September 24, 2015

"The key to making money in stocks is not to get scared out of them." - Peter Lynch[i]

Peter Lynch amassed one of the best track records of any investor in any era. As you may know, he navigated the Fidelity Magellan fund for 13 years – May 1977 through May 1990. He is insightful and wise, so it is smart to at least consider his advice. In this letter, I want to draw on several of his insights because his perspective may be helpful – particularly during periods of turmoil.

Perspective Matters – What do You See?

You may recall from my last letter that most people have a very real aversion to loss (even those that subsequently prove temporary). Indeed most people will not wager a great deal on a game of chance unless the odds suggest they stand to win $2.00 for every $1.00 they stand to lose. Since history reveals the stock market has fallen 20% or more with some frequency (but not regularity) it is understandable why some folks choose not to wager good money on the “risky” stock market. First let’s look at some disquieting data that shows the magnitude of peak-to-trough declines in the S&P over the past 40+ years.

Notable market declines (S&P 500) since 1972

Peak-to-trough dates	1/11/73 - 10/03/74	9/21/76 - 2/28/78	11/28/80 - 8/12/82	8/25/87 - 12/04/87 #	7/16/90 - 10/11/90	3/24/00 - 9/21/01	3/19/02 - 10/09/02	10/09/07 - 3/09/09
% decline	-48.2%	-19.3%	-27.1%	-33.5%	-19.9%	-36.8%	-33.6%	-56.8%
duration days	630	525	622	101	87	546	204	517
Recovery required *	93.1%	23.9%	37.2%	50.4%	24.9%	58.2%	50.7%	131.3%

* the required recovery to "break even"   # most of the '87 decline occurred on October 16th and 19th

In light of the data above, you may be surprised to learn that Mr. Lynch also wrote, "Far more money has been lost by investors preparing for corrections, than has been lost in corrections themselves." I am quite sure Mr. Lynch is not a doe-eyed Pollyanna, so we need to look beyond just the peak-to-trough results. Next please see the data for the subsequent bull phases --

Notable recoveries in S&P 500 following the major declines

Trough-to-peak dates	10/03/74 - 9/21/76	2/28/78 - 11/28/80	8/12/82 - 8/25/87	12/04/87 - 7/16/90	10/11/90 - 3/24/00	9/21/01 - 3/19/02	10/09/02 - 10/09/07	3/09/09 - 9/23/15 #
% gain	73.1%	38.0%	250.4%	72.5%	395.7%	29.1%	94.4%	186.6%
duration days	719	1004	1839	955	3452	179	1826	2389

It is unknown how long or high this recovery will persist. Through 9/23 it has been 2389 days and 187%

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You may be saying, 'it is clear that at extremes, the stock market goes up and down a lot – it still looks like a casino to me.' I find it useful to look at the long-term returns for both purchases made at the bottom as well as market tops, because this captures the range of outcomes that an investor might experience if she bought and then held a broadly diversified U.S. portfolio like the S&P 500. @

Returns of S&P 500 through September 23, 2015

Hi date	1/11/1973	9/21/1976	11/28/1980	8/25/1987	7/16/1990	3/24/2000	3/19/2002	10/9/2007	9/23/2015
Hi price	120.2	107.8	140.5	336.8	369.0	1,527.5	1,170.3	1,565.2	1,938.8
Growth of $1	$16.12	$17.98	$13.80	$5.76	$5.25	$1.27	$1.66	$1.24	
Number of days	15595	14246	12717	10256	9200	5661	4936	2906	
Annual return	6.7%	7.7%	7.8%	6.4%	6.8%	1.6%	3.8%	2.7%	
Years	42.7	39.0	34.8	28.1	25.2	15.5	13.5	8.0	
Low date	10/3/1974	2/28/1978	8/12/1982	12/4/1987	10/12/1990	9/21/2001	10/9/2002	3/9/2009	9/23/2015
Low Price	62.3	87.0	102.4	223.9	295.5	965.8	776.8	676.5	1,938.8
Growth of $1	$31.13	$22.27	$18.93	$8.66	$6.56	$2.01	$2.50	$2.87	
Number of days	14965	13721	12095	10155	9112	5115	4732	2389	
Annual return	8.8%	8.6%	9.3%	8.1%	7.8%	5.1%	7.3%	17.5%	
Years	41.0	37.6	33.1	27.8	25.0	14.0	13.0	6.5	

