



## Defining Quality<sup>SM</sup>

### WALL OF WORRY

As long as the stock market is climbing a “wall of worry” we should feel reasonably confident about the longer term outlook. It is from the base of a “wall of worry” that bull markets begin. It is the lack of worry when things get out of control. Scaling “walls of worry” occur when prevailing political and economic uncertainties dominate and extreme fear is the prevailing emotion. The current market is an excellent example.

Over the past 10 years or so we have enjoyed periods of “irrational exuberance” when visions of future wealth seemed like a sure thing. During those times we tend not to worry very much and find investing an easy discipline to maintain. We experienced the exuberance in the stock markets in the late 90s and again in real estate in the early 2000s. When we look back most of us admit to becoming less and less rational as returns climbed higher and higher.

Our eagerness to invest when we feel confident is only human. The more confident we feel the more we tend to invest. It should not be surprising we tend to over invest at market peaks when confidence and returns are at their maximum. During times following long periods of higher prices, making money is too easy. As more and more “easy” money is made the market tends to be dominated by greed. When greed takes hold, bad things can and do happen.

It is obviously impossible to be rational and angry at the same time. While not as apparent, greed overwhelms rationality.

Likewise it is not possible to think when fear dominates. Fear is the dominate emotion now.

Including the current crisis, since 1880 there have been five occasions when the markets were severely impacted by financial panics. As we have repeatedly reminded our readers, each period was marked by at least 10 years when market returns were less than or near zero. In the case of the previous 4, all were followed by 10 or more years when annualized returns were more than 15%. Only time will tell us with certainty about the current period.

The previous periods when 10 year stock market returns were near zero occurred in and around the following:

- Panic of 1873
- Panic of 1893
- Stock market crash 1929

- Bear Market of 1973-1975
- Tech bubble 1999
- Real estate bubble 2005-2006

The one we refer to most frequently is the 1929 crash and the Great Depression. Most people know the 1930's caused severe financial hardship in the lives of most people.

When Franklin Delano Roosevelt was inaugurated in 1933, the unemployment rate was more than 20%. Fear dominated the lives of the people when FDR said:

This great Nation will endure as it has endured, will revive and will prosper. So, first of all, let me assert my firm belief that the only thing we have to fear is fear itself – nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance.

What happened in the stock market from 1932 through 1937 was truly remarkable-- prices more than quadrupled. Nothing really changed in terms of the economy. Unemployment remained high while there continued to be widespread suffering. The stock market climbed the "wall of worry."

By the time FDR made his famous inaugural speech March 4 1933, the market had already increased 31% from its low recorded the previous year on March 5, 1932. After the speech the market went up another 360%. The spectacular gains occurred in approximately 4.7 years.

In the current crisis the market has gained more than 70% from its March 2009 lows. Again the market is climbing the "wall of worry." Our nation may be fearful. Confidence in the government and the economy is very low. Anxiety is high. But the market is climbing rather dramatically as it did in 1932. The same pattern of spectacular increases in market prices occurred after each period in our history when markets suffered big declines.

We believe investors should be referencing history more than they were in 2009 and so far in 2010. While the stock market is climbing the "wall," investors are, unfortunately, doing the expected. They are selling stocks and buying what they consider to be "safe" investments.

In 2009 investors redeemed \$8.8 billion from stock funds. At the same time new investments in bond funds were \$374 billion! So far this year investors have purchased 10.9 billion in stock funds but new bond fund investments total about \$47 billion.

Investor behavior based on history is likely to be proven very wrong. "Fear" is in control now as greed was leading up to the crisis that began in 2009. Instead of buying stocks investors are buying bonds.

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Worse still is bonds and cash are being accumulated at historically low interest rates. Bonds have been in a bull market for almost 30 years. Bad things happen at the tops of bull markets that seem to be understood only after it is too late.

Curran believes we are at the end of a 30 year bull market in bonds. In the beginning of the Bull market in bonds rates were 15%-20%. Over the following 30 years rates moved lower until they finally have reached almost 0%.

Why would investors buy bonds today at near zero interest rates? I doubt it is because they have rationally analyzed prospects for inflation and have concluded it is not a problem now nor will it be in the immediate future. They are buying bonds because they are afraid. They have not rationally analyzed the impact on interest rates because they are most likely to increase. The only exception occurs if there were a period of deflation. I have not spoken to one person who expects deflation.

Does it make sense that investors are pouring record amounts into bonds when their prices reflect historically high prices and historically low rates? Investor response to buy longer term and/or lower quality bonds to increase yield is risky and in our opinion reflects irrational behavior common to patterns reflected in previous asset bubbles.

We frequently said during the last years leading up to the financial crisis and the fall of the stock market, "investors were unwittingly taking more risk than they understood."

We are saying the same about bond investors today.

A handwritten signature in blue ink that reads "Tom". The signature is written in a cursive, slightly slanted style.

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