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By John Mauldin

Writing on the train to Yorkshire from London, I am surrounded by a gorgeous English countryside on a beautiful spring day. Life has its moments. I like the trains in Europe. Quite a civilized way to travel. Yet every time I pull out my wallet, I am reminded of reality. The ebb and flow of the dollar has made this a most expensive country for someone from the states. Nearly everything is the same price, just in pounds instead of dollars. And a pound that is worth more than two of my pitiful dollars, at that.

It has given me cause to think about cycles, because some day in the future, the English will be complaining about how expensive it is in the states. Maybe not for a long time, but all things ebb and flow, currencies included, but especially the stock market.

The stock market in 2005 has gotten off to a mixed start. January presented losses, often not a good sign for the rest of the year. We had a little hope with a positive February, yet we are back in negative territory after March. Most investors want to better understand the implications of the current secular bear market—how long will it last, what can we expect from it, and why is it happening?

We can find these answers and much more in an incredible book by good friend and industry colleague Ed Easterling called Unexpected Returns: Understanding Secular Stocks Market Cycles. I am going to review his book at length this week because it will help you to answer pressing questions about secular stock market cycles, the current cycle, and what you can expect in the years to come.

As you may remember, Easterling’s firm is Crestmont Research (www.CrestmontResearch.com) and his work has been included in many of my letters in the past. Many of you will recall that some of the research and charts were included as well in two co-authored chapters in Bull’s Eye Investing. One of his most recognized charts is the Stock Market Matrix, the colorful mosaic of stock market history that was a large foldout in Bull’s Eye Investing.

Easterling’s background and experience includes extensive work in the financial markets and hedge funds. He also serves on the adjunct faculty in the Cox School of Business at SMU and teaches a graduate-level course on hedge funds to MBA students. In Unexpected Returns, he has successfully taken detailed research and a scholarly perspective and presented it in a layman’s style for the benefit of a very broad audience.
For all of you that have visited his website, you have seen the extensive charts and graphs that he uses to reveal insights about stock market history, interest rates, and secular stock market cycles. *Unexpected Returns* includes his charts and graphs, over 60 of them, in full color—you will not find many other investment books that include such graphics that make it so much easier for readers to understand their meaning and messages. Beyond its great presentation, the real value of his book is the information and powerful insights. You can order the book at Amazon [insert your link]. It should be required reading for professionals. Serious investors will devour this book and profit.

You should get your kids to read this book before they start investing or as a condition for getting their inheritance. If you don’t understand how the markets cycle, you get caught up in chasing them, which is a prescription for losing money. It is the way we are psychologically hardwired. See deer. Chase deer. Kill deer. Eat Deer. Life is good.

Except the markets are not like a deer. The market is a very cunning, mean and vicious predator, luring us into a chase, toying with our emotions until it turns and devours our retirement plans. You can handle and tame the beast, but only if you understand how it works. And right now, it is setting up a generation – my generation – for a feast. Only we will be the menu and not the guests.

I had the opportunity to read Ed’s manuscript. It is not something meant to be read in one evening. It must be read chapter by chapter and meditated upon. It is not fast food, but sustenance for a month. Let’s dig into the details; it will forever change the way you approach investing in the stock market.

**Your Investment Journey**

Easterling’s approach in *Unexpected Returns* is to guide the reader on a journey that reveals the nature of secular cycles in the stock market, the fundamental causes of the cycles, and the ways to adjust your investment strategy. The book is divided into six bite-sized sections. The first one sets the stage for the details that follow. He introduces basic concepts to the reader that become useful tools through the rest of the book. You will begin to see the messages forming on the horizon and will be intrigued to dive into the rest of the book.

One of the concepts that threads throughout the entire book is the idea that long-term returns can be misleading if misused. Investors need to focus on time periods that are relevant. Easterling explains the concept of “farsightedness”:

“In the field of ophthalmology, farsightedness is the ability to see distant objects better than objects that are nearby. It is probably fair to say that most stock market optimists suffer from investment farsightedness. A long-term perspective is quite relevant for scholarly studies and for the assessment of long-term relationships, but it is not a good idea for developing assumptions that are to be used for investment planning. Most investors do not have such long-term horizons in their real lives; further, their investment performance can be improved by including assumptions that take into account the likely effects of shorter-term conditions.
"Interestingly, farsightedness is more often experienced with stocks than with bonds. The conventional wisdom on stocks is that you should invest with a long-term perspective and can expect the long-term return over time. Keep in mind that such advice held the same long-term return outlook for the investor in stocks in early 2000 as it does for an investor today—according to conventional wisdom, both investors can expect the same long-term return. Understandably, you know that such thinking is not logical or reasonable, yet that reasoning has become mainstream thinking by many investors and is reflected in the advice of many professionals."