@ *Investors cannot invest directly in an index*

Please note that the impact of buying high versus low is a one-time adjustment (albeit an important one). In other words, if the stock market's value drops by 50% then the investor who bought at the top will always have ½ the amount than if he purchased the shares at the bottom. Thereafter the growth per $1.00 invested is identical. Most importantly over the long term, even investments made at market tops can provide good results for investors. I say this because just on ***price change alone***, each $1.00 invested at the top in January 1973 would have grown to about $16.63 as of September xx, 2015. Please also note that while the price return on investment made at the top of the market in early 1973 was negative for several years, it has compounded at a healthy annualized rate of 6.6% over the past nearly 43 years.

On the other hand, the return from the bottom in 1974 was robust in the early years but it has moderated to 8.7% over the past 41 years. Over time, the percentage return differential will converge such that really high returns moderate and really low ones increase with the passage of time. Indeed this is what we should expect to see when we look at purchases made near more recent market highs and lows. Over the long-term, the annual price gain on investments made at the market bottom in early 2009 will likely decrease while those made at the top in late 2007 will likely improve.

As highlighted above, the return data shown reflects price change only. Returns that include dividends and reinvested dividends would be approximately 3.0% higher over most of the past 40+ years. When added to both sets of return streams (e.g. from the tops and bottoms), the differential is that much closer. Nevertheless, I like using price only, because many clients take withdrawals of the income generated by the securities that they own. Please also note that if an investor takes withdraws more than the dividends generated, her rate of compounding would be lower than the figures shown in the tables above. As these tables reveal, seemingly modest differences in annual return translate into large differences in long-term value. Therefore, we advocate low investment costs and high tax efficiency because those factors, along with avoidance of poor timing decisions, all tend to aid net realized returns.

We have seen this Movie Before and it has a Happy Ending

I recognize that it can be difficult to infer much about long-term stock market returns when you only look at a relative handful of market peaks and valleys. Furthermore, ***most of us do not make all of our purchases at either extreme peaks or valleys so our personal results will generally fall inside of the extremes.*** That being the case, I thought it might be useful to provide some data that I shared in a prior letter, albeit with a slightly different twist.

In my letter titled *The Dog is a Sideshow* from March 23, 2015, I recommended that investors focus on the trend in corporate earnings and dividends as opposed to the more highly volatile prices of publicly traded stocks. That is still my advice, but I want to share the aggregate price change data of every year in the past nearly 56 years in the context of a common end point (e.g. 12/31/2014). I think you will agree that there is more similarity than difference in the annualized price returns across time. In my view, this record is favorable relative to inflation. Therefore most investors should allocate capital to equities for the long term, expect a volatile ride and otherwise focus their energy on more important things than trying to outguess the markets. ***Timing is difficult and it opens up a range of possibilities that could be far worse than just realizing the price change of the highly volatile stock market.***

Annual price change thru year end 2014

Year	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974
S&P 500 (price)	58.11	71.55	63.10	75.02	84.75	92.43	80.33	96.47	103.86	92.06	92.15	102.09	118.05	97.55	68.56
Earnings	3.10	3.37	3.67	4.13	4.76	5.30	5.41	5.46	5.72	6.10	5.51	5.57	6.17	7.96	9.35
Dividends	1.98	2.04	2.15	2.35	2.58	2.83	2.88	2.98	3.04	3.24	3.19	3.16	3.19	3.61	3.72
CAGR (price) *	***6.8%***	***6.5%***	***6.9%***	***6.7%***	***6.6%***	***6.5%***	***7.0%***	***6.7%***	***6.7%***	***7.1%***	***7.3%***	***7.2%***	***7.0%***	***7.7%***	***8.9%***
*CAGR (earnings) **	*6.9%*	*6.9%*	*6.8%*	*6.7%*	*6.6%*	*6.5%*	*6.6%*	*6.7%*	*6.7%*	*6.7%*	*7.1%*	*7.3%*	*7.2%*	*6.7%*	*3.7%*

