

The Outlook: Sept. 14, 2018

What investing is all about, again: common sense and nerve vs. cleverness and hard work.

A couple of years ago, a professional investor named Wesley Gray asked a wonderful question: “If an investment manager really did have a crystal ball, so that he could make a fortune for his clients, would they keep their money with him?”

To answer that question, Mr. Gray looked at 90 years of S&P 500 history. There were 18 five-year periods from 1926 to 2016, and he calculated the return rate for a money manager who knew in advance which 50 stocks (from 500 in the index) would perform the best, from the start to the finish of each 5 years. Mr. Gray called the manager “God.”

“God” averaged 29% per year for the 90 years. The whole market (S&P 500) averaged about 9%. So far, so good. Then Mr. Gray dug deeper. He asked, “How many cliff-diving, heart-stopping plunges would “God’s” clients have to endure, along the way to earning 29% per year for 90 years?”

The answer? 10 plunges of more than 20% (and too many plunges of 5% to 19% to count.) Here’s Mr. Gray’s table. Don’t bother with anything but the first columns at the left.

Drawdown Rank	Drawdown	Date of Prior Peak	Date of Low	Date of Recovery	Peak to Low (days)	Low to Recovery (days)	Peak to Peak (days)
1	-75.94%	8/30/1929	5/31/1932	6/30/1933	1005	395	1400
2	-40.75%	5/31/2008	2/28/2009	3/31/2010	273	396	669
3	-39.51%	8/31/2000	9/30/2001	9/30/2003	395	730	1125
4	-38.54%	2/27/1937	3/31/1938	12/31/1938	397	275	672
5	-30.81%	12/31/1973	9/30/1974	4/30/1975	273	212	485
6	-27.69%	8/31/1987	11/30/1987	1/31/1989	91	428	519
7	-26.94%	5/31/1946	11/30/1946	4/30/1948	183	517	700
8	-24.61%	11/30/1980	9/30/1981	8/31/1982	304	335	639
9	-21.53%	2/28/1962	6/30/1962	1/31/1963	122	215	337
10	-20.13%	3/31/1934	7/31/1934	4/30/1935	122	273	395

The results are hypothetical results and are NOT an indicator of future results and do NOT represent returns that any investor actually attained. In fact, these returns are EXPLICITLY IMPOSSIBLE TO ACHIEVE. Indexes are unmanaged, do not reflect management or trading fees, and one cannot invest directly in an index. Additional information regarding the construction of these results is available upon request. Note: these results were updated on 6/14/2017.

Pretty frightening, isn’t it? “God’s” clients would have had to endure a 76% loss of their wealth at the beginning of the Depression; a 41% plunge during the Calamity of 2008 – 2009; a 40% plunge when the dotcom bubble burst; and plenty of others merely in the 20% to 39% range. Of course, “God” would have reminded them (probably every single day of the sickening downturns) that these weren’t “losses” but “temporary declines in value.” He would have been absolutely right; and if his clients had stuck it out, their 5-year returns would have averaged 257%, over and over again.

“But,” Mr. Gray asked, “would they stick it out?”

And that, of course, is always our \$64,000 Question, as investors. The investment world, as Outlook has remarked a few times, is filled with smart, hard-working people. And as Warren Buffet and Charlie Munger have remarked, a few times, that's not enough. To succeed—that is, to be certain of succeeding in long-term investing, which is the only kind of investing that offers anything like certainty—what investors and/or their professional managers need is two more things: the common sense to see the real world as it actually works; and plain nerve. In Outlook's 41 years of experience, cleverness and hard work are not always accompanied by common sense and nerve—in fact, they seldom are.

The really wonderful opportunity in the investment world is the chance to let outstanding business leaders and their companies grow our wealth for us. The closest thing to certainty in the investment world, in Outlook's opinion, is that when we buy large, financially-strong companies whose stocks are despised by the market—because the companies have stubbed their toes, sprained their ankles or even broken a leg—we are very likely to earn outstanding returns. That's because the vast crowd of people which is the market lacks the patience, nerve and “common sense about how the world works” needed to live with those awful plunges and be untroubled—or at least endure them.

Mr. Gray's answer to his own question—“Would “God's” clients stick out the plunges?”—was a sad “Not a chance!” He was thinking about the mountain of statistics showing how many investors sell low, and buy high, rather than the opposite. They do that because they're understandably afraid, having watched their savings spiral down; and because (if they happen to own great companies at great values) they do not understand what they own. Fear is mostly cured by understanding; and in the business of investing, nothing is more important than having a clear sense that the market's frightened judgments of good companies are dead wrong, with a probability approaching 100%.

Eight of Outlook's core stocks have been hanging in rather well, during this late summer of anxiety in the market. Three—Micron, Transocean and Freeport—have faced the full force of the market's frightened judgment. They were remarkable investment values before this late summer; they're extraordinary values now. We hold, and buy more.

© Dave Raub
Outlook Capital Management, LLC
[125 S. Wilke Road, Suite 200E](#)
[Arlington Heights, IL 60005](#)
847-797-0600

The remarks above aren't a general recommendation to buy or sell particular securities. Such decisions should only be made in the context of an investor's own circumstances. Stocks and bonds carry the risk of loss.