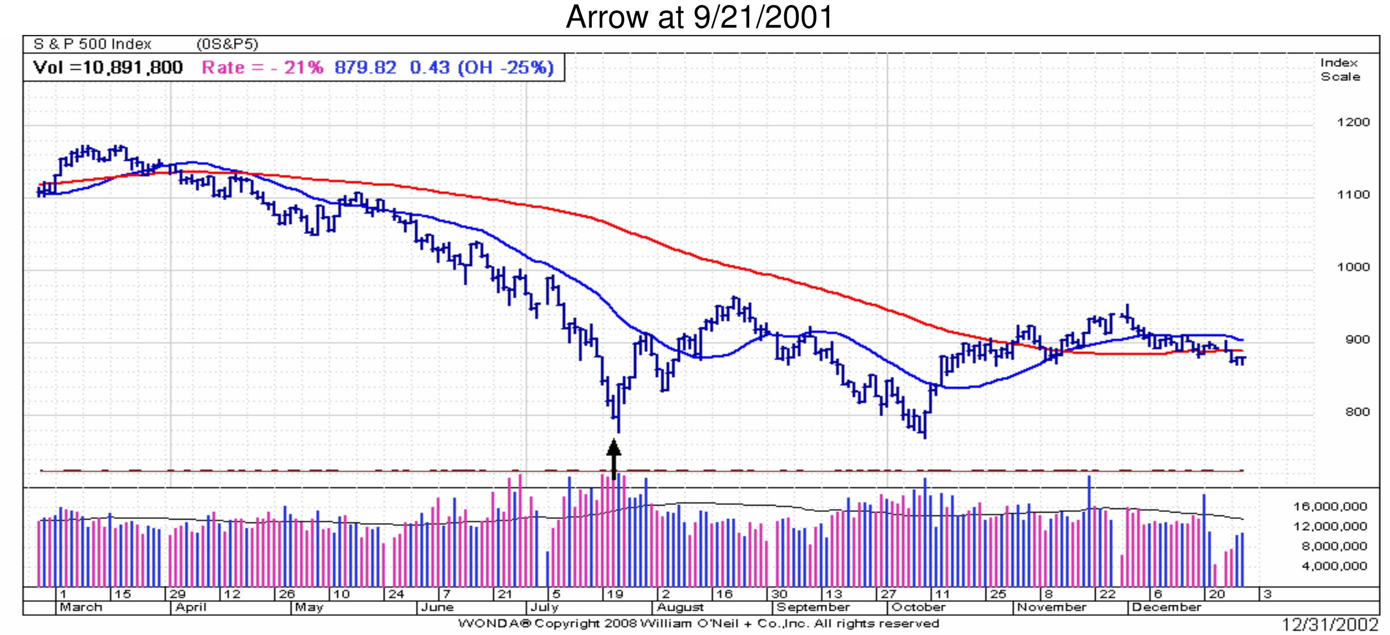
Arrow at October 28, 1997



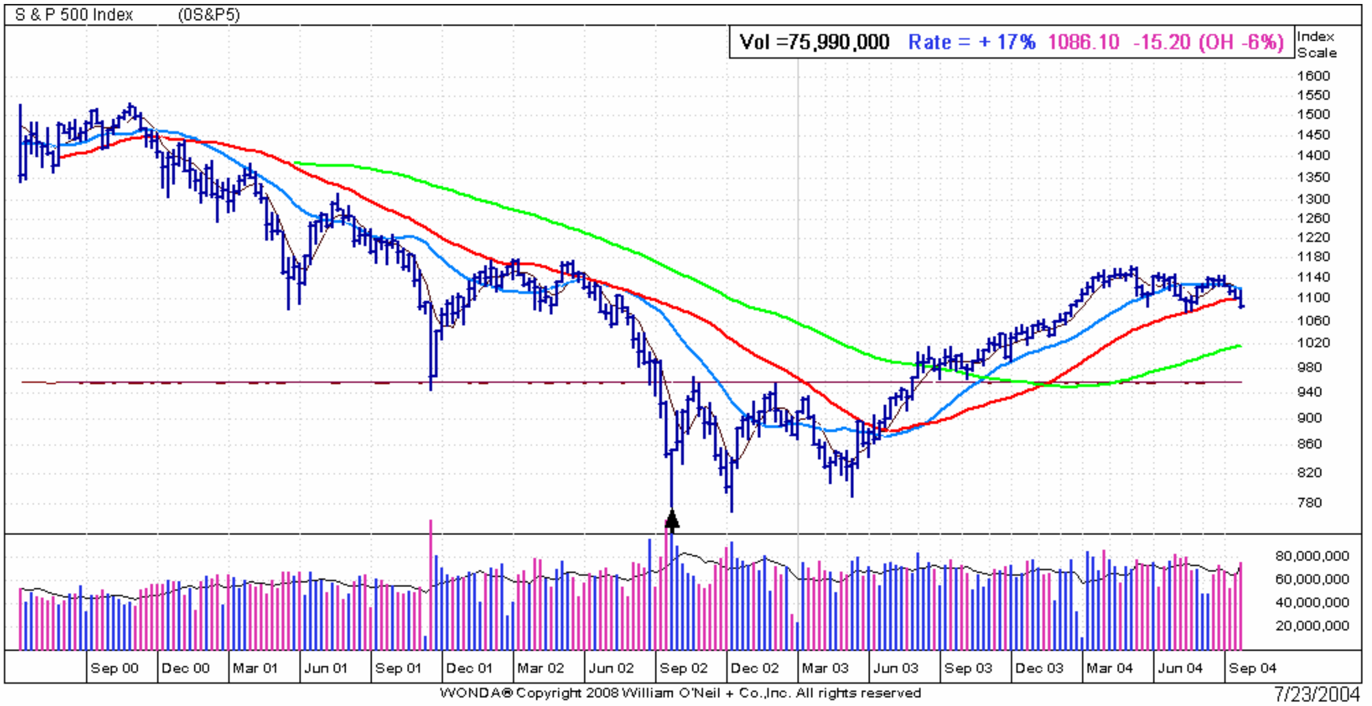
Arrow at 8/31/ 1998



Arrow at 9/21/2001



Arrow at July 23, 2002 (In this one particular case, let's look at the next chart showing the next two years.



Arrow is at that first left shoulder experienced on July 23, 2002.

You can see very plainly that as the emotions are running with wild abandon for the bomb shelter, when the adrenalin is flowing at peak levels, and when emotions cloud the brain cells, in every case in these last 10 years, or even in the case of the 7%+ declines shown on the first example, it pays to hunker down and let the emotions pass.

There is no doubt that the last 28 years of prosperity has brought so much wealth and power to many. Power ALWAYS corrupts, it seems, and even if you have the best resolve, you actually start to believe you are something special and deserve to bestow special privileges on yourself. I've seen it, probably even participated in some of it. Almost every one of these climactic events I've cited, that is like yesterday, has produced a new vision, and actually a cleansing of the excesses of the past.

We still envision an amazing future for the U.S. and the world. It most definitely has taken a serious cross current from anything we expected. But in truth we didn't expect the extent of the October 19, 1987 debacle, and no-one else did as well, but it served to clean the excesses of the greed that had built up in the prior 5 years. In the long-run it was a very healthy cleansing that served to help fortify the future gains. Staying the course resulted in huge gains in the next few years.

We never envisioned the extent of the calamity that occurred after 9/11/2001, and resulted in that horrendous decline on the week of 9/17 to 9/22/2001. But in hindsight, it woke up the world (especially the U.S.) to the new enemy of Democracy that had been festering for the prior 20 years. It was a healthy wake-up call, even though the short-term pain was so intense. Staying the course has resulted in major gains for us since that time.

