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# WOODRIDGE CAPITAL
portfolio management

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# Market Comments

Through out history the US stock market has had seasons which are multiyear periods of secular, meaning long term, bull and bear markets. Just as farmers plant summer crops in the spring and winter crops in the fall there are different market approaches to use in secular bull markets and secular bear markets.

Stock market seasons can, and do, extend for many years. Market seasons average about 18 years in length and some have run for over 20 years.

Currently the US stock market is in the middle stage of a secular bear market that began in the year 2000. Unfortunately, most investors tend to think of the secular bull market that ran from 1982 through 2000. This, like all, secular bull market was a time of tremendous gains and short lived declines. Secular bull markets are a time in which just staying invested in the stock market produces phenomenal results and relative return strategies (generally thought of as a comparison between the utilized strategy and the stock market.) work very well. However, investors who continue to use relative return strategies, or even think in relative return terms, suffer tremendously during secular bear markets. In many cases these investors abandon the stock market altogether and miss the strong gains that can be made with non relative return strategies. This happens because they fail to recognize the market season in which they were operating in at the time.

### Bull Markets Look Different Than Bear Markets

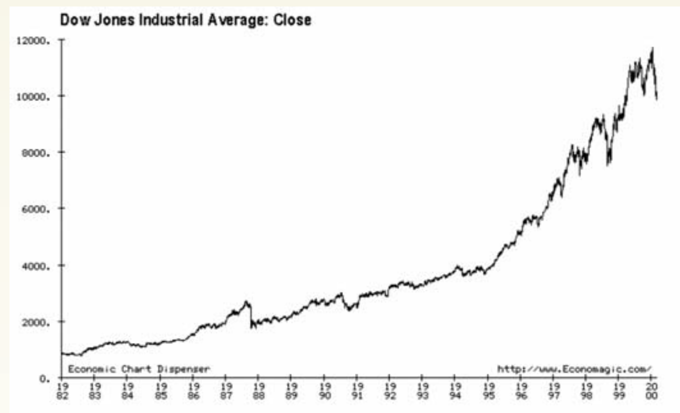
During time periods of secular bull markets it is easy being an investor. Extended periods of profitability occur when price to earnings ratios are in a rising trend. Since corporate earnings generally rise over time, the compounding effect of rising earnings and higher price to earnings ratios makes it easy to have extended periods of positive returns.

Most importantly, bull markets mint money for investors. The 1982-1999 bull market saw the Dow Jones Industrial Average move from 875 to 11,497; an increase of 1,200 percent. This type of increase is the norm for secular bull markets.

Those with open eyes and minds can see when a secular bull market trend is under way. According to Edwin LeFevre in his book "Reminiscences of a Stock Operator:"

"Nobody should be puzzled as to whether a market is in a bull market or bear market after it fairly starts. The trend is evident to a man who has an open mind and reasonably clear sight, for it is never wise for a speculator to fit his facts to his theories."

Here is a long term perspective of a bull market:




### Bear Markets Look Different Than Bull Markets

Secular bear markets, in contrast, look nothing like secular bull markets. Secular bear markets are violent and choppy. They begin with a sharp decline followed by a sharp increase. These sharp increases are typically used by market pundits to convince people that a new bull market has begun when, in reality, the market is merely doing what the market does in secular bear markets. Secular bear markets are

characterized by sharp moves in both directions, some lasting several years, and typically end about where they started. A secular bear market is similar to being on a roller coaster that lets you off where you started – after a 16 to 20 year ride. This is what happens to people who employ an indexing, relative return, or buy and hold approach to their investments during a secular bear market.

Secular bear markets offer tremendous opportunity for people who invest in the intermediate term up trends that naturally occur, and it is also very important to sit out the devastating down trends. For an investor to employ such an approach, they must have the mental ability to sit out the trendless time periods as well. Investors who constantly compare their performance to that of some market index will find secular bear markets frustrating at best and devastating at worst.

The savvy investor will first recognize the season of the market and invest utilizing a strategy that is designed for the current season. This is similar to the farmer who plants vegetables in the spring and winter wheat in the fall.