Year	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
S&P 500 (price)	90.19	107.46	95.10	96.11	107.94	135.76	122.55	140.64	164.93	167.24	211.28	242.17	247.08	277.72	353.40
Earnings	7.71	9.75	10.87	11.64	14.55	14.99	15.18	13.82	13.29	16.84	15.68	14.43	16.04	24.12	24.32
Dividends	3.73	4.22	4.86	5.18	5.97	6.44	6.83	6.93	7.12	7.83	8.20	8.19	9.17	10.22	11.73
CAGR (price)	***8.4%***	***8.1%***	***8.7%***	***8.9%***	***8.8%***	***8.3%***	***8.9%***	***8.7%***	***8.5%***	***8.7%***	***8.2%***	***7.9%***	***8.2%***	***8.0%***	***7.3%***
CAGR (earnings)	*7.2%*	*6.7%*	*6.6%*	*6.6%*	*6.1%*	*6.2%*	*6.3%*	*6.8%*	*7.2%*	*6.6%*	*7.1%*	*7.7%*	*7.6%*	*6.2%*	*6.4%*

Year	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
S&P 500 (price)	330.22	417.09	435.71	466.45	459.27	615.93	740.74	970.43	1229.23	1469.25	1320.28	1148.09	879.82	1111.91	1211.92
Earnings	22.65	19.30	20.87	26.90	31.75	37.70	40.63	44.09	44.27	51.68	56.13	38.85	46.04	54.69	67.68
Dividends	12.35	12.97	12.64	12.69	13.36	14.17	14.89	15.52	16.20	16.71	16.27	15.74	16.08	17.88	19.41
CAGR (price)	***7.9%***	***7.2%***	***7.3%***	***7.3%***	***7.8%***	***6.6%***	***5.8%***	***4.5%***	***3.3%***	***2.3%***	***3.2%***	***4.6%***	***7.3%***	***5.8%***	***5.4%***
CAGR (earnings)	*7.0%*	*8.1%*	*8.1%*	*7.2%*	*6.6%*	*6.0%*	*5.9%*	*5.8%*	*6.1%*	*5.5%*	*5.2%*	*8.7%*	*7.9%*	*7.0%*	*5.4%*

Year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
S&P 500 (price)	1248.29	1418.30	1468.36	903.25	1115.10	1257.64	1257.60	1426.19	1848.36	2058.90
Earnings	76.45	87.72	82.54	49.51	56.86	83.77	96.44	96.82	107.30	114.74
Dividends	22.38	25.05	27.73	28.05	22.31	23.12	26.02	30.44	34.99	38.57
CAGR (price)	***5.7%***	***4.8%***	***4.9%***	***14.7%***	***13.0%***	***13.1%***	***17.9%***	***20.2%***	***11.4%***	
CAGR (earnings)	*4.6%*	*3.4%*	*4.8%*	*15.0%*	*15.1%*	*8.2%*	*6.0%*	*8.9%*	*6.9%*	

* CAGR = compound annual growth rate for both S&P price level and earnings through the common end values of year end 2014
Source: www.damodaran.com Dr. Aswath Damodaran is a Finance Professor at the NYU Stern School.

I observe that no matter when the starting point, the annual return through the common end date and price of 2000 is rather remarkably consistent. This is particularly true for all seasoned returns (e.g. the starting point was at least 20 years ago). Of course the return series for periods at or near market bottoms is higher than those made at tops, but the range is pretty tight. Please also note that the annual growth in price tends to track closely the change in earnings. Indeed it is the growth in earnings that causes/enables the growth in price over time.

Here is what Peter Lynch advised, “If you can follow only one bit of data, follow the earnings - assuming the company in question has earnings. I subscribe to that crusty notion that sooner or later earnings make or break an investment in equities. What the stock price does today, tomorrow or next week is only a distraction." I too subscribe to that crusty notion.

If you are Patiently Waiting Your Chance to Join the Game

I confess I used to have an incredibly strong aversion to investing in securities that had valuations that seemed a tad too high. I have come to believe that this can handicap results as much as paying too little attention to valuation. Here is an example that might help illustrate how and why my thinking has evolved. My hope is that it can help some readers who are sitting in cash to take some action.

