FEAR AND GREED

Investment risks and opportunities in a turbulent world
Sample
FEAR AND GREED

INVESTMENT RISKS AND OPPORTUNITIES IN A TURBULENT WORLD

NICOLAS SARKIS
To Bob
My mentor at Goldman Sachs – a great figure I have always admired, who later became Under Secretary of the United States Treasury under Hank Paulson’s leadership

To Bulat
The most exceptional and talented businessman I have ever met – a truly inspirational figure
# Contents

*About the Author* vii  
*Acknowledgements* ix  
*Introduction* xi  
1. *A Lost Era in Equities* 1  
2. *Will Deleveraging Drag us Down?* 21  
3. *Gold's Glittering Path* 41  
5. *Dread, Denial and Default* 87  
7. *Fear and Loathing on Wall Street* 127  
8. *When Rules and Regulators Fail* 149  
10. *Central Banks: Leave, Improve or Abolish?* 189  

*Conclusion* 217  
*Index* 219
ABOUT THE AUTHOR

Nicolas Sarkis started his career in 1993 as an Associate with Goldman Sachs’ Institutional Equities division in New York. He relocated to London in 1994. He became a Vice President in 1997, at the age of 26. He spent more than 12 years with Goldman Sachs where he was successively Head of the US Shares institutional sales and trading group in Europe and then a Vice President in the Private Wealth Management (PWM) department where he worked for about 9 years.

While in the US Shares group, Sarkis and his team ranked number one in the McLagan Survey of Institutional Investors three years in a row, providing equity research coverage to several of the largest European institutional investors and successfully placing many high profile Initial Public Offerings of the 1990s – Ralph Lauren, Steinway Pianos, Associates First Capital, Real Network, China Telecom – as well as secondary block trades – e.g. the sale of BP stake by the Kuwait Investment Office.

While in PWM, Sarkis managed investment portfolios for some of Europe’s wealthiest families and largest foundations. When he left Goldman Sachs at the end of 2005, Sarkis was running one of Goldman’s largest PWM teams in Europe.

Sarkis set up AlphaOne Partners at the beginning of 2006 as he felt he could put together a more pertinent service offering for very large investors from the vantage point of a buy-side institutional
investment platform. Such investors are typically those whose assets are too large to be managed by a bank.

AlphaOne’s model revolves around three simple principles:

i) conflict-of-interest free investment advice – AlphaOne does not have any in-house products and investors are not shareholders

ii) improved investment methodology by focusing on a tried and tested investment process, similar to that used by the most successful university endowments globally

iii) cutting transaction and management fees whenever possible, thanks to AlphaOne’s institutional investor status

In May 2008, the Wall Street Journal Europe ranked AlphaOne amongst Europe’s top wealth advisers; it was the only firm in the top 5 of this annual ranking which was not affiliated with a banking institution. In January 2009, AlphaOne ranked at the top of Wall Street Journal’s Wealth Bulletin investment management league table. In December 2009, Spears, one of the UK’s leading wealth management magazines, chose AlphaOne to be the recipient of its annual asset management award.
In the course of writing this book, I have been fortunate enough to have had access to some of the finest economic and financial databases in existence. These collections of market data are the result of many years of painstaking research by their creators. I want to express my gratitude to them all publicly for their generosity in making their invaluable findings available to me.

In no particular order, I would like to thank Professor Carmen M. Reinhart of the Peterson Institute for International Economics for her permission to cite figures from the database of government indebtedness that she assembled with Professor Kenneth S. Rogoff of Harvard University.

Likewise, I am thankful to Professor Robert S. Shiller of Yale University for letting me quote from his figures relating to US stock returns, inflation and interest rates going back to 1871.

My task was also made considerably easier by perusing the superb compendium of global asset price performance compiled by Professor Elroy Dimson of London Business School, and his colleagues Paul Marsh and Mike Staunton, and which is published annually as the Credit Suisse Global Investment Returns Yearbook and Sourcebook.

My thanks also go to Professor David Le Bris of Université Paris-Sorbonne, France, for supplying me with the superb recreation of France’s CAC 40 index going back to 1854 that he constructed.
with Professor Pierre-Cyrille Hautcoeur of the Paris School of Economics.

