Investment Lessons from the Last Decade

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Disciplined Growth Investors

The Way Wealth Is Built

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The year 2008 was the exclamation point on a decade-long bear market in common stocks. In that sense 2008 was a game-changer in the investment environment. Investors will have to relearn the very hard lessons dished out by the financial markets during the last ten years.

The decade started badly with a severe bear market in stock prices from 2000 until 2002. The decade ended with the near-collapse of the U.S. financial system.

In this piece we are going to examine the investment lessons from the last decade. In this effort we are choosing to focus on the most liquid markets: stocks, bonds, and money market funds. We acknowledge that there have been equally profound changes in the political and economic environment. We have found that analysis of the political and economic environment is not very helpful for investors. Overall political or economic progress occurs slowly, and it is difficult if not impossible to identify inflection points that might sharpen one's investment decisions. Also, there is not a clear linkage between politics, the economy, and investment returns.

The investment environment, especially the stock market, tends to respond more quickly and decisively than the political or economic environment. The liquidity of the stock market allows investors to adjust their portfolios far more easily than less liquid asset classes. It is this tendency of stocks to adjust relatively faster that offers the true investor a huge competitive edge over those who believe investment returns are largely determined by major political and economic events.

The markets have already spoken about the last decade and their message is loud and clear. The path forward for investing is available to anyone who wishes to hear the message of the markets.

Stocks, Bonds, and Money Market Funds

During the last decade the investment world in stocks, bonds, and money market funds was turned on its ear.

Stocks—Two Severe and Distinctly Different Bear Markets

In 2000 stocks were flying high. Cisco was the bellweather stock of the period. At its peak price Cisco sported a market capitalization of nearly $600 billion. General Electric had nearly the same valuation. Both companies were successful enterprises but were unable to sustain their lofty stock valuations. Cisco stock peaked at $82 per share in 2000; GE at $60. Twelve years later, Cisco trades at $16 per share and GE at $20.

In 2000 the "growth manager" paradigm collapsed. The publicly traded stocks of even the best growth companies became excessively valued. The stocks themselves became highly risky. The "value managers" were disciplined in their unwillingness to pay too much for a stock; these managers were able to largely escape the wrath of the 2000 bear market.

The 2000 bear market lasted until 2002. Along the way, we saw the spectacular corruptive failure of Enron and WorldCom, but at its core this bear was a product of valuation excess.

In 2008 the bear market was much different in character. The financial system nearly collapsed. This bear market was shorter, but no less brutal in the end. The 2008 bear market was the exclamation point on the decade; it got investors' attention.

Many venerable and trusted corporations were not the "safe havens" that investors believed. AIG and Lehman Brothers failed outright. Fannie Mae and Freddie Mac were placed into conservatorship. Bear Stearns and Merrill Lynch were acquired in distressed sales. CountryWide and Washington Mutual also failed and were absorbed into larger banks. Citibank stock collapsed. Prior to 2008, these companies were considered to be financial blue chips. Merrill Lynch was synonymous with Wall Street. AIG was the world's largest insurance company. Lehman Brothers was founded in 1850, more than 150 years ago. Fannie Mae and Freddie Mac were government-sponsored entities; their debts had the implied backing of the U.S. Treasury.

In 2008 the “value manager” paradigm collapsed. Seemingly well-priced stocks, many with good dividend yields and long histories, succumbed to the failure of the companies underlying the stocks. 2008 was not a bear market based on excessive valuation; it was a bear market based on misunderstanding the businesses behind the stocks. Those “value managers” who exercised careful valuation discipline in 2000 but failed to exercise proper due diligence in 2008 and 2009 were annihilated.

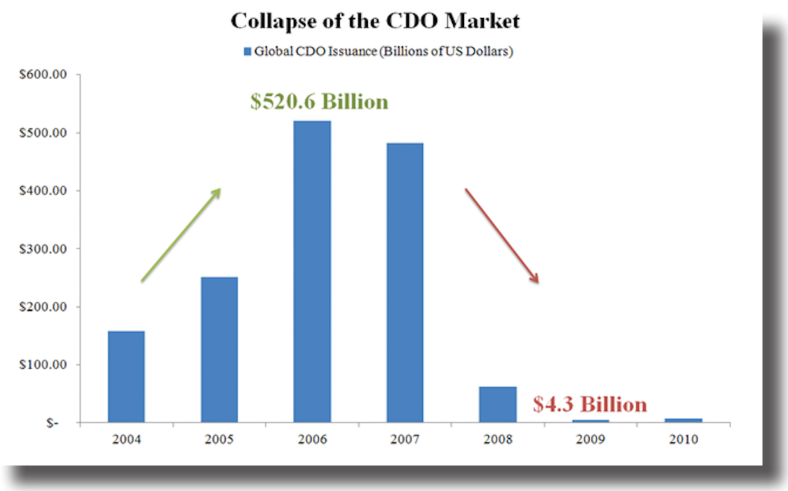
The two bear markets since 2000 have taught investors two vital and distinctly different lessons. In 2000 investors should have recognized that paying too much for a stock can be financially deadly. In 2008 investors should have realized that failing to understand the operating business behind a stock can be equally lethal. To a lesser—but no less remarkable—extent has been the progress of non-financial corporate America. In spite of a tech recession in 2001, a financial meltdown in 2008, and a sluggish recovery since 2008, corporations have managed their businesses well. Two years removed from one of the worst profit recessions in the last 50 years, corporate profits and cash flow are at record highs.