Here is a long term perspective of a bear market:

Looking at the above stock market chart and looking at the current stock market chart below should make it obvious that there are time periods, long time periods in fact, that require a much more dynamic approach than buy, hold, and hope.

Summary

Markets go through seasons in which key factors line up for high returns over a very long time period; periods when factors off-set each other resulting in low or negative returns. These time periods typically last around 16 – 20 years, and strategies that work across one season might not work in another season. Knowing the season that the market is in is the first step in developing and following an appropriate investment strategy. Currently we are entering the 13th year of a secular bear market, and the factors that have existed at the beginning of all secular bull markets are not in place.

Profitable investment strategies are different in secular bull markets and secular bear markets. Secular bull markets allow us to sail on the winds of the market while secular bear markets require us to work harder and stay on top of the cyclical trends that are a normal part of secular markets. This is a market that requires rowing, not sailing.

If you have not been in to go over our investment systems, or if you would like to go over the part that identifies the current market trends, we invite you to come by and look under the hood at your earliest convenience.

Research sources for this article include: Unexpected Returns by Ed Easterling–Crestmont Research.com and Economagic.com

Thank you,

Clark Smith
Partner

## Relevant Facts

Here is one of the most common questions that I hear in my business. Do you think I will be ready to retire at a certain age? Obviously, this is an important question that deserves an appropriate amount of attention, and becomes even more important as you approach or enter your retirement years.

Most of us think that age 65 is the target age for retirement. This is greatly influenced by the age full retirement benefits become available through Social Security. This age has gradually increased for those born in 1938 or after. For those born after 1959, the full benefit age is 67.

I recently read an article in the Wall Street Journal (Jan. 21, 2012 edition), titled, "More Elderly Find They Can't Afford Not to Work." It describes a lady that was in her late 70's that decided that she could not retire as she had plannedbecause she had lost about half of her retirement account during the recent market downturn. Unfortunately, this has been the experience of many due to one reason or another. The most recent market decline (2007-2008) gave a wake-up call to many investors.

You may recall some information in previous newsletters that pointed out the 5 worst market declines during the past 50 years. Those declines were from a (negative) -30+% to a (negative) -50+%. In addition to these devastating declines, the time that it takes for these situations to unfold, are painstakingly long. The second worst decline took almost 10 years for it to go through the up and down cycle to where your investments recovered. We know that there are many reasons why people wind up with too little money to retire.

Here are just a few of the reasons that I have heard:

- High Risk Investing
- Not Starting Early Enough
- Setting aside too small of an amount
- Thinking the Market will recover in time
- Not Planning well
- Did not work long enough to build adequate capital
- Good health and lived longer than anticipated
- Bad health and needed more for health care

I'm sure we could think of other reasons but you get the point.

Retirement planning is more than plugging in a bunch of numbers into some web based software and spitting out the results. This may give you some guidance, but if you receive the returns of the market, we are afraid that you will fall short of your intended retirement goals. Often times, these programs will have you use an average rate of return in your calculations. If you take a look at how returns are generated, the average annual return can be very misleading in real life.

We encourage you to compare what you are doing today with our approach to investing. One of the 4 objectives of our system is to minimize the scope and duration of the drawdowns. This objective is intended to provide the investor with a smoother ride during volatile markets, and through this process, will help you achieve your overall retirement plans.

Danny C. Williams
Partner

## System Returns vs Investor Returns

Preface: *Returns presented are not actual returns for WCG or any individual portfolios or clients of Woodridge. Rather, they are hypothetical returns generated from extensive backtesting in an effort to identify the optimum combination of relevant factors that, over the period tested, would have produced the stated results. There can be sharp differences between hypothetical performance results and actual results subsequently achieved by any particular trading strategy.*

The Woodridge Capital Growth (WCG) stock portfolio back tested returns from 1992-2009 compounded at a rate of 18.21% vs the S & P 500 compounding at a rate of 7.77%. $250,000 invested in the WCG back tested portfolio would have turned into $5,056,048 while the same $250,000 invested in the S & P 500 over the same time period would have turned into $961,055. As you can see the difference over time is more than considerable. One of the major reasons is that WCG does not have an objective of beating the market.