I am also indebted to Chris Chantrill for letting me include figures derived from his website (www.ukpublicspending.co.uk).
Introduction

The global financial crisis that erupted in 2007 has dramatically transformed the world of investment. Many trillions of dollars of wealth have been destroyed, with few types of financial asset immune from the carnage. The ultimate owners of much of this lost wealth – the general public – now hold the investment industry in lower esteem than they ever have before, and understandably so. A great deal of what we investors thought we knew about markets and investment also lies in tatters.

I have witnessed the markets’ extreme fear and greed of recent years in about the most direct way possible. Throughout the period, I have worked as an investment manager, advising both individuals and institutions what to do with billions of dollars of their funds. Having worked for Goldman Sachs for a dozen years, I established my own investment firm – AlphaOne Partners – in early 2006, a mere eighteen months before the crisis struck. To say that this business underwent a baptism of fire is clearly an understatement.

It is one of my proudest achievements that I have helped AlphaOne’s investors not only to protect but also to grow their wealth amidst these torrid conditions. Without wishing to sound immodest, I believe that we have been able to do this because we had well-formed ideas about the sort of opportunities that the crisis was likely to create and were thus well prepared for them when they arose. These included successful investments in stocks, commodities,
real estate and private equity. Being prepared is essential, as the window of opportunity in these instances is often brief.

It was in the spirit of preparing for the next set of opportunities that I decided to write this book. As of late spring 2012, the financial crisis is still very much with us. Harsh but necessary austerity measures are biting savagely across much of Europe, casting people out of work and crimping living standards. There is a genuine risk that the single European currency will not survive in its current form, and that some developed world countries will end up defaulting on their debts. Investors need to have a plan in the event of one or both of these disastrous scenarios.

Even if the euro survives and if sovereign defaults are avoided, however, the coming years will still present enormous challenges to investors. Reducing indebtedness across the developed world is set to affect economic growth and investment returns for a long time to come. Deleveraging – as this process is known – poses an especially serious risk to those who hold government bonds, but also to anyone with ordinary savings. The freedom of investment choice that we have gained over recent decades could come under threat.

While one purpose of this book is to provide inspiration about how to invest in the years ahead, its lessons are drawn largely from history, and not just from that of the recent past. The difficulties for stock markets in the West began not with the credit crunch in 2007, but at the turn of the millennium. I argue that the period since then is merely the latest in a series of lost eras for equities that have occurred regularly over the last two centuries. During these lost eras, equities can easily struggle for a decade and half, until they become genuinely cheap once more. I believe we may still be some way from reaching that point.

As well as asking when today’s lost era for developed-market equities is likely to end, I have considered the outlook for two of the best-performing asset classes of recent years. Emerging-market equities and gold have delivered stellar returns since the start of the
21st century. Both have now acquired an enthusiastic following, which is something that experience suggests should make us cautious. Nevertheless, I believe that these asset classes could yet have a crucial role going forward.

It is not just wealth that requires rebuilding in the years ahead. Trust in the financial industry has also been destroyed on a grand scale. This may well prove much harder to repair than lost capital. The investing public has endured a steady succession of cases of outright fraud and financial wrongdoing, to whose perpetrators I have devoted a chapter. However, the public has also been badly let down by those who were supposed to protect them, namely central banks and financial regulators. I ask some fundamental questions here about their future roles.

The chapters in this book therefore fall into two categories. The first six chapters are mostly to do with the outlook for specific investments and market themes: equities (chapter 1), deleveraging (chapter 2), gold (chapter 3), emerging markets (chapter 4), government defaults (chapter 5) and the euro (chapter 6). The last four chapters address some bigger picture issues: fearfulness among investors (chapter 7), regulation (chapter 8), fraudsters and their victims (chapter 9), and the future of central banking (chapter 10). While I have grouped them in this way, the chapters can be read either sequentially or as standalone pieces.

Nicolas Sarkis

London, July 2012
A Lost Era in Equities

Following a century to remember, the stock market has suffered more than a period – of longer than a decade – that many investors would rather forget. Equities were the best performing asset class across much of the globe between 1900 and 2000, despite some spectacular upsets along the way. Since the dawn of the new millennium, however, shares in the developed world have delivered decidedly disappointing returns, inferior to those on most of the main rival asset classes.

