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PERSPECTIVES

First Quarter 2023

Reacquaint with History

By Bill Koehler, CFA, President and CEO

President Harry Truman was fond of saying, "There is nothing new in the world, except the history you don't know." Though he never attended college, he was an extremely well-educated man. It is said he read virtually every book in the Independence, Missouri public library over his lifetime. I believe, were he alive, President Truman would counsel investors to bolster their knowledge of market history to reduce the anxiety they may feel when markets correct. Last year certainly provided occasions to experience capital market angst. That said, looking back on 2022 also provides a timely opportunity for learning. This learning can then be used to formulate an objective, fact-based outlook for 2023 and beyond.

Learning Opportunity: 2022 Lessons

1. The unlikely can happen. Both stocks and bonds can be down in the same year. It has happened four times before 2022. Few, including FCI, believed both stocks and bonds would be down more than 10% in 2022. The facts are double digit losses in both high-quality U.S. stocks (S&P 500 -18.1%) and high-quality U.S. bonds (Bloomberg Aggregate Index -13.0%) had not occurred before.

2. Use the outcomes to improve. Use last year as an opportunity to learn more about the past so we can be better informed. We do not know exactly what lies ahead but we can establish an informed view for the future, if we are able to place the past in proper context.

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Angst Antidote: Market History Knowledge

In the course of my recent reading, I came across an article on HumbleDollar.com authored by Bill Kosar. Bill is not now, nor has he ever been, a professional money manager or investment adviser. In fact he retired, as he indicates in the article, six years ago after working 40 years in various roles as an engineering and business manager in the semiconductor industry. In my view, his background provides him with a unique perspective from which to research the question he broached....Over time, how frequently have both the stock and bond markets declined in the same year and what was their subsequent performance?

I thought his article, which looked at 95 years of market history, was so informative and helpful I picked up the phone and called him. After complimenting him, I asked if I could incorporate his work into our next Perspectives. He graciously consented. I also contacted the founder of HumbleDollar.com, noted long-time financial journalist and author, Jonathan Clements. He graciously permitted its use. Thank you to both of them. The link to the article is here: https://humbledollar.com/2023/01/after-the-swan-dive/

