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Factors in Focus

Different Circumstances, Same Results

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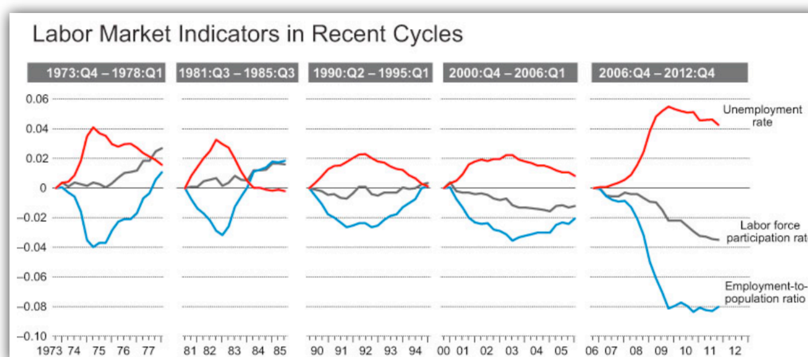
Just over three years ago, it looked like the economy and the stock market had reached a point of no return. With the S&P 500 down well over 50% since its highs in October of 2007, and smaller and more value oriented stocks at home and abroad off much worse, pessimism was universal. We were in the throes of a financial crisis, and there was little hope for recovery as housing prices continued to fall, corporate earnings continued to sag, and government "stimulus" efforts were decidedly anti-stimulative. In early March of 2009, when asked for his view about the state of the economy, Warren Buffet cooly proclaimed it had "fallen off a cliff".[1]

Surprising only to those who haven't studied history, three years later we find the situation has improved. The economy has reversed course and is growing once again, corporate earnings have rebounded and balance sheets are in significantly better shape. But this is far from the typical economic recovery. Home prices have continued to fall, and still remain over 30% below their peak. While the economy is growing, the 2-3% year over year rate is anemic at best when compared to previous recoveries. And with unemployment still north of 13 million workers and straddling 9% of the workforce, many are scratching their heads wondering if this is a recovery at all.

FIGURE 1



source: http://libertystreeteconomics.newyorkfed.org/2012/03/prospects-for-the-us-labor-market.html

It wasn't supposed to be this way. As Figure 1 above shows, previous economic contractions have begun to turn around much more quickly and more dramatically than our current circumstances.

So it's definitely a good thing that we cannot see into the future. During those dark days three years ago, despite the pessimism, disciplined investors found the courage to stay with their diversified stock portfolios because of the belief that things would improve, not just economically, but in the capital markets as well. Had investors known that the economic recovery would be as anemic as it has been, it's possible they would have assumed a similar fate for the stock market and seen no reason to stick around.

What Goes Down Has Come Back Up

While the downturn that began in 2007 was severe by any measure, we had seen these events before. The stock market, as measured by the CRSP 1-10 Index, declined by over 80% from 1929-1932, almost 50% between 1937 and 1938, over 40% between 1973-1974, and then again between 2000 and 2002. In each case, the economy and the stock market came roaring back.

Historically, the magnitude of the downturn was matched only by the speed and size of the recovery. And it wasn't just the big blue chip stocks that dominate the market that tended to recover. Smaller and lower priced "value" stocks had historically rewarded investors who suffered their greater-than-market declines with significantly greater recovery returns when markets finally started going again.

1. *Peter A. McKay and Rob Curran, "Dow Drops to 6547.05 as Dim View Spreads Out," Wall Street Journal, March 10, 2009*

As Table 1 below shows, the first three years of recoveries **(in grey)** from severe bear markets **(in white)** were very rewarding for the disciplined equity investor. While the Total Market Index (CRSP 1-10 Index) averaged 86%, a "Market-wide Value Index " that holds all stocks in the market with the lowest 25% of prices (50% DFA US Large Value Index, 50% DFA US Small Value Index rebalanced annually) returned almost 123%, or about 35% more than the "traditional" Total Market.

TABLE 1: Past Declines and Their Recoveries

TIME	Total Market	Market-wide Value
Sept 1929 - May 1932	-83.2%	-90.2%
June 1932 - May 1935	+153.2%	185.5%
April 1937 - March 1938	-49.0%	-64.2%
April 1938 - March 1941	+43.4%	44.5%
January 1973 - Sept 1974	-45.1%	-32.8%
Oct 1974 - Sept 1977	+81.8%	146.2%
April 2000 - Sept 2002	-44.8%	-2.4%
Oct 2002 - Sept 2005	+65.5%	114.4%
July 2007 - Feb 2009	-48.4%	-64.8%
Average "Bear Market"	**-54.1%**	**-50.9%**
Average "3YR Recovery"	**+86.0%**	**+122.7%**

This Time Wasn't Different

But these tremendous market gains were fueled by strong economic expansions. Would it be possible for equity markets to produce similar returns without the benefit of typically strong economic tailwinds, and would a market-wide value portfolio that held only the lowest priced stocks continue to recover more quickly?

As Table 2 shows, while the circumstances surrounding this economic recovery may be different, the stock market response has been the same. Compared to the previous four recoveries, stocks have produced even higher than average results, with the "Market-wide Value Index" again leading the way, **this time by almost 45%**.

TABLE 2: The Current Recovery

TIME	Total Market	Market-wide Value
March 2009 - February 2012	+102.6%	+148.7%

Descriptions same as Table 1

Expectations versus Reality

How can a disappointing economic recovery produce an even stronger than average stock market recovery? In short: *expectations vs. reality*. It is likely that by early 2009, the market had anticipated (or "priced in") an economic decline that was far more severe than even that which we had already witnessed. We now know the reality turned out to be much friendlier than originally feared. In retrospect, we realized that prices had fallen too far and markets had to adjust to the new reality with dramatically higher prices.

These same forces are at work every day in reverse as markets set the prices of successful growth stocks like Apple or growth countries like China extremely high to reflect their perceived safety and anticipated future success. But success cannot continue forever, and investors are ultimately surprised and disappointed as earnings and economic growth eventually slow, causing sharply lower stock prices—and today's growth becomes tomorrow's value.

So once again we learn *this time isn't different*. The circumstances surrounding our current economic recovery are different from past episodes, but the stock market hasn't noticed. Stocks of all types have rebounded strongly, with smaller and more value oriented companies (and "Market-wide Value" Portfolios) rebounding the most. We also see, it's not *what happens* that drives market prices, but *what happens relative to what was already expected* that dictates outcomes. And because no one can accurately or consistently measure what is expected to occur, you are better off diversifying broadly, exercising discipline at every turn, and learning to live with the uncertainty that comes with being a long term investor. Without this uncertainty, our results would be significantly less.

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