A holding of worldwide shares worth $1 at the start of the 20th century would have grown to be worth $7,632 by the end of it. By comparison, $1 in worldwide bonds would have turned into just $75, while $1 of cash invested safely would have become only $54. The tables have since turned dramatically, however. In the first decade of the 21st century, a $1 investment in stocks would have grown to just $1.09 by 2010, versus $2.16 for bonds and $1.31 for cash. Equities have significantly underperformed other assets.

Despite stocks’ dismal showing since the dawn of the new millennium, the cult of equity remains largely intact. The cornerstone of this faith is that shares are the best bet when it comes to investing over extended periods of time. Its scriptures come in the form of such compelling research as that of Professor Jeremy Siegel, whose
bestselling book *Stocks for the Long Run* has even been praised as “the buy-and-hold bible.” Unsurprisingly, one of this cult’s most popular messages today is that, after such a lousy run since 2000, the stock market ought soon to resurrect itself.

Rather than obediently joining the flock, there is a strong case for questioning the orthodoxy on equities. While common stocks have indeed been winners over the very long run, there have also been times when they have struggled for a sustained period. Even in the US – the best performing market of all and the one for which the most detailed data exists – there have now been four periods from the early 20th century to the present when stocks have peaked, declined and then taken a generation or more to recover their former heights. I call these periods *lost eras*.

Fairly little has been said about these lost eras in equities compared to other episodes within stock-market history. After all, spectacular bubbles like the late 1990s tech mania and awesome crashes like that of October 1987 make for much racier reading. As a result, ordinary investors are largely in the dark about the very existence of these lost eras, let alone about their characteristics or what caused them. For obvious reasons, the cult of equity’s high priests – the banks and brokerage houses that dominate the financial industry today – prefer not to dwell excessively on these inconvenient, but very significant, exceptions.

While less sophisticated players may well prefer to kneel and pray that the poor returns on stocks since 2000 will soon somehow be miraculously transformed into a new bull market, serious investors should instead delve into the history books. By understanding what happened during previous periods of equity famine, we will be better prepared to cope with the challenges of the latest one – and position our portfolios accordingly.

*So, let’s begin by asking ourselves what exactly is a lost era in the stock market?*
DEFINING A LOST ERA

Looking at a chart of the price-to-earnings ratio (PE) of US equities adjusted for inflation over the past 140 years or so (Chart 1.1), these periods are easy enough to spot. Whereas the long-term tendency has evidently been for stocks to rise, there are also clearly some long stretches of time where the market has gone downwards or sideways in a persistent fashion. The beginning of each lost era is the point where the stock market makes a major high that is subsequently not surpassed for many years.

Chart 1.1 – S&P 500 price-to-earnings (PE) ratio after inflation, 1881 to 2012

The timing of the end of a lost era isn’t always quite as obvious as one might think, though. For two out of the three previous lost eras shown in Chart 1 – those that ended in 1920 and 1982 – the stock market’s absolute low also marked the start of the next long-term uptrend. Following the Wall Street Crash of 1929, however, stocks hit rock-bottom in 1932 but the market essentially then went sideways – albeit with some dramatic swings in each direction – until the next sustained uptrend finally got underway in 1949, some 17
years later. And it wasn’t for another decade still, until 1959, that the S&P finally regained its peak of 30 years earlier.

Measured from each stock-market peak to the time of the beginning of the next major uptrend, America’s three lost eras of the 20th century lasted some 14, 20 and 14 years respectively. From the peak of the previous uptrend to the absolute lows, the S&P 500 shed more than 60 per cent of its value after inflation in each of these three periods. Looking back even further to America’s two episodes of the early 19th century, stocks lost half and three-quarters of their real value. Interestingly, the three episodes in the 20th century were noticeably longer than the two lost eras of the 19th century, when the losses suffered were of a similarly major degree, but which nonetheless came to an end after seven years each time. We shall consider a possible reason for this later on. Of course, it is not all one-way traffic during a lost era. Stocks can rally mightily in these periods. Following the horrendous meltdown on Wall Street of 1929-32, to give just one example, the S&P soared by 132 per cent between 1935 and 1937. It then subsequently gave up more than 60 per cent of its value over the next five years. In Japan, where the Nikkei 225 stock index peaked in 1989 and remains depressed more than 20 years later, there have also been five occasions during that period where stocks have gained more than 50 per cent, only then to resume their long-term downtrend. These episodes merely serve to lure investors back into equities but end up leaving them disappointed – not to mention poorer – before very long.