Let’s say you believe that over the long-term, well capitalized XYZ Corp. that you know and like strikes you as an enduring franchise capable of generating healthy earnings growth of say 6% to 7%. Let’s also stipulate that it is currently priced at 20x earnings (e.g. its PE ratio is 20x) and it provides a current and growing dividend yield of 2.0%. You fear that the PE ratio could fall to 16x so your concern is the shares might be 20% overvalued. You decide to wait for a better entry point. In the meantime, several years go by and the desired entry point never materializes. Now the share price has risen two-fold on the back of a two-fold increase in earnings. Clearly the decision not to invest is costly. However, let’s say you do make the purchase at 20x and within days the share price drops 20% (to 16x). Are you doomed? Hardly. Without restoration of the PE ratio it will now take about 3 years (excluding the dividends) to get back to your original purchase price. From that point forward, you will then earn an ***average*** of roughly 9% per year (7.0% earnings growth plus the 2.0% dividend yield) for many years. Over a very long time horizon your return, including the initial 20% decline begins to approach the same 9%. It could get even better. If the shares once again garner the 20x PE multiple, you will have realized 9% total return over the entire holding period. In a world where cash earns 0%, is that a bad result? Please note XYZ Corp could just as easily be a diversified basket of stocks. With respect to timing, Peter Lynch wrote, “It would be wonderful if we could avoid the setbacks with timely exits, but nobody has figured out how to predict them." For the record, as a “value investor” I would prefer to buy the shares at 12x, so I appreciate discipline. We just need to make sure it isn’t overly costly as healthy earnings streams are the life blood of favorable long-term gains.

Experience Shapes Our View

In a couple of weeks, Anne and I are heading back to Washington, D.C which is where we met and fell in love in the late 1980s. We are excited about the trip as we are heading back to see classmates of mine from the Georgetown, M.B.A. program. While it does not seem possible, it is our 30th reunion. This upcoming trip combined with the current action in the markets has placed me in a reflective mood and I thought it could be helpful to share how my experiences in late childhood and early adulthood helped shape my views on investing.

As you may know, I grew up in Youngstown, Ohio. In its heyday Youngstown was the second biggest steel producer in the country and indeed probably the world. The city flourished for many decades and wave upon wave of immigrants from all over Europe as well as African American migrants from the Deep South found opportunity in this once thriving town. Then in the late 1970s (during my junior year of high school) the first of the major mill closings occurred and the community’s fortunes changed decidedly and decisively for the worst. Safe in the confines of college in the early 1980s, I saw another boom and bust albeit in a much more compressed time frame.

While Youngstown was reeling, Texas was riding high on the backs of an oil boom and then record high prices. I had a number of classmates from the Lone Star state whose families flourished at that time. However, by the time we graduated in 1983, that boom had turned to bust and large fortunes were lost – especially for those operators who had overextended on debt. Also my classmates with degrees in geology found particularly lean job prospects in their sector in that generally difficult economic environment. After graduating from Georgetown, I joined a D.C based broker dealer as an equity analyst. These were exciting times as the recovery from the lost decade of the ugly 1970s gave way to a rather impressive rise in the stock market. Then two years into my career, I experienced firsthand the crash of ’87. I recall on Tuesday after the carnage of the preceding two trading days, our research director declared, “We are in a bear market”. At the same time a much younger colleague named Rob muttered, “We have already had it.” For sure I did not know who was right (it turned to be Rob), but I discovered that Wall Street also goes both ways. Lastly, perhaps the hottest field when we graduated from Georgetown was commercial real estate. Indeed some of my best friends began their careers in real estate. These were heady times, especially in markets like metropolitan D.C. as prices were on a steep upward trajectory for years. However by the time Anne and I moved in August of 1989 real estate prices had already peaked and significant price declines in Washington’s real estate market occurred over the ensuing years. Once again there were large reversals of fortune for good hardworking employees, business owners and investors alike.

I never lost faith in capitalism but I became increasingly aware of the need to manage risk. In retrospect, Youngstown and other industrial towns were likely doomed to lose in highly competitive markets where cost-efficiency matters a great deal. Youngstown’s mills were antiquated and highly inefficient compared to the then state-of-the-art mills that were built in other cities and countries after World War II. The lesson being conditions can change rather abruptly and many companies can be cheap for good reason. History shows not all once great businesses endure. For investors, survival is a must. The takeaway from the early '80s oil market, the ’87 stock market correction and the 80s into the early 1990s real estate boom and busts was to not be over-extended. Indeed many folks who had capital (or at least access to capital) made fortunes buying good quality merchandise at rather distressed prices. More importantly, folks who merely weathered the downturn often saw a restoration of their financial wealth as markets recovered in the years following the sharp declines.

