

Learning From History

To help your investment clients, learn how changes over time drive the markets.

By Brian Dightman

Before the year 2000, making investment decisions was a lot easier than it is now. Economic growth and systemic stability created a portfolio manager's dream and many came to regard the environment from 1982 to 1999 as a permanent condition.

During this period of unbridled economic expansion, it was easy for managers to adopt investment strategies based on secular considerations because they contributed to a strong bull market in stocks. Few understood that macroeconomic, political, technological, demographic and geopolitical forces change over time and drive both long-term bull and bear markets.

With the new millennium, everything changed. In the U.S., stocks have experienced big swings in value over the last 10 years but have not been able to advance past the highs reached in 2000. There's been a shift to a secular bear market that's made it difficult for an expansionary environment to reemerge.

Among the structural characteristics of the current secular bear market in U.S. stocks are household debt, government fiscal policies and an aging population. While secular markets are measured in years/decades, within them exist shorter, cyclical markets measured in quarters/years.

These cyclical markets are predominantly influenced by expansions and contractions in the business cycle, which are largely autonomous but can be influenced by government actions, including interest rates, tax policy and stimulus programs. The business cycle is the natural ecosystem of capitalism at work: Companies grow during periods of growth, over-expand, struggle



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and are ultimately forced to downsize, merge or go out of business. A few great companies will thrive.

Example of a secular bear market

The best example of a modern-day secular bear market can be found in Japan, with the world's third largest economy. In 1989, the Nikkei 225 Index of Japanese stocks peaked at 38,915. Twenty years later, it closed at 10,443.

It has been said that history does not repeat, but it often rhymes. The period at the turn of the 20th century was similar for the U.S. We had a large trade surplus, consumer credit was expanded, interest rates were low

and we were busy buying inflated assets in Britain.

In the decades that followed the crash of 1929, there were long periods when stocks rose and long periods when they fell, but it was not until the 1950s that new highs were reached on the Dow. The period from 1966 to 1982 is another long period when stocks moved up and down but essentially ended where they started 16 years earlier.

Today, we suffer from the same types of structural problems found in previous secular bear markets. Money is cheap but now harder to get, and financial engineering has brought down companies and nearly the entire economy.

From a secular perspective, we are in the midst of a protracted and contracting bear market. Despite this background, it's possible to see several periods of positive returns on stocks because within this secular bear market lives a cyclical bull market. Before we can transition to a secular bull market, household debt levels must be reduced, government finances improved, and lower U.S. consumption levels (assuming higher saving rates materialize) replaced with higher consumption levels by foreigners.

Steps you can take

As a financial advisor, you need to recognize cyclical nuances within secular markets in order to make sound investment decisions for your clients. In educating your clients, explain how the current environment calls for a more nimble asset-management approach.

Moving to a discretionary arrangement and expanding the use of technical analysis could help. There are numerous investment services available to help

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guide decisions. Buy and sell rules may also need to be updated.

If you outsource your management activities, you might want to look for managers with greater flexibility in their investment approach, such as a bond manager using futures contracts to protect against a rising rate environment. Regardless of the approach used, you can benefit by explaining to your clients that in this type of environment, the strategy is to try to avoid crippling losses first, and generate positive returns second.

Once we get back to a secular bull market, we should see longer periods of stock-market appreciation. Whether the next secular bull mirrors

the eye-popping 1,048 percent S&P 500 appreciation of 1982 to 1999 is moot, of course. But as an advisor, you must change your attitude biased toward strictly secular bull market considerations in response to a dynamic and changing environment. Those not advising their clients within the context of both secular and cyclical considerations are making investment decisions with an incomplete set of information.

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