Whereas lost eras have been the exception rather than the rule for the US, they have been far more ubiquitous in many other countries. French equities were trapped in a secular downtrend for more than half of the period between 1854 and 2000. Adjusting for inflation, French stocks also declined in five decades of the 20th century. By way of comparison, British stocks declined in only two decades of the same period.
WHY LOST ERAS OCCUR

WHILE AWARENESS OF THE EXISTENCE of lost eras is crucial for investors, it is only the first step. A much bigger challenge is explaining why these periods of equity famine actually occur in the first place. Today’s lost era in the West began in 2000, with the bursting of the technology bubble. One possibility, therefore, is that previous lost eras were also at least partly the result of bubbles having burst.

BUBBLES

The mania for technology, media and telecom stocks that began in the late 1990s was a clear example of a bubble even before it burst – at least to the more far-sighted among investors. The NASDAQ 100 index – home to many firms from the hot industries of the day – soared by an incredible 1,092 per cent from the start of 1995 to its peak five years later. Such perpendicular gains are themselves often a warning sign that things are getting out of control.

Of course, spectacular stock-price increases can sometimes be justified – particularly if corporate earnings are growing at a similar pace or are projected to do so with good reason. But it is hard to argue that this was the case for the late 1990s. Not only did the US stock market as a whole reach its most extreme ever level of valuation in terms of earnings, but many of the favourite hi-tech companies of the day did not have any earnings – or even revenues, in certain cases.

To justify this orgy of speculation, enthusiasts claimed that the game had fundamentally changed. New technologies – such as the internet – were supposedly going to improve the economy’s potential to grow forever. Turning received wisdom on its head, equities were even argued to be less risky than government bonds, rather than more so. And conventional cash-flow based techniques were abandoned and even ridiculed as being outmoded.
Aside from the vertical increases in stock prices and the fanciful arguments that the old rules no longer applied, other prominent bubble characteristics were clearly in evidence in the late 1990s. Edward Chancellor – a leading authority on financial-market manias – has listed other generic features of a bubble, including rampant credit growth, corruption and blind faith in the authorities’ ability to prevent a sticky ending. These traits were clearly evident in the 1990s tech bubble.

The other great lost era for equities of the present age also began with the implosion of a spectacular bubble. Japan’s Nikkei 225 index shot up by 469 per cent between the summer of 1982 and the end of 1989. This boom too was fuelled by a cocktail of inappropriately low interest rates, generous – and often irresponsible – lending by banks, and a widespread sense of confidence in the superiority of the Japanese ways of business and finance.

All of these elements were also present in spades during the decade known as the roaring 1920s. Easy credit stoked debt-fuelled speculation in Florida real estate, while Wall Street got carried away with such exciting modern technologies as mass-market versions of radio and the motor car. Excessive confidence in the investment outlook was best encapsulated by the contemporary economist Irving Fisher, who infamously remarked that “stocks have reached what looks like a permanently high plateau.” The Great Crash of 1929 got underway just three days later, wiping out much of the professor’s own fortune.

A big problem with the theory that lost eras result from bubbles bursting is that the 20th century’s other two lost eras in the US were not preceded by manias of the same sort. The 1960s did see something of a boom in the stocks of certain growth companies, in particular, as well as the initial proliferation of mutual funds. But the US stock market as a whole did not experience runaway price growth.

6

Fear and Greed
The S&P 500 index went up 84 per cent from the start of the decade to its peak in 1968. And while there was a big influx of novice investors into equities thanks to the arrival of mutual funds, the enthusiasm never came close to that of the late 1990s, where newcomers were so enthusiastic yet uninformed that they sometimes bought into a particular stock mistakenly, merely because its name or ticker was similar to that of a technology stock.

Likewise, even though there was certainly some evidence of exuberance in the stock market around the very start of the 20th century – when stocks rose 163 per cent between August 1896 and September 19067 – this hardly compares to the NASDAQ’s meteoric ascent in the late 1990s, or to the six-fold increase in the US market during the roaring 1920s. The market finally came decisively unstuck when it emerged that the chairman of a leading financial institution of the day had been using the firm’s assets in an attempt to manipulate the copper market.

So, bubbles are significant in that they preceded many lost eras of the past, but they cannot be the sole explanation for why these eras occur.