"…The value of history rests in the insights that it can provide about the many shorter-term periods that comprise the long term. Conventional wisdom often takes a long-term view, however, and ignores the underlying details, thus missing the opportunity to learn from history. The research presented in the chapters that follow will unpack uncommon insights about stocks and the financial markets by looking at the trees that create the forest. Further, the book will provide you the tools and understanding to more accurately interpret the wide range of information streaming from investment sources."

"During the 1980s and 1990s, the brawn of the bull market enabled every investor to generate gains in his or her portfolio. The stock market environment changed in 2000 when the bubble of the late 1990s burst. Over the past several years, the market has deflated back toward reality. Many investors now are hopeful that the market can resume its historical ascension and again provide average returns. In reality, the fundamental market conditions are positioned for returns to be below the historical average for some years to come.”

A Storm of Volatility

Section II delivers details about stock market and interest rate history. One of Easterling’s messages is that most investors are not fully aware of the high level of volatility that is typical in the financial markets. During the last secular bull market in the 1980s and 1990s, the big moves were always to the upside. Investors are much less aware of downside volatility than upside volatility. That is why 2002 seemed like a 100-year flood. Yet as Easterling explains, such downside volatility is quite consistent with history. That hundred year flood happens with regularity. Quoting from chapter 3:

"The stock market is much more volatile than most investors realize. One measure of volatility is the range of annual moves in the market from year-end to subsequent year-end. The market moves dramatically both positively and negatively to ultimately produce its modest long-term average return.

"The average annual change for the Dow Jones Industrials Average stock market index, as a simple average, is just over 7% over the past century, 1901–2003. Over that period, in what percentage of the years would you expect that the annual change would occur in the range of –10% to +10%? Most investors seem to guess a number between 60 and 70 percent—that a clear majority of the years would be inside the range. What range would be required to include half of the years inside that range? As reflected in figure 3.6,
it is very surprising to most investors that the yearly change in the stock market has been inside the range of –10% to +10% only 30 percent of the years. Remarkably, to include half the years inside the range, it has to be expanded to –16% to +16%. The profile is not affected by years early in the century; the percentages are very similar over the past fifty years and the past twenty years.

“Yes, when you awaken on New Year’s Day and contemplate the coming year’s impact on your investment portfolio, there is a 70 percent chance that it is going to be a double-digit year—up or down. In addition, there is a 50 percent chance that the change up or down will be in the high teens or greater! If New Year’s Eve did not give you a headache, the level of volatility certainly should.”

He really drives home the risks and expectations for volatility in the current secular bear cycle when he expands the chart in chapter 5 to highlight that secular bull markets have upside volatility and secular bear markets have a higher proportion of downside volatility. Again from Unexpected Returns:

“By expanding the Significant Swings analysis from chapter 3, figure 5.2 reveals that the distribution of the return profile differs greatly between secular bull and secular bear markets. Even when the data is separated into secular periods, the frequency of years inside the 10% and 16% ranges remains consistent. The revelation is that the extremes reflect a contrasting pattern.
“Across the past 103 years, 50% of the years ended within the broader range of –16% to +16%. When the years are again delineated into secular [bull and bear market] periods, the frequency of years within the broader range remains fairly constant during both secular bull periods and secular bear periods. Note that secular bulls have 50% of the years inside the range and that secular bears have 49% within the range. The volatility of dispersion again remains fairly constant across secular periods.

“Note that over the entire 103 years, 30% of the years ended within the range of –10% to +10%, the so-called single-digit years. When the years are delineated into secular periods—the secular bulls with generally rising P/E ratios and the secular bears with generally declining P/Es—the frequency of single-digit years remains fairly constant during both secular bull periods and secular bear periods. Note that secular bulls have 30% single-digit years and that secular bears have 29% single-digit years. The volatility of dispersion remains fairly constant across secular periods.