I don't really understand the total consequences of yesterday's failure to pass the Paulson plan, and since I have placed a lot of confidence in my appraisal of Bernanke and Paulson, I most definitely would have voted for it. But I am also see a lot of opinion, not just by that red-neck observer, but by scholarly people that say the plan was devised so quickly in the heat of the moment, and did not fully meet the problem. I rebel at those quick emotional response against those that voted against the bill. They were expressing the opinion of their constituents, and maybe history will prove they have an important point to make that this bill did not cover.

I will be producing an addendum to this report right after we send this to you, that gives a little more of my thoughts about the failure of the Paulson plan, but in the interest of getting this out to you quickly—before the market opens, let me just end this with a quote from the Zack's website this morning which almost perfectly matches our philosophy about yesterday's panic and how to react.

Investors should continue to look at stocks, with a focus on fundamentally sound companies with rising earnings estimates that are trading at attractive valuations. This is what the most successful investors do.

Most importantly, don't panic. Investing is about long-term wealth creation, not short-term market swings.

In light of the historical significance of previous panic declines, it becomes even more important today to hunker down, let this emotional zone pass, and if history is any guide, you have a very, very high probability of outstanding results in the next few months and especially years.

In view of today's hysteria, YOU HAVE OUR PERMISSION TO COPY AND DISTRIBUTE THIS LETTER TO ANYONE YOU WISH. We don't do this often, but these are very important times to not let your emotional response determine your investment decisions.