# The Patient and Disciplined Investor…

***Ruminations on long-term wealth building***

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***"I have observed that not the man who hopes when others despair, but the man who despairs when others hope, is admired by a large class of persons as a sage." – John Stuart Mill***

## Pessimism Hasn't Worked Before…Why Should it Work Now?

Consumer sentiment indicators recently hit new lows. Pessimism apparently is rampant. Are we depressed because we're in (or going into) a recession, or are we in (or going into) a recession because we're depressed? Well, hard to say. I know things are difficult for many people right now, but let's keep the faith. This is the United States and regardless of your politics, this country arguably remains the most free, prosperous, technologically advanced, and militarily strongest country on the planet.

We can probably mostly agree Congress can't seem to get much done lately and that they probably blew it on the debt issue. But can you imagine this country if Congress were, in fact, good at getting things done? As the old cliché goes, be careful what you wish for. The founders purposely set up a system of government that was, by definition, inefficient. They were correctly concerned with tyrannical rule by a majority. Our democracy, - or more correctly in America, a republic – is, by definition, inherently inefficient. While this has historically been a strength, it could turn out to be a curse on this debt issue because meaningful reform does indeed need to happen. But at least we're finally discussing and debating it.

Experience tells me that too many people make important decisions with their long-term investment funds based on the pessimistic hyperbole shrieked about in the media. To get back on track, let's consider all of the alleged "crises" and pessimistic forecasts over the last 50 years that did NOT cause our investment markets to crater or relegate the United States to a second-class economic power. It's an impressive list, and I'm sure I've missed a "crisis" or two. Had you capitulated to these pessimisms and sold your investments (or refrained from investing), you probably would have regretted that decision. In no particular order, the pessimisms include: bird flu, Y2K, nuclear winter/extinction, terrorism, urban pollution, over-population and third-world poverty, 1970s inflation and the associated high interest rates and economic malaise, various wars, 9/11, running out of oil, superior Japanese business acumen in the 70s and 80s, crime and violence, communism, Ebola, AIDS, and SARS (among other imminent viruses and plagues, including mad-cow disease), acid rain, disappearing ozone, and asteroid impacts - not to mention killer bees, ever-expanding government, falling savings rates, trade deficits, Jimmy Carter and Richard Nixon (arguably the two worst Presidential offenders of sound economic policy), thinning forests and disappearing rain forests, and expanding deserts.

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Yet, during all of these "crises", here is a look at the closing price by decade on the last day of the year over the last 50 years for the S&P 500 along with the earnings per share of the S&P 500:

| | S&P 500 Close[1] | S&P 500 Earnings[2] |
|---|---|---|
| 1960 | 58 | $ 3.10 |
| 1970 | 92 | $ 5.51 |
| 1980 | 135 | $14.99 |
| 1990 | 330 | $22.65 |
| 2000 | 1320 | $56.13 |
| 2010 | 1258 | $83.66 |

These closing prices do NOT include dividends. And notice how earnings increased 49% from 2000 through 2010, yet stocks were down 4.7% (stocks were most likely overvalued in 2000). Companies continue to earn plenty of money – and earnings ultimately drive stock prices – despite each successive, repetitive, gloomy headline.

**And here's where it gets very interesting. There are an additional three billion - yes that's B as in boy - people in emerging markets who are beginning to participate in the world economy by moving from poverty into the middle classes.**

Today, the media has fun torturing us with global warming, Greek debt, the economic and military rise of China, outsourcing of U.S. jobs, the near certainty that the dollar will lose its reserve currency status, and U.S. government debt, blah, blah, blah. Sure, these could be problems with which we must deal (and I do believe that our government debt needs more creative, disciplined solutions), but investment decisions driven by pessimism have yet to be a good long-term investment strategy since human beings started trading stocks on exchanges and the first industrial revolution started about 200 years ago. In fact, despite temporary setbacks, things have gotten decidedly better whether it's medicine and health care, food distribution, life expectancy, manufacturing, food and product safety, science, animal species preservation, textiles, computing

power, crime prevention, communications, agriculture, or transportation. You name it, we're better at it – much better at it. Why? Because of the exponential progress human beings are making by sharing ideas, technologies, and information – all of which is explosively being taken to new levels by the internet.

