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The lost decade

Client Newsletter
Quarter Ending December 31, 2009

The decade of the 2000s began with the sharpest drop in the U.S. economy since the Great Depression, and ended on an even worse note, eclipsing the drop of the beginning of the decade, and ushering in the Great Recession.

The Dow Jones Industrial average has suffered a 9.3% drop in the past decade, the first time the market has had a drop in a ten year period since the Depression. And that doesn't count the losses in purchasing power caused by inflation, or the effect of taxes on returns. The S&P and NASDAQ fared even worse, down 24% and 44% respectively. The dollar retreated almost 13% during this time, so overall it has been a very bad decade for investors. In the meantime, commodities, such as oil increased 210% in price, while natural gas declined. Gold soared 279%, as metals generally soared.

Being in the right sector of the market was important but also required nimbleness. For instance, technology stocks are down 52% for the decade in spite of a 63% increase last year. Consumer goods, where we have been represented, were up 37% in the decade, in spite of the collapse of automobiles, Health care, which we over weighted, was up 21.7% in the decade and financials down 20.6% as many banks collapsed or had to be propped up by the government.

Last year, asset allocation was simple: buy the riskiest stocks (see The Dash to Trash client letter June 30, 2009). After March 9, 2009, the appetite for risk returned to the market with gusto and some of the previously worst performing stocks did the best. As fiduciaries for our clients, we could not assume that level of risk, and so we underperformed the market in the first part of the year.

Homeowners saw the value of their homes fall while the cost of a pair of jeans at Gap soared 20% year on year, a Big Mac 10%, and a year in college 10%. No wonder people felt less wealthy and feared the future. Job losses mounted.

Manufacturing employment was down 33%, with motor vehicle and parts production down 50%. Educational services led the way in job creation with an increase of 32% followed by health care with 30% and Hospitality with 12%. Government employment increased over 9%.

The government's massive stimulus and spending program, while not lifting the boat may have kept it from sinking further.

We can expect more of the same from the government: Massive borrowings to fund programs, as the government leverages itself beyond any previous measure. Like Japan the borrowings will exceed GDP, like Japan interest rates will remain low. Like Japan will we have another lost decade?

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Is today an historic buying opportunity for equities or can we expect the doldrums? We have many problems ahead of us. Housing is still a big issue; unsold houses have yet to be absorbed, and as I have said before, we cannot begin a recovery until house prices stabilize. Unemployment remains stubbornly high and may go higher, although there is some evidence of business hiring. Commercial loans must be rewritten or commercial property will suffer the same fate as homes. Banks may have to absorb yet more losses, and the banks know it. Banks have been hoarding money to save their own business at the expense of other businesses. The commercial lending market is still not normal, and must normalize for any recovery. The consumer is still deleveraging their balance sheet at the cost of consumer spending, although Christmas spending was stronger than most thought.

Profits will recover as business have cut costs dramatically; employment will follow, but we need some more top line growth which means more consumer spending. With interest rates low, the dollar remains under pressure, but this helps export growth. The question is will investors continue to buy U.S. treasuries in the quantity they are being offered? And by the way, how much of the debt is actually being sold, and how much is actually the government buying back its own debt, simply printing money to pay creditors? There are many questions to be answered before we can know our future path, and by the time we answer them it will be too late to act.

What we can see is that during the last disastrous decade, those investors who had a prudent asset allocation of 50% bonds 25% stocks and 25% international stocks, who began with $100,000.00, stayed the course, and invested $1,000.00 per month with annual rebalancing, saw their portfolio rise 250% against the 24% loss of the broad market. Not a bad result for slow and steady. But, as I have said before in a quote attributed to Samuel Coleridge "History is but a lantern to our stern."

While the 50/25/25 allocation may have been the best for the last ten years, no one could have known that at the start, and there is no assurance that it will be right for the next ten years. One should not expect bonds to do well in a rising interest rate environment which we are surely going to have. International investments should do well in the next decade as the dollar continues to weaken and emerging countries especially, experience strong growth. A much lower allocation to bonds and a higher allocation to stocks, especially international stocks would seem to be the right course for the next decade.

As always, we thank you for the opportunity to be your investment manager.

Best personal regards,

William D. Rutherford, President
Rutherford Investment Management LLC.

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