Bonds—The High Cost of Opacity

Sometime in the mid-1980s investment bankers on Wall Street learned how to transform bonds from mundane financial instruments into rocket-fueled investments. We believe it started with mortgages. Wall Street learned how to take a standard 30-year mortgage and strip out the 360 monthly principal payments and 360 monthly interest payments. The principal and interest payments were then sold separately into the markets. This allowed for a dizzying array of possible outcomes based on changes in interest rates. If you bought a principal payment due in seven years and the mortgage was refinanced, you received your principal payment seven years early. Of course, on the other side you lost your interest payment due in seven years.

This financial alchemy was high-proof booze poured into the punch bowl. There was an early sign of the danger of these instruments with Piper Jaffrey’s bond fund failure in the early 1990s. But Wall Street weathered the storm and marched on.

By 2007, three letter symbols defined the bond market, including CDO, MBS, CDS, and ABS, to name a few. The intent and consequence of far too many of these instruments was to separate the lender from the actual borrower. Wall Street created pools of debt and split the pools into different tranches. The last tranche to default often received a Triple A rating, even though the securities in the pool were of poor credit quality. These pools exploded in popularity early in the decade and collapsed after the 2008 financial crisis. The table at right, courtesy of Wikipedia, illustrates the dramatic increase and collapse of Global CDO issuance from 2004-2010.



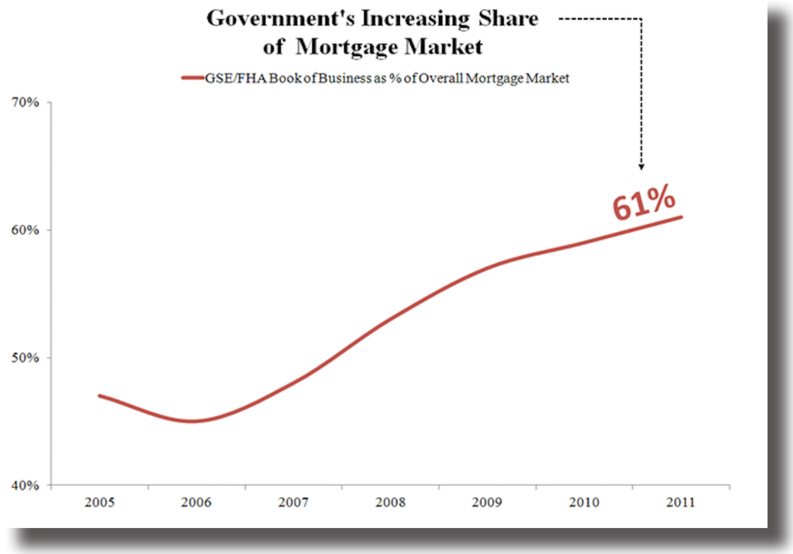
The rating agencies should have been watchguards over the credit quality of the bond pools. Inexplicably, the agencies allowed tranches of the pools to be rated investment grade and thereby qualified for trust-quality institutional portfolios. The collapse of these bond pools was a major factor in the near-collapse of the financial system in 2008.

The other debt story is the socialization of private debt. The U.S. Treasury initially eased its way into the private debt markets at least two decades ago when Fannie Mae and Freddie Mac began to become huge factors in the mortgage market. Goaded by ambitious politicians and aided by the implied guarantee of the U.S. Treasury, the management of these companies were all too willing to set aside prudent lending standards in the mortgage market. Fannie Mae and Freddie Mac were unable to survive the 2008 meltdown.

Since 2008 the federal government has continued to socialize private debt through the FHA, Fannie Mae and Freddie Mac, and the Federal Reserve.

In the mortgage market the big change since 2007 has been the increased activity of the FHA, which guarantees loans. The overall principal loan guarantees by the FHA has risen from $400bn in 2007 to $1.1tn in 2011.