**Overvaluation**

While bubbles may not have preceded all of Wall Street’s main lost eras, overvaluation certainly has done. Stocks obviously looked very expensive as the market was peaking both in 1929 and 2000. But they were also noticeably dear in the early 1900s and the late 1960s. This is pretty much true whichever valuation technique is used, whether comparing stock prices to earnings, dividends or company assets. When equity valuations get extremely high, they tend eventually to return to their long-term average. As they do so, they very often overshoot the average to the downside.

A popular way of measuring the valuation of stocks over history is to use the cyclically-adjusted price-to-earnings ratio (PE), an approach popularised by Professor Robert Shiller. Rather than
comparing the stock market’s current price with its most recent year’s earnings, which is the standard approach, Professor Shiller’s technique compares the market to its average earnings over the last ten years. The logic of this method is that it smoothes out a lot of the most distorting effects of the economic cycle, thereby giving us a more stable view.

Since 1881, America’s S&P 500 index has on average traded on a multiple of 16 times its earnings of the previous decade. In advance of every lost era, however, this multiple has reached at least 24 times — or some 50 per cent above the long-run average. The absolute peak in this valuation has typically come ahead of the top of the market itself, in one case as much as five years ahead, as Table 1.1 shows.

\[ \text{Table 1.1 – Lost era valuations} \]

<table>
<thead>
<tr>
<th>Peak valuation date</th>
<th>Peak long-term PE valuation</th>
<th>Lost era begins</th>
<th>Peak long-term dividend yield (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 1901</td>
<td>25.2</td>
<td>September 1906</td>
<td>4.4</td>
</tr>
<tr>
<td>September 1929</td>
<td>32.6</td>
<td>September 1929</td>
<td>3.7</td>
</tr>
<tr>
<td>January 1966</td>
<td>24.1</td>
<td>December 1968</td>
<td>2.9</td>
</tr>
<tr>
<td>December 1999</td>
<td>44.2</td>
<td>July 2000</td>
<td>1.1</td>
</tr>
</tbody>
</table>

Source: Robert J. Shiller

Overvaluation, then, seems to play a significant role in bringing about lost eras on Wall Street. And as we shall see shortly, lost eras tend to end once the stock market has become significantly undervalued. But are there any other common features that may cause lost eras?

Every one these of episodes since the early 1900s has played host to a major international conflict in which the United States was a leading combatant, namely the first and second world wars, the Vietnam War, and most recently, the conflicts in Afghanistan and Iraq.
While lost eras have tended to encompass major wars, this is not the same as saying that the conflicts caused those periods of poor stock returns. Both world wars and the War on Terror broke out unexpectedly and some time after the lost eras had begun. At the very most, therefore, it may have been the case that these conflicts deepened the stock market’s difficulties in these periods. If so, there is one consequence of warfare in particular that could have hurt equities – inflation.

**Inflation**

Times of war are almost invariably times of inflation. Rather than meeting the expense of the war effort by issuing bonds and raising taxes alone, governments typically resort to printing money and manipulating interest rates in order to keep them artificially low. The inevitable result of these tactics is persistently rising prices, especially when combined with the shortages of consumer goods that have usually occurred during the great conflicts of history. And inflation is one of the worst enemies of stock market returns over time.

There is a widespread misconception that equities always offer a hedge against inflation. It is said that because companies often have the power to raise their prices, corporate profits are therefore able to keep pace with inflation. In the long run, there may be some truth to this. But short bursts of high inflation are generally very harmful to the stock market. In the case of the US stock market, for example, real returns have always been negative in years where consumer prices have risen by more than six per cent.⁹

The link between inflation and lost eras becomes even clearer when we look more closely at the specific years in question. Since 1900, there have been 23 years where the US consumer price index rose by more than six per cent. All but one of those highly inflationary years occurred within lost eras for Wall Street. Not
surprisingly, perhaps, all but three of these years came after the establishment of America’s central bank, the Federal Reserve, in 1913.

**The Federal Reserve and Central Banks**

Since inflation is largely a creation of the Fed and of central banks in general, at least some of the blame for lost eras must surely be laid at their door. It was mentioned earlier that Wall Street’s two lost eras of the early 19th century came to an end far sooner than those of the modern era. One reason for this could be to do with the intervention of the Federal Reserve. Markets can adjust to the right level much more effectively when not subjected to meddling by governments.