“The most significant dynamic of the analysis relates to the frequencies outside of the range. Across all periods, 35% of the periods reflect changes that are greater than +16%. Further, 16% of the periods present themselves below –16%. In the long run, having twice as many super-positive periods helps to offset the super-negative periods.

“When the years are divided among secular bull periods and secular bear periods, the contrast is illuminating. During the periods of generally rising P/E ratios, none of the years were below –16%! All of the years outside of the broader range of –16% to +16% were super-positive years in excess of +16%. During the periods of generally declining P/E
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ratios, there were almost twice as many years below –16% as there were above +16%. The super-negatives were almost double the super-positives.”

Gentle readers, the ride for many years to come will be rough and rugged. Although we will be trudging along in a muddle-through economy with an occasional recession, the stock market will be all but calm. This has significant implications for managing your portfolio and for developing your retirement plan, especially if you are in or near retirement. You will not want to look back in five years and wonder why the second half of this decade was similar to the first five from 2000 to 2004.

The Calm Before the Storm

Easterling has packed chapters three and four with perspectives on the performance of the stock market over the past century. Unlike the approach of most market cheerleaders that consider the past 80 years to be homogeneous, he slices-and-dices the market into meaningful views and looks at returns over twenty-year periods, returns based upon starting P/E ratios, and many other insights. Easterling reveals the long-term seasons of the market and does not try to blend summer into winter—he highlights these differences and helps his readers to adjust their investment strategy accordingly.

By the third section of the book, you will have grasped a firm understanding of key principles and stock market history; Easterling then explains secular cycles and their profile. In chapter 6, he very effectively builds the case that the current cycle is a secular bear and that it is early in its reign. Easterling demystifies secular cycles and explains that they are not an unexplainable pattern or coincidence; rather secular cycles are caused by the trend in the P/E ratio. Corporate earnings tend to grow over time, whether in secular bull or bear periods. During the periods of secular bulls, earnings growth is magnified by a rising P/E ratio. For example, when earnings grow by 6% annually over a 12-year period, they double. Compounding has a powerful effect. If the P/E ratio remains the same over that period, the stock market would double based upon the increase in earnings. During a secular bull cycle, P/Es have often started near 10 and ended over 20, a doubling of the P/E ratio. When combined together, however, the effect is a four-fold increase in the market! A raging bull that provides stellar returns.

In a secular bear cycle, P/E ratios fall from high to low. In the prior example, had the P/E started at 20 and ended at 10, the change in the P/E would have offset the rise in earnings to produce a flat result. Many secular bear markets have been long, volatile periods with little to show at the end. And some of them start with P/Es well over 20 and end well under 10—those periods deliver negative returns. Even when the market is flat over a long period, Easterling points out that the effects of inflation cause investors to have a substantial loss in purchasing power.

His fourth section in Unexpected Returns explains the reasons that P/Es tend to rise and fall over many years. In a step-by-step process, he builds the components that tie factors in the economy to the stock market. The result is a clear understanding of the impact of inflation on P/E ratios. With inflation recently at low levels, the likely direction
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for the stock market is down, because rising inflation is never good for the stock market, nor is deflation. To expect inflation to always be low and stable simply ignores history.

Easterling’s Valuation Cascade explains the natural peak for P/E ratios. He uses the principles of the dividend discount model to explain what many scholars have determined, there is a natural limit to P/E ratios in the low 20s. That is why past cycles have peaked in the 20s (except for the bubble of the 1920s and 1990s) and why this cycle is no different from the past. You must heed these warnings for your investment portfolio; the messages are clear and unmistakable.

Of particular relevance recently, as investors have begun to reach for return by taking on more risk or investing in riskier investments, Easterling makes another great point early in the fifth section by distinguishing between expected returns and probable returns. He writes:

“The phrase “expected returns” is used in the financial community as a reference to the rate of return that an investor should require from a certain investment, given its risk profile. In 1952, when Harry Markowitz published the principles of Modern Portfolio Theory in The Journal of Finance, he referred to expected returns in his “expected returns—variance of returns” rule. In that context, expected returns “include an allowance for risk.”