While the total mortgage portfolio for these three entities' (FNM, FRE, FHA) has increased since 2007 (from $5.3tn to $6.2tn), the overall mortgage market declined (from $11.2tn to $10.3tn). Overall government involvement in the mortgage market has risen from 48% (2007) of mortgage debt owned or guaranteed to 61% (2011).



The table at right illustrates this significant change.

Private lenders to these bond pools violated this fundamental investment principle: know what you own. Purchase of opaque pools of bonds with the blessing of the rating agencies may have been the stylish way to improve interest income. Unfortunately, it was not prudent.

Money Market Funds

Money market funds were one of the great concepts in the mutual fund industry. The idea that a fund could provide access to short-term capital markets for a group of smaller investors was revolutionary. By the end of 2008 there was nearly $4 trillion invested in money market funds. The market value of money funds that year actually exceeded the market value of the other two mutual fund categories- equity funds and bonds funds.

The concept of a money market fund contained two major flaws. The funds were always priced at par, so the fund may or may not reserve for bad debt losses. Second, the money market funds needed generally high short-term interest rates to pay their management fees.

Investors were making investments in securities about which they knew very little. Were they willfully ignoring the risk, or were they using flawed assumptions of risk?

In 2008 the money market concept crashed. The Reserve Fund, hit by credit losses, was unable to hold its value. Investors were trapped in the fund. Another major problem with money funds developed over the years. Investors began to think all money market funds are the same. This was dangerous. Many funds purchased auction-rate preferred securities to enhance their yield. These funds were unable to redeem their client requests for money.

Since the end of 2008 money market fund assets have declined about 40%, to $2.5 billion.

From our comments above a common thread across all three asset classes emerges in 2008. Investors were making investments in securities about which they knew very little. Were they willfully ignoring the risk, or were they using flawed assumptions of risk? We think the evidence shows that many investors were using a flawed model for assessing and managing risk, one based primarily on volatility. This proved fatal for many investors in 2008.

In our piece titled, "A New (Old) Era of Risk Management," published in 2009, we discuss in-depth our view of volatility as a measure of risk. You may access this piece via our website, www.dginv.com.

Forecasts

Adverse events can teach great and enduring lessons. During the last decade investors suffered two of the five worst bear markets in the last century. What an opportunity to learn!

We can apply those lessons to make forecasts about the future returns. We will focus on stocks, bonds, money market funds, and investors' perception of risk. These areas are most important to us and our clients.

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Stocks

Our work shows that stocks will be the clear winner over the next seven years. Based on reasonable forecasts of revenues, earnings, and cash flow, our stocks are priced to yield returns above our hurdle rates (12% for mid-caps, 15% for small caps).

There are other equally compelling reasons to favor stocks today. The business model of America has improved. Profit margins and cash flow are at record highs, and we believe they are sustainable at levels higher than long-term historical averages might suggest given the vastly more profitable business models. Advancements in distributed computing and networking have revolutionized the U.S. business world. Corporate cash on hand is at record levels.

The U.S. economy is stagnant in the aggregate, but is very dynamic when viewed on a sector-by-sector or company-by-company basis. The revolution in shale oil and gas is breathtaking. Housing appears to be bottoming after a five-year depression. The collapse of the shadow banking system has opened up possibilities for regulated banks to earn better loan spreads. Well-managed companies in virtually all segments of the economy are focusing on managing their businesses well. They are capturing market share and achieving record levels of profitability.

The pace of applied technological innovation is rapid. Apple, the largest capitalization company in the world, was an obsolete PC company 12 years ago. Google and Facebook did not exist then. Amazon is rewriting the rules of retailing. There are more Apples in the tree; even if they achieve one-third the impact of Apple, they will change the commercial world and provide tremendous opportunities for alert investors.

The stock market is sufficiently transparent for investors. Over the past 20 years, corporate America has been forced to clean up its act. Financial statements are issued in a timely manner and are refreshingly accurate. Investors in stocks today have sufficient information to make good decisions on stocks.