This issue is more relevant today than ever before. The Federal Reserve responded to the onset of today’s lost era in the early 2000s with near zero per cent interest rates, producing a 105 per cent bull market in stocks between 2003 and 2007. And its money-printing programmes since 2009 have helped deliver similarly impressive results, with the S&P also rising more than 100 per cent in an even shorter period of time. The danger, however, is that the Fed may simply be delaying the necessary bankruptcies and falls in asset prices. And, even if it succeeds in preventing these, it may only be doing so at a cost of creating stubbornly high inflation in the future, which would inevitably harm stocks.
How to cope with lost eras

While it is interesting to consider the reasons why lost eras happen, the most important question for us as investors is how we should deal with them. The first lesson of history is clear: we cannot simply rely on a buy-and-hold strategy to deliver the sort of returns to which we aspire during these periods. Annualised capital returns after inflation for the S&P 500 during the lost eras of the 20th century averaged minus 3.8 per cent.

All investors are aware, of course, that capital gains are only part of the story. To fully understand performance of equities during lost eras we also need to consider dividends and particularly the effect of reinvesting those dividends back into the market. Over extended periods, what really grows one’s portfolio is the effect of reinvesting dividends received. The performance of all the stock markets of the developed world over time looks a great deal better once reinvested dividends are included. This is true even during lost eras; once reinvested dividends are included, the annualised real return during lost eras for the S&P 500 improves to minus 1.5 per cent. Even with this recalculated and improved performance, it is evident that a buy-and-hold approach is not wise during these lost eras.

So, what are investors to do?

Diversifying into emerging markets

Of course, there is no reason to remain exclusively invested in US stocks or those of any other single market. Today, more than ever before, we can get exposure to equities from far-off lands with ease. And the experience of previous lost eras suggests that we may indeed be well advised to consider doing so. While lost eras have often occurred in numerous markets simultaneously, some nations’ equities have not only survived these periods better than others but have even prospered in absolute terms.
The Great Depression lost era of the 1930s initially saw concerted declines in stock markets around the world, as economic growth and international trade shrank alarmingly. However, some emerging equity markets of the day bounced back noticeably sooner and delivered much better returns. For example, stocks in Australia and New Zealand delivered an annualised real capital return of 3.5 and 2.2 per cent respectively from 1930 to 1940. By comparison, the S&P 500 made annualised real capital loss of minus 3.5 per cent a year in this period.10

A similar pattern emerges in Wall Street’s lost era of 1968 to 1982. Asian stocks far outshone Western markets, including those of the US, UK and the larger continental European players. Japan – which was making the transition from emerging to developed market status around this time – achieved an annualised capital return before inflation in US dollar terms of 13.6 per cent, compared to 0.4 per cent for the S&P 500. Taiwan, meanwhile, generated an annualised return of 11 per cent and Hong Kong 18.1 per cent.

Getting access to emerging markets was much harder for Western investors in the past than it is today, even had they been adventurous and far-sighted enough to have wanted to do so. Whereas today’s investors can easily speculate upon far-flung assets via exchange-traded funds that trade on their local stock exchange, no such products existed in the 1970s. Also, currency controls and other restrictions prevented many people from investing in anything beyond their home shores.

However, while we do now enjoy the freedom to invest in emerging markets as never before, there is one reason why this strategy may not work as well as it would have done a generation ago. The world economy and its many financial markets are much more closely intertwined than they were back in the 1970s. Barriers to trade have been pulled down, while capital flows across borders more or less unfettered. While these things are good for economic growth and for investor freedom, they also mean that stock markets are prone to move more closely together.
Happily, investing in emerging markets has paid off nicely during the latest lost era on Wall Street since 2000. From the turn of the new century to the end of 2011, the MSCI Emerging Markets Index – which tracks the performance of the stock markets of 26 emerging countries – went up by 47 per cent after inflation. The S&P 500 was down by 36 per cent in real terms over the same period.

At the worst moments of stress during today’s lost era, however, emerging markets have actually fallen even more than Wall Street. Stocks in China, India and Brazil – three of the most exciting growth stories of our age – all underperformed the S&P in dollar-adjusted terms during the painful bear market between October 2007 and March 2009. In other words, diversifying into these exotic markets is an approach that can let us down at the precise times when we most require the benefits of diversification.