“Therefore, expected returns, other than yields from risk-free Treasury bills, include a risk premium—a gross yield before any losses. In the example of the higher- and the lower-quality bonds, the lower-quality bond is priced to yield higher interest payments due to its greater risks. Consider the example of a higher-quality bond, a U.S. Treasury Bond yielding 5%, and a lower-quality bond issued by a risky company. Due to the greater risk of loss, investors will require that the corporate bond have a higher yield, say 10%. Since there is generally no risk of loss on the Treasury bond, the expected return of 5% will be 5%. But, the expected return of 10% on the corporate bond may be realized at 10% or it may be less if there is a credit loss.

“In a portfolio diversified across numerous corporate bonds that yield 10%, it should be expected that the realized portfolio return will be less than 10%. There is a high probability that at least a few losses will occur given the higher risk profile of the bonds. As a result, there will be a difference between “pre-risk expected yield” and “post-risk probable yield.” Investors are often seduced into higher-yielding investments without considering the likely post-risk return. This is a crucial concept when considering the risk premium of asset classes, including stocks.

“Every security is priced to an expected return based on its risk profile; yet, the probable return for investments with risk is not the expected return.”

Timely Advice

Easterling’s insights are particular timely as investors continue to reach for return. The volatility of the markets has declined over the past year to unusually low levels and
the interest rate spreads on high-risk bonds have fallen as well—signals that investors have become complacent to risk and are beginning to expect the expected return. They are forgetting about the losses that inevitably occur with risky investments.

During secular bear markets, the trends swing from short bull market moves to short bear market declines. These conditions can last for a decade or more. I have been writing since 1999 that if you want to be successful with your investments, you will need to change your approach during secular bear market conditions; the approach in the past two decades during the secular bull will not work in a secular bear cycles.

As Easterling states: “Current market conditions are positioned for higher risks and lower rewards than average. It is a good time for investors to develop stronger business plans for investing—plans that both consider the expected market environment and incorporate the strategies for wealth development and wealth preservation that do not depend on strong stock market gains.” Toward developing a better approach to investing, Easterling introduces the concept of “Row, Not Sail” investment strategies. He explains:

“The traditional approach to investing in stocks and bonds is known as asset class investing. An asset class is a series of securities whose price tends to move in a similar direction based on external market conditions. For example, stocks and bonds each are individual asset classes. Harry Markowitz’s Modern Portfolio Theory (MPT) encourages investors to hold diversified portfolios of stocks and bonds to realize the general trend of the market. Over longer periods of time, both stocks and bonds have produced solid investment returns for investors who held onto the portfolios and rode the trend in the market.

“As discussed in chapter 5, those returns tend to come over intermediate periods characterized by secular bull or secular bear markets. During the periods of secular bull markets, an investor can enjoy the plentiful gains in the market simply by holding portfolios of the rising asset classes. Much like the sailor, the investor does some directing and generally enjoys the ride. MPT and the traditional approach to investing provide a few simple rules about diversification and patience, which, in the long term, should provide success.

“Rowing, as an action-based approach to boating, is analogous to the absolute return approach to investing. The progress of the boat occurs because of the action of the person doing the rowing. Similarly, in absolute return investing, the progress and profits of the portfolio derive from the activities of the investment manager, rather than from broad market movements.

“When the secular bull market changes into a secular bear market, the investor can either wait for the next secular surge or grab the paddle. Without rowing, the boat would eventually achieve the historical progress that investors expect over the long run. By its definition, the long-run average is the average of periods of secular bull markets and secular bear markets. Historically, however, the secular bear markets have lasted for five, ten, and as much as twenty-year periods. For investors with shorter horizons of only a decade or two, a strategy of patiently watching a flapping sail during a stalled market may
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not be satisfactory. Further, in some secular bear cycles, there are periods of being pushed backwards into investment losses. At times, investors who desire to avoid losses or generate gains may need to grab the paddle. Examples of rowing strategies can include buying undervalued securities while selling overvalued securities short, exploiting temporary mispricings or market inefficiencies, investing in producing assets such as royalty trusts or timber, and selling options on core investment positions.”

Into The Sunset

As Easterling brings your journey to a close, he looks into the future of investment management and sees a convergence of the traditional approach of relative return investing and the more progressive approach of absolute return investing. One of the main drivers will be the demand by investors to include risk management in investment management.