Bonds

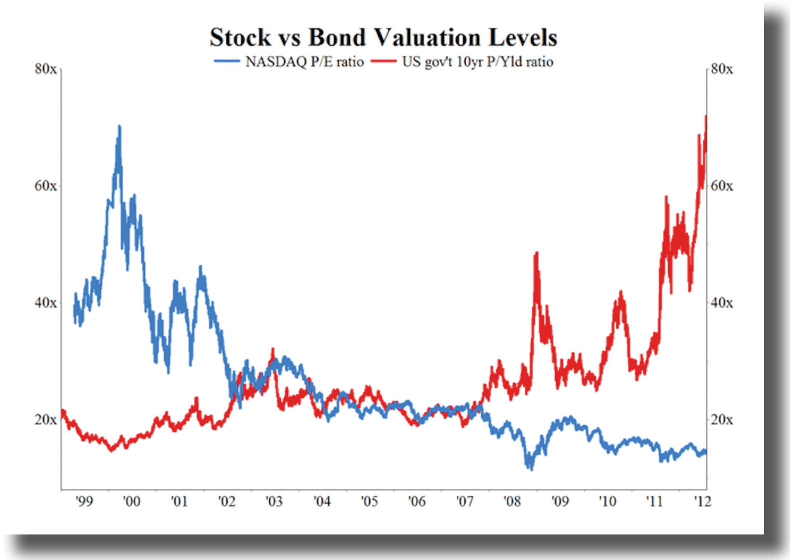
The bond market is a mess and yields are low. The market is just taking the initial steps towards sufficient transparency. There has to be a closer connection between the lender and the borrower. The lender must be able to sufficiently know the borrower so as to properly assess the riskiness of the loan.

We expect it will take years to restructure the bond market.

The federal government has socialized the bond market. Formerly bad credits are now on the books of the federal government. In addition the federal government is running large current deficits and likely future deficits from entitlement promises. The federal government is, simply, poorly managed and is clearly imprudent in its financial affairs.

It will take years to restructure the federal government. Why wouldn't a prudent investor seek to minimize exposure to federal government debt?

To make matters worse. Interest yields on U.S. Treasury debt are extremely low. Ten-year U.S. Treasury notes offer a yield-to-maturity of about 1.5%. That means an investor in U.S. Treasury notes will receive a compound return of 1.5% per year before expenses for the next ten years. This sounds like the return from the S&P 500 for the last decade.
The bond market, reflected by its largest borrower (U.S. Treasury bonds), is clearly overpriced. The chart at right shows the overvaluation of stocks in 2000 and the overvaluation of U.S. Treasury bonds today.



Money Market Funds

The money market fund industry will change radically over the next decade. The money fund industry is likely to become smaller. We expect that money market funds will experiment with floating the value. Credit loss reserves may be established. It is probable that the banks will garner a larger share of short-term investment assets.

Risk Management

Entering 2008, risk management models were so skewed that many—if not most—investors needed to significantly revise their models. Volatility must be replaced by other measures, such as knowing what you own and paying a fair price or less for an asset.

We expect it will take years for many investors to:

1) recognize that their existing risk model does not work
2) develop a new risk model
3) test the new model
4) implement the new model.

As a gauge of investor progress in revising their risk models, we can examine mutual fund cash flows. Since June 30, 2008, (nearly coincident with the bottom of the 2008 bear market) investors have withdrawn over $400 billion from equity mutual funds and deposited over $800 billion into bond mutual funds. From this data we can surmise that the initial response of investors to flawed risk models was to shift from a high-return, sufficiently transparent asset class to a low-return, opaque asset class.

This suggests it will take years for investors to revise their risk models.

Political and Macroeconomic Conditions

The macroeconomic and political backdrop to this environment will not be comfortable. One of the key factors for investors will be the political and economic after-shocks after 2008. In 2011 it became clear that the Keynesian economic model does not work as expected in the United States. Unemployment in the United States has become chronically high. Also, in 2011 the serious cracks in the Eurozone model have become apparent. The possibility that Greece, an inconsequential economic entity, could tip over the European banking system is hard to fathom.

To make matters worse, a change in the Mideast of historic proportions became evident last year. Beginning in Iraq in 2003 with the fall of Saddam Hussein, the Arab strongman model is crumbling. In 2011 the pace quickened with an uprising in Tunisia. Now Khadafy is gone in Libya, Mubarak in Egypt, and the House of Assad is teetering in Syria. Israel may be more vulnerable than ever. With the exception of the fall of the Berlin Wall in 1989, the turmoil in the Mideast is the most important political upheaval in decades.

These major political/economic events are going to take years to resolve and their ultimate resolution is not yet clear. There is a wide range of possible outcomes. Investors must appreciate the difficulty in coping with these major issues.

Most importantly, investors must not allow these issues to distract them from the fundamentals of investing. This period of turmoil offers high potential returns to those who learn and apply the lessons of the last decade.

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Forecasts contained in this article are based on Disciplined Growth Investors' internal assumptions for individual securities at the time of publication and are not a guarantee of future performance.

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About Disciplined Growth Investors

Disciplined Growth Investors is a Minneapolis-based investment management firm specializing in prudently exploiting investment opportunities in publicly held small cap and mid cap growth companies. Founded in 1997, the firm remains employee owned and completely independent.

About the Authors

Fred Martin is Disciplined Growth Investors' founder and Chief Investment Officer. Fred has been managing portfolios since 1976 and is the primary architect of the investment philosophy employed by the firm.

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