**Bonds and Cash**

The best way to spread our equity risks during a lost era is clearly to look beyond the equity markets. As we saw at the beginning of this chapter, both US bonds and cash have proved much better investments since Wall Street entered its latest long-term funk. This is also the case in Japan, where investors have achieved excellent returns from holding long-term and short-term government bonds, despite record low yields on these assets.

In the 1930s, America, Britain, France and many other nations suffered from falling prices resulting from a massive collapse of debt. In this environment, the highest-quality bonds were among the clear winners. US government bonds produced a real return of seven per cent a year between 1930 and 1940. With the advent of the Second World War, inflation came roaring back in the US, as during every other major conflict. Bonds made an annualised loss of two per cent in that decade.
Much depends on the nature of the particular lost era as to whether bonds and cash prosper. The last lost era that ended in 1982 involved particularly fierce inflation. As such, longer-term US government bonds made an annualised loss after inflation of 1.7 per cent in the 1970s, while short-term bills suffered a decline on the same basis of 0.95 per cent a year.\textsuperscript{11}

As of 2012, inflation has yet to become a serious problem in the US and much of the rest of the developed world. In fact, deflation is widely considered to be the more serious threat, hence central banks’ pursuit of zero-interest rate policies and money-printing programmes. However, these things can change quite quickly. There are precedents for inflation following hot on the heels of deflation. It is not inconceivable, therefore, that we experience a lost era of two halves. If so, consider that deflation is usually good for bonds and cash investments while inflation negatively impacts the performance of these assets.

**Gold in lost eras**

Despite inflation not yet having become a problem in the period since 2000, gold has been one of the strongest performers of the present lost era. Its price rocketed from $286 an ounce at the start of the new millennium to more than $1,925 by September 2011. This amounts to an annualised real return of some 13.7 per cent. Driving this stunning performance has been cheap money. When real interest rates fall, gold has typically come into its own.

Comparing gold’s showing over recent years with how it did during Wall Street’s previous lean spells is somewhat difficult. For most of the first seven decades of the 20th century, gold’s price was essentially fixed by government decree, reflecting its historic use as backing for the US dollar and other currencies. Sizing up returns from holding gold during the lost eras of the 1910s and the Great Depression alongside those of more recent times is not entirely realistic, therefore.
However, gold did become freely traded around the outset of the last lost era for equities in 1968. And it famously proved to be an excellent investment during the inflationary years of the 1970s, hitting a then record high of $875 by early 1980, twenty-five times above its price of a decade earlier. As of early 2012, gold has yet to surpass its peak of 1980 in real terms, which in today’s money equates to around $2,420. If the current lost era enters an inflationary phase, gold’s chances of matching and surpassing that price seem very good.

**Spotting the end of a lost era**

To buy-and-hold investors, a lost era in stocks can seem like an eternity. However, these episodes do eventually come to an end. This clearly throws up an opportunity to earn significant returns, as anyone who was fortunate enough to have bought heavily into US stocks in the early 1920s, 1950s or 1980s would be able to attest. So, what might the end of today’s lost era look like?

**The length of lost eras**

In terms of time, Wall Street’s current long-term losing spell has already lasted some 12 years as of early 2012. The shortest lost era of the modern age was just under 14 years, whereas the average over history is around 15 years. On this basis alone, there could be further lacklustre returns in store for US stocks and those of developed markets elsewhere.

**Equity valuations**

A more important clue is likely to come from equity valuations. We have seen how lost eras tend to begin with significant overvaluation
in US stocks. They also come to an end after equities have become genuinely *undervalued*. We take the end of a lost era to be when the next long-term uptrend begins. In each of the last three cases, the next long-term uptrend in the market has got underway when the S&P’s cyclically-adjusted price-to-earnings ratio has dipped well into single digits. The data for this can be seen in Table 1.2. (The index traded on a multiple of 5.6 in 1932, although the next bull market did not start for another 17 years.)

