

News & Views

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TRYING TO PREDICT THE MARKET?

For the quarter ending March 2008

We live in historic times. And when current market events are being compared to previous periods, you hear headlines like “the biggest decline since 1987”, “the most bears since 1990”, “the worst earnings comparisons since 2002”, and so on. What is not being said is that the data for this “worst of times” is comparable to many other periods in history that were coincident with market bottoms, not the start of major down turns.

Market bottoms are made on bad news, and over the past five months, the market has already been reacting to the heavy dose of pessimism that we are receiving today. What we seem to forget is that the market anticipates these economic trends 6-12 months in advance and what we are now seeing are likely the reasons that the market is down here in the first place.

A sign that the market may be near the bottom is market volatility. In case you haven't noticed, the market's volatility has vastly increased, with prices collapsing one day and soaring the next. The market has had 12 sessions in which share prices rose or fell more than 2% in one day-something that did not even happen once in 2004 or 2005.

Volatility has often increased around the time of changes in market direction, as evidence of changed conditions clashes with expectation of more of the same. In 2002, volatility soared as the stock market approached and hit bottom. Volatility had also risen in 2000 and 2001, as the previous bull market was ending.

Of course markets can and will certainly fall: from 1920 to 2007, the Standard & Poor's 500 stock index fell 3 out of every 10 years. Some declines can be substantial. And there can be times when the market is sluggish for very long periods, like the 1970's.

So what should you do? We have some general considerations that should guide you.

No one ever went broke from too much liquidity. In volatile times like these, cash is your best friend. True, you earn very little interest on cash these days.

True, if the stock market has a huge move-up and you are largely in cash, you will be sad. But it is also true that cash does not crash.

The answer?

Having a plan is vital. It does not have to be a perfect or precise plan. Such a plan must consider the likelihood of much higher inflation. And such a plan must include a diversified portfolio of large-and-small capitalization stocks, foreign and domestic, emerging and developed markets. Diversification must also include some financials, with their fabulous yields, and commodities. Commodities may have hit an air pocket, as commodities do, but they will be back.

Such a plan must include a significant portion of your money still staying in the market. It can be costly to miss the window of opportunity. A hypothetical \$1,000 investment over the last 20-years (12/30/87-12/31/07) would have produced a compound return of 11.5% if you had stayed in the market the entire period. But only a 10.1% compound rate of return if you missed the top 5 days; a 7.9% rate if you missed the top 15 days; and only a 6.2% rate of return if you missed the top 25 days.

The best return for stocks come after periods of extreme pessimism. It is just when the horizon seems darkest and cloudiest that we find above-par returns. And it is just when hopes seem dimmest, that the economy seems to rally. If you have enough liquidity, if you are well diversified, now might be the time to start stepping back into the buying pool.

Prudence is the order of the day. If you can remember that, you should be really well off when, soon enough, the good times start really rolling again.

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Our 7th Annual Client Appreciation Dinner was held Tuesday, March 4, 2008. More than 100 clients and guests enjoyed a fabulous dinner and “entertainment” which consisted of two speakers who provided insight as to the direction of the stock market and interest rates. Everyone left with a smile, feeling full, and wiser.

Sincerely,

LAWRENCE A. KRAUSE & ASSOCIATES, INC.