I believe these earlier experiences taught me the importance of risk control and also the need to look beyond the immediate here and now. Living in the moment is great for dogs, but it is not a prudent means to grow capital over the long haul. Because I have learned to expect the unexpected, I have learned that it makes sense to carefully consider valuation when allocating capital. However, it is important to own a diversified portfolio that is built to last/survive the inevitable setbacks that lie ahead for the global economy and markets. Therefore, the most important thing to do is to provision for rough seas (so that you have staying power). Experience has taught me that time and diversification can be our allies.[ii]

Looking into the Future

As often stated, I do not have a crystal ball. The U.S. stock market has had a wonderful run since the bottom in 2009 and we could certainly see additional declines from today’s levels. That said, it does not seem that valuations or sentiment are close to the extremes that are normally associated with market tops and bottoms like those shown in the tables on page one. In other words, I would not be the least bit surprised to see the market move up or down 20% in the near term. Okay, now let’s look at potential S&P 500 price levels in the decades that lie ahead.

Potential Price Levels in the Decades to Come

S&P Starting Value 2000	Number of years				Growth of $ 1,000,000			
	10	20	30	50	10	20	30	50
Rate of growth								
3.5%	2,820	3,979	5,613	11,169	$ 1,410,598	$ 1,989,788	$ 2,806,793	$ 5,584,926
4.5%	3,105	4,822	7,490	18,064	1,552,968	2,411,713	3,745,317	9,032,635
5.5%	3,415	5,835	9,967	29,083	1,708,143	2,917,756	4,983,950	14,541,960
6.5%	3,753	7,046	13,228	46,612	1,877,136	3,523,644	6,614,365	23,306,678
7.5%	4,121	8,495	17,509	74,378	2,061,031	4,247,850	8,754,954	37,189,745

This is a hypothetical example. It is not an attempt to model the returns for any particular investment strategy.
All investments entail risks including the permanent loss of capital.

I was reluctant to place the 10-year figures in the table even though this is merely a compounding exercise. There is a chance that the level could be lower in 10 let alone 5 years than it is today. While lower price levels 10 or 5 years from is not my expectation, it is certainly possible. If that does prove to be the case, the likelihood increases that the years beyond then will be that much more rewarding. As the record shows, long-term figures tend to converge over time such that below average returns pave the way for future above average and vice versa.

Final Observations about Peter Lynch

I hope this letter helps you better appreciate why Peter Lynch observed that more money is lost trying to avoid downdrafts than is lost in the declines themselves. In order to win the game, you have to go out on the field. History shows that over long periods of time, the greater risk to investors is not being in the markets; as opposed to the risks and temporary setbacks that long-term investors incur along the way. Mr. Lynch is deservedly recognized as a true investment icon. However, it is interesting to note that he may have been very adept at timing his career. I say this because it is unknown how he would have fared when the market's preferences shifted to high tech in the mid to late '90s and then oil and basic materials stocks in the early to mid 2000s. Those companies may not have been in his bailiwick.

In any event, ***because we don't know, we diversify***. We believe this helps to ensure good outcomes for you and your family while other approaches including market timing introduce risks that are impossible to quantify but that could nevertheless lead to unacceptable outcomes. Lastly, we believe our over-weights to emerging markets and mid and small cap U.S. stocks makes sense for the long term. Not only have these segments performed quite differently than large cap U.S. stocks but it is possible that they will continue to generate slightly better long-term sales, earnings, cash flow and dividend growth. This might aid long-term results and as the data in this letter reveals, small differences in growth rates can translate into large differences in portfolio value.

W. Richard Jones, CFA
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[i] This quote appeared in Mr. Lynch's 1994 book, ***Beating the Street***. The other 3 came from his 1989, ***One Up On Wall Street***

[ii] Diversification and asset allocation do not ensure a profit or protect against a loss.

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