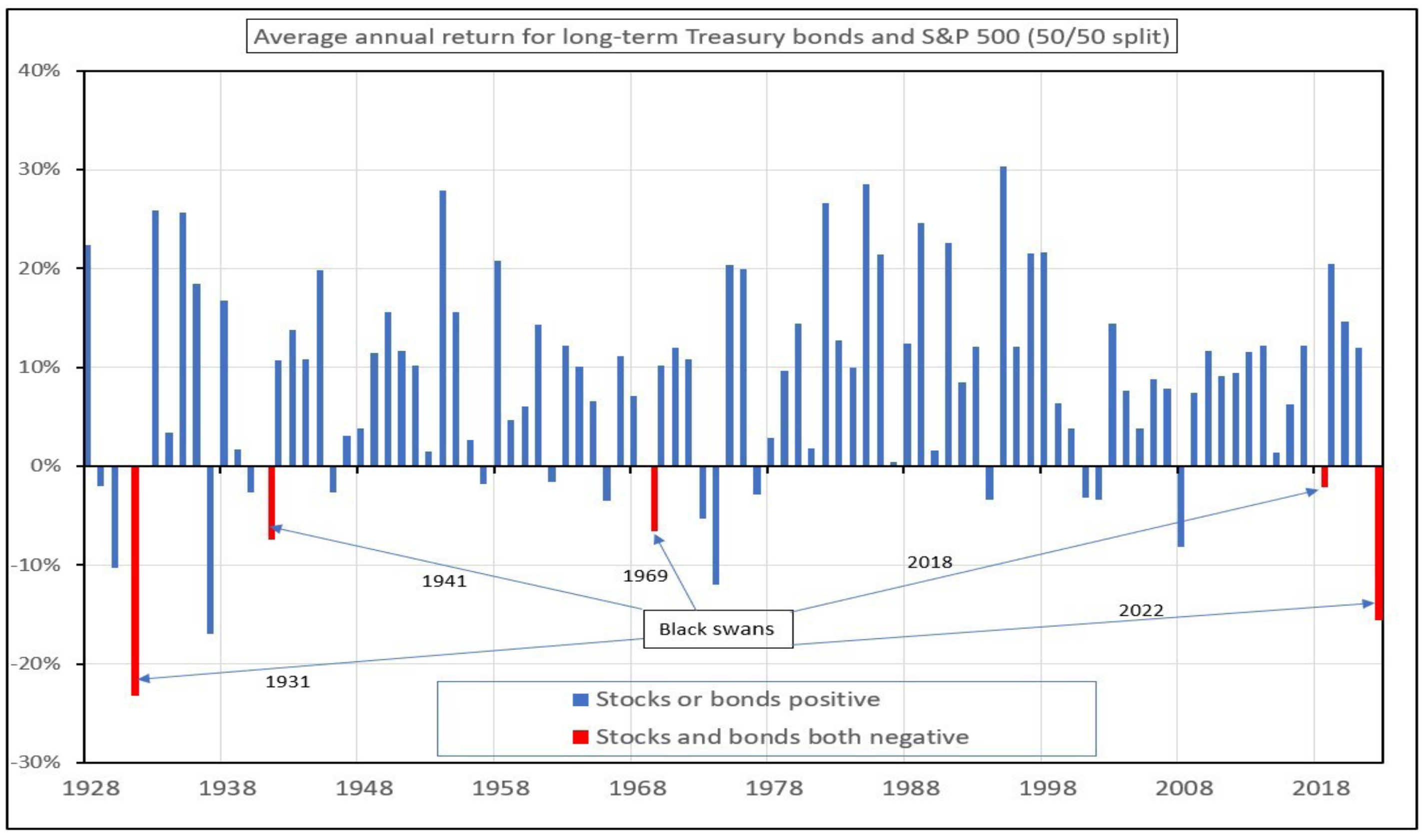
After the Swan Dive

Bill Kosar | Jan 2, 2023

I'VE BEEN RETIRED for six years and—like many retirees—I rely on my portfolio's appreciation, interest and dividends for most of my retirement income. The high inflation of 2022, coupled with poor stock and bond market returns, have me pondering what history would predict for 2023's performance.

I decided to look at how frequently both the stock and bond markets have performed poorly in the same year, and what subsequent returns have typically been. Simultaneous declines in both the U.S. stock and bond markets might be considered a "black swan" event—something far outside what's normally expected. The term was made popular by the bestselling book by Nassim Nicholas Taleb.

And, yes, 2022 qualifies as a black swan: Simultaneous annual stock and bond declines have occurred just five times over the past 95 years, as you'll see in the chart below, and 2022 was the first year when both stocks and bonds posted double-digit drops. The chart shows the total annual returns for the S&P 500 and 10-year Treasury notes for 1928-2022, which I got from the site [https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html] maintained by New York University finance professor Aswath Damodaran.



What does Damodaran's historical data tell us? My conclusion: Markets tend to have healthy recoveries in the three years after bad years. Indeed, for a 50% stock-50% bond portfolio, all four of the prior black swan years were followed by at least three up years, with the cumulative three-year gain ranging from 27.5% to 57.8%. While black swan years have been relatively rare, the data suggest that maybe investors in those years were overreacting to fears of future economic problems that didn't come to pass.

The lessons: It's important to maintain a large enough cash reserve to cover at least three years of your foreseeable retirement spending, so you're never forced to sell long-term investments at low prices to cover your short-term spending needs—and it's equally important not to overreact to a single bad year.

A Steward's Obligation

After a year like 2022, it is not always easy to listen to investment advice that leads with "focus on the long term" particularly if someone has recently retired in their 70's or older. I understand that sentiment. However, it is work like Bill's above that can provide a sense of calm and encouragement in light of more challenging market conditions. His historical findings of subsequent returns over the ensuing three years being materially stronger, are instructive for all investors. While not a prediction by any means, it helps frame what types of returns may be possible going forward.

Investing remains a leap of faith. Faith is defined as belief without proof. We have a belief in our institutions and our capitalist system. The nearest thing we have to proof is often history. Doing our best to understand market history and using it to help contextualize market events is our obligation as investment professionals.

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One final President Truman quote speaks to the value of knowing history through reading. He said, "Not all readers are leaders, but all leaders must be readers." If anyone is leading themselves or others along a path of capital market navigation, they owe it to everyone involved to be as well acquainted with market history as possible to best serve as capable stewards. Stay calm and carry on in 2023.

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