

“These are the times that try men’s souls”*Founding Father, Thomas Paine in 1776*

Thomas Paine wasn’t referring to the financial markets, but his quote certainly can be applied to today’s financial market environment. By Thursday last week the S&P 500 Index had fallen 52% from the high reached in October of last year, surpassing the 49% drop during the last bear market from 2000 to 2002.

As if you need reminding, the stock market has fallen further and faster during the current downturn than all but the worst bear market in history. The S&P 500 Index did not exist in the 1930s, but the Dow Jones Industrial Average (“DJIA”) fell 89% over 846 trading days between Sept 3, 1929 and July 8, 1932. In this current bear market, the DJIA has fallen 47% over 284 trading days (and down about 25% over the past 846 trading days).

When will the markets stop going down?

The truth is that no one knows. Once a market deflating rout starts it is very difficult to stop. It’s like trying to convince the stampeding crowd in the theater that there really is no fire after all. Today there is a figurative fire in the financial markets and so far government intervention has not been able to put it out. Wall Street Journal columnist, Jason Zweig wrote, “It’s important to realize that the financial markets are never under some obligation to stop falling merely because they have already fallen by an ungodly amount.”

So it’s very important to think about how you will cope if the stock market falls further. Think about how you will react if it falls another 10%, 20%, or more. How will you respond if your worst case scenario comes to pass? Think about it now so that you can plan ahead and take the action you want to take, rather than the action that feels right during the time of greatest despair.

Remember, your investment portfolio is there to support your financial needs. In the short-term, do you have enough cash to meet your needs for the next 12 months? What level of cash allows you to sleep at night while the markets are finding a bottom and working things out?

In November 1974, after the stock market had fallen 44% from its peak, Jim Fullerton, then chairman of the Capital Group (investment advisers to the now one trillion dollar American Funds family) gave a speech to the firm’s clients. The investment environment was much like today and Madison Wealth Management’s Paul Chenault was there listening as Fullerton explained, “One significant reason why there is such an extreme degree of bearishness, pessimism, bewildering confusion, and sheer terror in the minds of investors right now is that most people today have nothing in their own experience that they can relate to, which is similar to this market decline.”

Fullerton went on to say “My message to you, therefore, is “Courage!” We have been here before. Bear markets have lasted this long before. Each economic, market and financial crisis is different from previous ones. But in their very difference, there is commonality. Namely, each crisis is characterized by its own new set of nonrecurring factors, its own set of apparently insoluble problems, and its own set of apparently logical reasons for well-founded pessimism about the future. Today almost every financial

journal carries a list of reasons why investors are standing on the sidelines. They usually include (1) continued inflation; (2) illiquidity in the banking system; (3) shortage of energy; (4) possibility of further outbreak of hostilities in the Middle East; and (5) high interest rates. These are serious problems.” Thirty-four years later that list still seems quite relevant.

What will turn the market around?

Again, turning to Fullerton’s 1974 speech, he offers the following thoughts on how the market turned around after the Great Depression: “Simply a return to reality. Simply a slow but growing recognition that despite all the bad news, despite the gloomy outlook, the United States was going to survive, that strongly financed, well-managed U.S. corporations were going to survive also. The reality was that those companies were far more valuable than the prices of their stocks indicated. The DJIA is not reality. Reality is not price-to-earnings ratios and technical market studies. Symbols on the tape are not the real world. In the real world, companies create wealth. Stock prices don’t. Stock prices are simply proxies for reality.”

Fullerton closed with the following thoughts, “Some people say they want to wait for a clearer view of the future. But when the future is again clear, the present bargains will have vanished. In fact, does anyone think that today’s prices will prevail once full confidence has been restored? That comment was made 42 years ago by Dean Witter in May of 1932 – only a few weeks before the end of the worst bear market in history. Have courage! We have been here before and we’ve survived and prospered.”

In our view, Fullerton’s words and Dean Witter’s comments fully apply to today’s situation.

Coming back to the present, here’s the problem: it’s extremely stressful to watch your investment portfolio decline day after day after day and not do anything about it. Author, Michael Lewis recently said “We have entered a period of risk aversion unlike anything we’ve seen in our lifetime. You’ll read stories about people who got rich betting against subprime mortgages and then about people who combed through the wreckage and found bargains. The next rich wave will be those who figure out where the value is. As for the average American investor, he’ll be a deer in the headlights for years.”

So now we all have a choice to make. And, it’s framed by two forms of regret. On one hand, we can identify very attractive investments that without much imagination will produce excellent returns over a reasonable period of time. The problem is that these investments might get a lot cheaper before they start going up. In this case, we suffer bitter regret from buying them too soon.

On the other hand, because we can identify many attractive investments, if we don’t buy them and wait for things to clear up, as Dean Witter said in May 1932, “the present bargains will have vanished.” In this case we would have terrible regret that we missed an opportunity to recover losses and create new wealth.

So the question to ask ourselves is ‘which regret is worse?’ There’s no single right answer, but each of us can think about it in this way and come up with our own right answer. It’s a question of balancing the two forms of regret. How much bitter regret from seeing prices decline further can we stomach versus the terrible regret from seeing opportunities not taken vanish? Either way, your courage will certainly be tested.

At Madison we remain invested alongside our clients and confident, like Fullerton, “We have been here before and we’ve survived and prospered.”

“Regret for the things we did can be tempered by time; it is regret for the things we did not do that is inconsolable”

Sidney Harris