The objectives of the portfolio are to:
Compound money in a meaningful way over time.
Mitigate the size and duration of draw downs.
Rapidly recover from draw downs.
Provide the ability to profit in both bull and bear markets.

This weekend I was doing some research for a project and I came across some information that really did not surprise me. There is a company, DALBAR, that does investor return research. The latest 20 year study that I have access to found that from 1988-2008 the stock market returned an average of 8.35% while the average investor in stock market mutual funds had an average return of 1.87%. These are average returns, which are not as meaningful as compounded returns, but the difference in the two numbers is striking. And yes, you read that right: 8.35% for the market and 1.87% for individual investors. I will explain what I believe to be the biggest culprits to investors not getting all that they should out of a good investment system, or even from the market itself. I base my opinions solely on my 22 years working as either a financial advisor or as a portfolio manager.

1. Investors typically do not have a scientifically tested portfolio management system, or strategy, that is designed to accomplish their objectives. Much of the work being done in the investment world is based on work that was done in the 1950s that is theoretically sound and functionally not. This is why, I believe, that so many state and company pension plans are woefully underfunded and have no chance of meeting all of their future obligations. A scientifically tested portfolio management system can not use "long term" market average returns and then simply assume that the market will return the same rate of return in the future. This is because we don't live in, or have investment time horizons of, 80 year time frames. In fact the academic research that I am referring to leaves the future return assumptions up to the investor and is not how the research is typically applied. I studied this subject at length in graduate school, and again at the Wharton School of Business in their Certified Investment Management Program, and on a lower lever while working in the brokerage firms. I will write

a paper on this in the near future either for this news letter or for our web site.

2. Human Biases. This is a topic that I have written about many times before. In fact, believe it or not, we all have a bias that we are not affected by biases, or at least not as affected as others by biases. These biases show themselves in my conversations with investors as well as with what I see investors actually do with their money.

One thing that is very noticeable to us is the fact that a lot of new money comes into our firm after periods of very strong performance. This is because there is a bias that causes investors to project the immediate past into the future. I feel very confident in saying that we will have a lot of new money come into the firm after our portfolios have their next 20% + up move. I have talked to other managers who experience the same thing and it is because it is after these runs that past performance looks the best. Recently we had a draw down that was directly in line with draw down expectations, based on testing, which resulted in the lowest new money quarter of the year for our firm. The highest two quarters of new money flows for our firm were in fact right after the large performance times that we experience in 2010 and 2011.

3. Beat the Market Bias. A good system will handsomely out perform the market over time and will be built as something whose performance is designed to perform in a different manner than the market. If it can't perform in a different manner then it is subject to the huge losses that the market provides from time to time. One thing that I have found is that people generally understand this on an intellectual level but not on an emotional level. I know of one manager who has compounded money at a rate of over 28% for over 20 years and his largest single negative year was a little over -10%. According to "Trend Following" by Michael Covel not many people have stayed with him for the phenomenal ride. This is because in 1998 his clients were up 4.39% while the stock market was up over 28% and then in 1999 he was up 4.76% and the stock market was up over 21%. Of course this is when most left him and he followed those two years with +13.54%, +19.16%, and +21.51% over a 3 year time period that the S&P 500 went -9.11%, -11.98%, and -22.27%. There are times that his system does not "work" if "working" is defined by a comparison to the stock market and this is the case of all good systems that I have looked at and been involved in building. His clients who had beat the market bias in 1998 and 1999 should have been asking if his system was still performing within it expectations parameters, it was, instead of asking how the performance compared to the markets. This simple conversation could have helped them make over 60% instead of losing over 38%.

There are many more biases that affect investors, actually I have barely touched on them, and space prevents me from writing more for this news letter. I will write more in the future.

Clark Smith
Partner

*The diva in this picture is Roger and Joy Davis' talented daughter, Grace Davis – age 11. Here, she is delivering a moving National Anthem before the January 26th basketball game between Ole Miss and Florida…*

***She brought down the house!!***

***Man performs, engenders, so much more than he can or should have to bear. That's how he finds that he can bear anything — William Faulkner***

## Disclosure

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