**Table 1.2 – Valuations at the end of lost eras**

<table>
<thead>
<tr>
<th>Lost era end date</th>
<th>End valuation (long-term PE)</th>
<th>End valuation dividend yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 1920</td>
<td>4.8</td>
<td>6.1%</td>
</tr>
<tr>
<td>June 1949</td>
<td>9.1</td>
<td>6.2%</td>
</tr>
<tr>
<td>August 1982</td>
<td>6.6</td>
<td>6.4%</td>
</tr>
</tbody>
</table>

Source: Robert J. Shiller

Since its last great top in 2000, Wall Street has not come anywhere near to being as cheap as it was at the end of any previous lost era. When the S&P hit its lowest point to date in today’s lost era, back in the dark days of 2009, it traded on a long-term price-to-earnings multiple of 13.3. This is more than double its average valuation at the end of previous lost eras. The same is true when we look at dividend yields, which have risen to above six per cent at the bottom in every previous lost era. The highest dividend yield registered since 2000 is a mere 3.2 per cent, by contrast.

A commonly heard argument from stockbrokers is that we will probably never again see such depressed valuations as were recorded at major lows in the past. After all, the Federal Reserve nowadays seems to regard propping up the stock market as part of its mandate – or at least as a highly desirable goal – and will therefore inject money into the market in hard times, keeping valuations...
permanently higher. These policies, however, risk stoking inflation, which would almost certainly ultimately undermine valuations.

The entire notion that long-term average valuations have become irrelevant in the modern age sounds uncomfortably similar to the sort of logic that was employed to justify past equity bubbles. One need only recall Professor Fisher’s pronouncement that Wall Street had reached a “permanently high plateau” in 1929. For a present day case of how extreme valuations can revert to where they were in the past, we should look to Japan.

In the 1970s, the dividend yield on the Japanese stock market averaged around 2.2 per cent. Shortly after the stock market bubble burst in December 1989, the yield had been squeezed to a mere 0.4 per cent. While the yield remained below one per cent until late 2002, it has since returned sharply to pre-bubble levels.

**Prices of bonds, copper and market volatility**

Besides valuation, there may be other signals we can look for to help determine that a lost era might finally be coming to an end. In his masterful study of the major bear markets of the 20th century, Russell Napier found that the prices of bonds, copper and investor activity can all provide pointers. Specifically, he shows that copper, government and corporate bonds all tend to make their final low and then turn upwards ahead of the stock market. He also advises watching out for a final slump in the stock market accompanied by low numbers of shares actually changing hands.¹²

**The public mood**

While asset prices and valuations give us much of what we need to determine when the balance has shifted too far against stocks, it is worth also monitoring more subjective evidence of the public’s mood. In August 1979, towards the end of the last lost era, *Businessweek* magazine ran a cover story entitled ‘The Death of
Equities’, which bemoaned the poor outlook for stocks. It ended with a quote from a young executive: “Have you been to an American stockholders’ meeting lately? They’re all old fogies. The stock market is just not where the action’s at.”

Joseph Kennedy – father of JFK and first chairman of America’s Securities & Exchange Commission – is reputed to have sold his stock holdings in advance of the Great Crash beginning in 1929. He famously claimed to have been spooked into divesting himself of his portfolio when his shoe-shine boy started giving him stock-tips, a dead giveaway that the lowest echelons of the general public were becoming unthinkingly involved in the market.

An anecdotal sign that the present lost era has ended could well come when the subject of equities again becomes almost socially unacceptable. When we reach a point such as this it may well prove a good moment to renew one’s faith in the cult of equity.

**Endnotes**

1 Elroy Dimson, Paul Marsh, Mike Staunton, *Credit Suisse Global Investment Returns Sourcebook 2010*, p. 178.


4 I am grateful to Professors David Le Bris and Pierre-Cyrille Hautcoeur for letting me use their excellent recreation of the CAC 40 back to the mid-19th century.

5 Elroy Dimson, Paul Marsh, Mike Staunton, *Credit Suisse Global Investment Returns Sourcebook 2010*, p. 90 and 163.


7 Calculation made from stock market data set of Robert J. Shiller, originally published in *Irrational Exuberance*.

8 Data from the stock market data set of Robert J. Shiller, originally published in *Irrational Exuberance*. 

10 Dimson, Marsh, Staunton, *Global Investment Returns Sourcebook 2010*.


Fear and Greed

Investment risks and opportunities in a turbulent world

Nicolas Sarkis

Available direct from Harriman House and all good booksellers. To order a copy of the print or ebook edition go to:

www.harriman-house.com/fearandgreed

Hardback: 9780857192431
eBook: 9780857192295