And here's where it gets very interesting. There are an additional three billion - yes that's B as in boy - people in emerging markets who are beginning to participate in the world economy by moving from poverty into the middle classes. It's nearly inconceivable what this will do to propel human progress forward as they begin to participate in the information exchange with the developed world. Ideas are "mating" with each on the internet, and this will continue – and accelerate - the evolutionary trajectory we've seen the last 200 years.

Of course, the question for investors is how might all of this translate into higher earnings for companies - and therefore higher securities prices. I believe that it will be a positive thing. Sure, there might be even more economic disruption, and probably volatility in our markets, but the investment opportunities could be staggering. As people move out of poverty and into the middle classes, they are better able to plan and invest for the future, purchase land, and start a meaningful business. They might take a job with a large U.S. multi-national company, care about the pollution in their environment, and buy the products and services produced by American companies. And, perhaps most importantly, they will be able to buy stocks and bonds.

For an excellent and detailed discussion on the emerging middle classes in the world, see the OECD Development Centre, Working Paper No. 285 by Homi Kharas entitled "The Emerging Middle Class in Developing Countries".[3] The author argues that it is the middle classes which have historically propelled societies forward, starting with the bourgeoisie in the late 1300s.

> [T]he middle class has been thought of as the source of entrepreneurship and innovation – the small businesses that make a modern economy thrive. Middle class values also emphasize education, hard work and thrift. Thus, the middle class is the source of all the needed inputs for growth in a neoclassical economy – new ideas, physical capital accumulation and human capital accumulation.

According to the author, the middle classes contribute four major things to societies. First, more middle class people tend to cause more democracy in societies. Second, the middle class is a large source

[1] http://www.davemanuel.com/where-did-the-djia-nasdaq-sp500-trade-on.php

[2] http://people.stern.nyu.edu/adamodar/New_Home_Page/datafile/spearn.htm

[3] http://www.oecd.org/dataoecd/12/52/44457738.pdf

of entrepreneurs. Third, more middle class citizens result in higher rates of savings and human capital (including education, infant mortality, and life expectancy). And fourth – perhaps most importantly from an investment perspective -- there is a link to consumption. "[T]here is a kink in consumer demand curves around USD6000 per capita. Above this level, the income elasticity for items like consumer durables as well as for services like *insurance* rises well above one." (emphasis joyfully added!!)

The amount of people moving into global middle classes could be truly staggering: "Globally, the size of the middle class could increase from 1.8 billion people to 3.2 billion by 2020 and to 4.9 billion by 2030."[4] And China and India will most likely be the driver of this seismic shift. "China's middle class today is already large in absolute terms – at 157 million people."[5] (which, my dear readers, is only about 12 percent of China's population). South Korea was in a similar position in the 1960s and 1970s. Today, 94% of South Koreans are middle class.[6] Similarly, a McKinsey Global Institute 2007 report said that India's middle class will rise from 50 million (in 2007) to 583 million by 2025.[7]

This is not some Pollyanna wish from a guy in Colorado who is simply hoping for better economic times. To the contrary, this is a megatrend that I believe will eventually win the day for patient, disciplined investors – despite our current economic pain. Moreover, you could be the recipient of some breakthrough medical technology that eventually saves your life which is developed in Jakarta, Indonesia or Calcutta, India – a breakthrough that would not have happened if it wasn't for the middle-class transformation now taking place in the world.
Stay invested, my friends.

**Bottom Line: Admittedly, there are some dark clouds that hang over the U.S. economy. But I remain firmly optimistic on the investment opportunities as we move into the medium and long-term future. The rising global middle class is a megatrend -- ignore it at your peril. Since the first industrial revolution, things have become better – much better.**

[4] Ibid.
[5] Ibid.
[6] Ibid.
[7] http://www.mckinsey.com/mgi/mginews/bigspenders.asp.

