The Gazette

Three expensive myths about the stock market

In my last conference, held on November 1st 2011, I talked about the “myths of the stock market”. The Dow Jones Index has been on a wild ride lately (what else is new?). You can read or hear a wide array of explanations everywhere, with most being just myths, far from the reality of long-term investing.

The first myth is that “Buy and Hold is finished”. In the last 50 years, the S&P 500 has increased 100 fold. If you had invested $10 000 in the S&P 500 in 1961, you would have more that $1 million today. That is around a 10% annualized return. The only reason the S&P 500 has returned 10% a year is because companies have increased their earnings by around 7% a year and have returned 3% to their shareholders in the form of dividends. That’s it. No other reason. “Buy and Hold” works because when you own a company (or a group of companies) that increases its intrinsic value at a certain rate, the stock will eventually increase by that rate.

Now since 2000, it’s been a tough period for stocks in general. Most stocks have moved sideways. Is that because “Buy and Hold” is out of date? Let’s see what really happened by taking the example of the Dow Jones Index. Since 1999, earnings have increased from 455 points to 950 points this year. That is a 6.7% compounded growth rate, very close to the historical long-term average of 7% for stocks. But the Dow has gone from 10500 to 11983 during the same period, a tiny 1% return (not including the dividends). What has really happened is that the Price to Earnings ratio (P/E) of the Dow has gone from 23 to 13 times since 1999. The historical average P/E of the Dow is around 16 times. So the simple reality is that the Dow was a little ahead of itself in 1999 and now it’s undervalued. Earnings will continue to grow in the future but this time, P/E ratios will increase instead of shrink and suddenly “Buy and Hold” will seem to work again!

The second myth is that it is easy to buy low and sell high. In theory, in 1999, when stocks were expensive, it was a good time to sell and today, at much cheaper levels, it is a good time to buy. But most investors do just the opposite. As I explained in previous articles, when stocks are high, the optimism is high and people want to buy stocks with enthusiasm. And when they are low and cheap, people are afraid to buy them! That is why the returns of investors in general tend to be much lower than those of the S&P 500 (by around 5.3% annually according to Dalbar). It is not easy to “time” purchases because most humans have what I called in my last column the “tribal gene” which drives them to follow the tribe. So – when aware of this – most investors would do well to not time their entry and exit of stocks. They would do much better by just buying and holding their stocks many years (not months).

The third myth is to try to “time” purchases based on economic data. We would tend to think that to invest when unemployment and government deficits are high – as they are today – would be a bad idea. To the contrary: if you had invested in the S&P 500 at the top of the fiscal cycle (when the deficit was low or even at a surplus) since 1945, you would have a return of 7% after three years. But if you invested when the deficit was at its peak in the last 10 recessions, you had a return a 35% after three years. You have similar data with unemployment: Since 1933, the average 12-month return of the S&P 500 after the peak of unemployment is 15%. So waiting for the “economy to improve” (how often have I heard that one you think?) is not a winning strategy.

These myths are all based on the idea that most investors want to wait for a “better time” to invest in the stock market. But they don’t realize that the market reflects the mood of the capitalist world in advance. And the lower the mood, the lower the prices of stocks and the better the opportunity of higher returns.

I learned from great investors like Warren Buffett and Peter Lynch that you have to look at stocks not based on world events or economic data but almost in spite of them. When you find a great company, managed by great people, that trades at an attractive valuation, the time to buy is now. If you try to “time” your purchase based on some non-company-related things, you can easily become distracted by all the myths that surround the investing climate.