“Early investment management was largely speculative, and the financial markets were not sophisticated. Eventually, pioneer researchers helped bring rational approaches to security valuation and portfolio construction. The early investors were hands-on managers of their portfolios. Later, academic research provided the insights and technology to address the elements of risk and risk management through diversification. Ultimately, a significant growth in mutual funds enabled investors to evolve into portfolio managers, who could hire numerous underlying specialists to perform securities selection. More recently, the emergence over the past two decades of readily available risk management tools and the expanding awareness of risk is driving further evolution for investment management.”

“… Moving forward, as the investment industry evolves in sophistication, it will begin to develop further tools and techniques of risk management that will become available to all investors. As a result, absolute return investing will be accepted and practiced by a much wider range of investors. The expected secular bear market will accelerate this evolution in the same way that the secular bull market encouraged the rise of the mutual fund industry and relative return investing.”

“Business consultants often say, “If you can measure it, you can manage it.” As risk measures are adopted as a component of total performance, investment professionals will be seeking the tools and investment funds that enhance the return and risk relationship. For mutual funds, performance is currently based on one-, three-, and five-year returns. For hedge funds, performance is based not only on returns, but also on the consistency of returns and the magnitude of any monthly losses. As risk measures are further integrated into traditional investment management, the number of mutual funds with an absolute return approach will increase. Further, the addition of risk measures will refine the ways in which mutual funds are categorized. The industry can expect that funds will increasingly be evaluated and categorized with a focus on evaluating measures of risk in addition to the history of returns.

“During this evolutionary phase of investment sophistication, investors will look for external risk management tools or for funds that internally employ risk management techniques. This focus, on both return and risk, will drive investors to adopt an absolute
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return philosophy and strategy for their investments. Today, twenty years after mutual funds began to proliferate, it is hard to imagine life without mutual funds—and traditional investing is now synonymous with the relative return approach. Twenty years from now, it will be hard to imagine life without risk-managed investments—and traditional investing will become synonymous with absolute return investing.”

Unexpected Returns is well organized and provides a solid balance of insights, perspectives, and actions that you can take to address the current environment. It combines solid principles, revealing graphics, and a reader-friendly writing style that makes the book available to a broad audience while it also will be enlightening to sophisticated professionals. Even the title of the book is well chosen. “Unexpected returns” is the term used by scholars to explain the difference between “expected returns” and “actual results”, the difference between theory and reality. Easterling’s book empowers you with insights and understandings that will forever change the way you approach investing. I encourage you to order the book today at Amazon [insert link]. Amazon offers a 3x% discount off the price of $xxx. The book will save you many times that amount on your portfolio.

Leeds, La Jolla, Houston and Napa Valley

I finish this up as we approach the city of Leeds in Yorkshire for a few meetings. I have spent two days in class studying for an exam on UK securities regulation. It is quite a daunting task, but I will take the exam next Wednesday and then head home for a few days and then off to see my partners at Altegris Investments in La Jolla. I will be in Houston April 26-27 to speak at the NAAMI conference, a brief private conference (more later) in Napa Valley in mid-May, and then my schedule looks clear for awhile.

I am starting to really focus on that UK regulatory exam next week. It is tougher than I thought it would be. I am not doing all that well on the practice exams, and need to step up. Lots of differences between the US and UK, and there are a lot of small unfamiliar facts to learn, as well as the British tax rules. (At least studying those makes you glad to be a Texan. Between the prices and the taxes, I couldn’t afford to be British.)

Of course, the study part is between interviewing hedge fund managers over here and talking to clients and the necessary work and study on the markets and economics. All in day’s and night’s work. Oh, yeah, I am going to Majorca with Niels Jensen and his team at Absolute Return Partners tomorrow early am, but between appointments I will work in a little R&R. No one should feel sorry for me. I do have fun on the journey.

Speaking of the journey, let me recommend a great publication called International Living. My old friend Bill Bonner started publishing the letter over 25 years ago. They write of homes you can buy all over the world that are still great values for the more adventurous. I really like this publication. Fun to read and it will open your eyes to the world around you. Cheap thrills and maybe something to inspire you to do a little travel. The following is a link to their promo page: <link>
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This is the weekend of the greatest golf tournament of the year. The Masters never fails to entertain. Watching the final day on Sunday evening here will be a great pleasure. Be sure you work in some pleasure for your weekend as well.

Your hoping for a four way playoff analyst,

John Mauldin