## More Evidence of Investor Fear and Pessimism

I enjoyed an excellent editorial that appeared in the Wall Street Journal on Monday, August 22nd written by Jeremy Siegal and Jeremy Schwartz entitled, "The Bond Bubble and the Case for Stocks." This article, however, is a reminder of just how much fear and pessimism is out there. I hope the politicians are taking note – at least if they want to get re-elected - because the story is in the numbers. And the story in these numbers is that people are afraid. How else do you explain a rating downgrade for the U.S. government – and then more money promptly piles into U.S. Treasuries (fear of deflation) and gold (fear of inflation). Strange times, indeed.

Messrs. Schwartz and Siegal note that the yield on the benchmark 10-year U.S. Treasury Inflation Protected Securities ("TIPS")[8] turned negative for the first time ever – meaning that investors are now lending money to the government with the hope of receiving back less money in ten years after inflation. In other words, they're willing to lose purchasing power – in an investment that is considered "safe". This "astounding situation" assumes some extreme assumptions by investors, according to the Messrs. Schwartz and Siegal, including zero productivity growth (it currently averages 2%), zero GDP growth

(the U.S. population is sill increasing 1% per year), and a decline in the labor participation rate at twice the rate over the last ten years – all unlikely scenarios. Considering new technologies, global interconnectedness, and more competition, it's hard to envision productivity rates going to zero.

Messrs. Schwartz and Siegal then note that you might consider dividend-paying stocks instead of U.S. Treasuries. They state -- quite correctly -- that "dividends of the S&P 500 firms have grown at 5% per year over the last half-century, which handily beat…inflation of 4%." In stark contrast to our government, balance sheets indicate that U.S. corporations are hoarding cash in record amounts – cash that can be used to buy other companies, buy back stock, and increase dividends to shareholders. These activities are generally good for stock prices.

[8] Bonds issued by the U.S. government beginning in 1997 that are designed to protect investors from inflation and rising interest rates. Remember that bond prices move inversely to market interest rates. In other words, as interest rates rise, bond prices decrease – all things being equal.

And don't forget that large U.S. companies are earning substantial amounts in emerging markets.

While Messrs. Schward and Siegal don't say it in so many words, patient, disciplined equity investors historically have been rewarded by sticking to a strategy during tough economic times.

**Bottom Line: Given the level of U.S. government debt, I, too, think I'd rather invest in corporations than the U.S. government.**

## Umbrella Protection – Are You Exposed?

One of the eight risks (as I've defined them by experience) that could derail you on your way to successfully reaching your financial goals is the risk that you might be sued after an auto accident or if something happens on your property (or away from it – such as hitting someone with a golf ball).

The average auto accident jury award has risen significantly to $972,682 – the median award was much lower at $41,486.[9] These divergent numbers, however, are saying that there have been some very large settlements – well in excess of the average award of $972,682. Jury awards for premises liability arising under a home insurance policy have increased to $2,001,754 with the median number coming in at $215,718. Think…your dog bites a neighbor in the face, your neighbor Joe slips on the ice on your sidewalk walking his dog and hits his head on the concrete resulting in a permanent brain injury, or a cute little Katie, a neighborhood girl on the block, is severely injured on your trampoline. By the time you figure in emotional distress, loss of marital consortium, lost wages, and medical bills (maybe even wrongful death), you can get to very large settlement numbers.

If your insurance policy does not have enough coverage to pay for the settlement awarded, then you could be forced to liquidate personal assets to settle the judgment. Colorado law only allows you to protect $60,000 of equity in your home - $90,000 if you're over age 60.[10]

You can do everything right – work hard, dutifully save, make tough choices and stick to a budget. Then one day it's gone because you overlooked your insurance coverage or declined to accept your agent's coverage recommendation…because you believed some bimbo on TV with a goofy smile who said "name your price" when you buy auto insurance…because you've seen too many auto insurance commercials over the last ten years that all claim to offer the lowest price – which caused you to overlook the more important decision of first selecting the proper coverages.

Fortunately, liability insurance offered through a personal umbrella liability policy is very affordable. The average premium is around $200 to $250/year. Should a terrible situation arise, you will be very glad you are protected throughout the process of a personal-injury lawsuit – a process that can easily last three years from the date of the accident before the lawsuit is settled.

**Bottom Line: Buy insurance for the things that could ruin your life, not ruin your day.**

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[9] http://www.verdictsearch.com/index.jsp?do=trends

[10] Section 38-41-201, Colorado Revised Statutes.