The Long View or the Short View?

By Katherine S. Newton, CFP®

What if I were to tell you that you could buy one of the following? Which would you choose?

> The premier brand of a certain type of cheese, which has all the wonderful qualities of that cheese variety but which might spoil if kept very long and which is more expensive than it's been in a long, long time, especially when compared to the second choice?
>
> A different brand of the same type cheese, which has the same great qualities of the premier cheese, which is expected to age well, but which sells for half the price of the premier cheese?
>
> Neither of the above. You don't like cheese and you'd prefer to eat your crackers plain.

Interestingly there is not a time in history going all the way back to the 1800s when we can find that stocks were cheaper compared to bonds than they are now. Or put another way, bonds are more expensive relative to stocks than they have ever been.

So why would investors be buying bonds, when stocks have yields which are comparable if not higher than those of bonds, bonds which can be expected to lose value when interest rates increase? Why would they buy the more expensive cheese rather than the better one which is comparatively less expensive?

Listening to Ralph Greggs of Fidelity Investment Management last week, I was impressed by this analyst's ability to communicate the big picture of the markets and of the economy rather than the more common ant's view, the view that we all are used to hearing in the daily financial news.

Last year during a similar talk he had accurately predicted we would continue in a long term volatile trading range, a "secular" bear market which began in 2000 -- which is exactly what I believe we are seeing now.

Perception vs. Reality:

Headline news, whether about European woes or US politicians' inability to compromise, dominates markets as investors continue to run for the perceived safety of bonds and cash, although yields on cash and cash alternatives are well under 1%. Price-to-earnings ratios on US large company stocks continue to be "compressed" after each downward spike in the markets. Markets and investors are hyper-focused on the "macro" picture rather than on the fundamentals of the investments they are buying.

A History Lesson:

One interpretation of market history might look like this:

Every generation has experienced its own "generational low." And so for my grandparents it was 1929, for my parents it was 1974, and for the current generation, March 9, 2009 was it.

And characteristic of the periods of time surrounding generational lows are the clearing up of excesses, excesses which have usually resulted from very unproductive ways of putting money to work. An example: Borrowing "equity" from a home and spending the money lavishly.

Also characteristic of these generational lows is very, very high market volatility. So what we are experiencing now isn't out of character for a time when big problems like deficits are finally addressed and hopefully and eventually resolved.

In each such period, this pressing down of market values has created opportunities for investors.

What to do?

Granted, the volatility is maddening and even angering to many investors. Everyone is worn out by the ups and downs. But what do you do while you wait for things to improve?

I think the trick is to get paid while you wait. Just as all markets "revert to the norm," normal volatility should return at some point.

Take Johnson and Johnson. The current yield on the stock is 3.54%. The yield on the 10 year J&J corporate bond is 2.95%. Which of these would you prefer, in an environment where interest rates are at 30 year lows and given that, if interest rates go up, the bond will almost certainly trade for less than par?

There are also potentially less volatile alternatives to equities in the form of convertible or high yield bonds in situations where excellent managers can weed out the good from the bad. Ask me about these when we next talk.

The Big Picture:

I think it's important to remember to get the big issues correct. Realities like scarcity of resources, emerging market industrialization, and the emergence of a huge new middle class are important. Example: Automobiles in this country per 1000 people is 705. In China the number is 128.

Also, I've always believed optimism is an option if you're willing to pick the appropriate time frame.

Here's a recent quote I like from J. Michael Martin in an article entitled "Innovation Always Trumps Fear":
"*Missing from [one analyst's] recent appraisal of the future is any enthusiasm for mankind's long-demonstrated ability to brighten a gloomy outlook through innovation.*"

Things are better than they feel. Lending is up. Corporate earnings, time and again, are reported to be higher than expected. Executives in many multi-national companies are very optimistic, buying in their own company's stock.

So, you have the long view and the short view, the strong hand (buyers of equities like Warren Buffet's recent purchase of IBM) and the weak hand (sellers of equities and buyers of bond), the inexpensive cheese or the expensive cheese, or maybe none at all, like cash, which has practically no return and which will lose purchasing power when inflation finally rears its ugly head.

I believe stocks of large US dividend paying companies are extremely compelling just now and that certain fixed income securities, US treasuries, for example, are very expensive and can even lose value. We may be in one of those rare times of opportunity for investors who are willing to wait out the discomfort of volatile markets and who might trade the discomfort for the "get paid while you wait" option in the form of dividends.

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