

FINANCIAL insight

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INSIDE

Prepare for the
Pending Recovery

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Prepare for the Pending Recovery

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How audacious it might seem to speak of an economic and market recovery at this time of gloom and doom. Yet it is just this scenario of pessimism that has positioned the stock market for wonderful future returns.

How bad has it been?

Since 1900, we have experienced 25 bear markets, defined as a decline of greater than 20%. The average market decline in a bear market has been 37%. Today's decline has been far steeper than average, with a loss of over 55% from a peak in October 2007. With the exception of bear markets during the Great Depression era, the depth of loss is the largest of the remaining 24 bear markets.

The length of time for the decline is also longer than average, currently 17 months versus an average 15 months. No wonder we all feel beaten and abused. Not only has the market dived, but it has remained in decline for an extended period.

How good can it get?

The bad does lead to the good historically. When the markets recover, and they

always have, the average gain in the first 12 months of recovery has been over 40%. That is not a misprint – the average increase has been 40% in the first year of recovery. And much of that one-year gain occurs in the first few months of the recovery.

Our worst post-World War II market season occurred in 1973 and 1974. The decline was a negative 45% and it lasted almost two years. The recovery was a positive 42% in 1975. I entered this profession in 1981, almost perfectly timing (or causing) a bear market that was 15-plus months in length and down 24% from the peak to the valley floor in August 1982. Even

the cover of the publication *Business Week* featured the prediction “the death of equities.” The ensuing one-year recovery was up over 50%. The believers, the steadfast and the courageous were handsomely rewarded.

But when will the recovery happen?

We do not know. We do know that



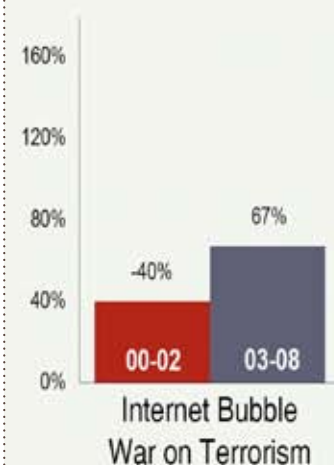
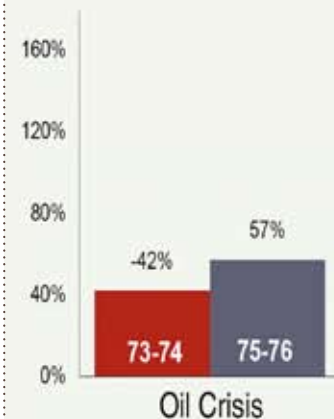
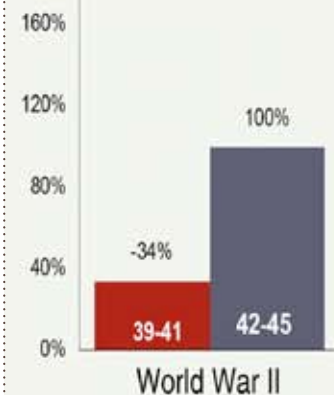
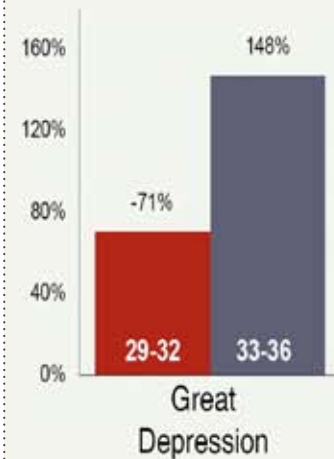
historically it has always happened. And every expert will tell you that as surely as the sun rises in the East, it will happen this time. The stock market is a forward-looking, anticipatory beast. Bear markets typically begin in advance of a declared recession, and market recovery begins ahead of economic recovery. Academics and market historians often cite the predictive timeframe at about six months. We could be in recovery now, for as I write, this market has been up for three days in a row. Recovery might not occur for several months. Again, I haven't a clue.

So let's have a little perspective.

How likely is this recovery of more than 50%? Statistically, it is what has occurred in the past. However, if the market does rise 50% from this point, it will still only regain half of its decline. To climb to its level of October 2007, it would need over a 100% gain, a doubling from here. To me, that thought of a 50% up move is not irrational.

Should we care when it occurs?

Of course we should, but investors are poor market timers. Let's say the market stays dormant at these levels for another year and then starts the aforementioned rebound. In that case, the upward move of (for the sake of discussion) 50% in the following year means that it would take two years to gain 50%. That's obviously not as great as if we could perfectly time the bottom (and they don't ring a bell to tell



Past performance is not a guarantee of future results.

us it is the bottom), but the result would be an annualized two-year return of more than 20%. Frankly, I cannot imagine an equity investor who would not be satisfied with that return.

Please don't ignore the income stream that one can receive in today's environment. The market as a whole pays an average dividend of almost 4%. This is more than we can earn on certificates of deposit and the dividends are less heavily taxed at a maximum rate of 15%. The dividends are pretty attractive rents on our invested money while we wait for the main feature to begin.

What to do.

If you have the financial liquidity to do so, think seriously about making a significant investment in a diversified, high-quality stock portfolio. This can be done in a variety of manners with the help and advice of your D.A. Davidson & Co. Financial Consultant. Position yourself to participate in the market recovery that will follow.

If you have been invested in stocks, you are no doubt discouraged and less wealthy than before. Please, don't capitulate and exit the markets now. If you do so, the odds of re-entering the market to take advantage of the rebound are virtually slim and none (and slim just left town). It takes faith to remain invested after all this pain, but you must to receive the gain. As Leo Tolstoy said in War and Peace, "The strongest of all warriors are these two — Time and Patience."

Avoid a Trail of Tears

Interest rates on U.S. Treasury bills, notes and bonds, certificates of deposit, money market funds, and other instruments of short maturities and high quality are at historically low levels. The returns available in ultra-safe securities are minimal at best, especially considering the effects of taxes and inflation.

This circumstance can lead investors to want to “stretch for yield.” That is, to be drawn to the higher yields offered by issues of far lesser credit quality. Remember, investors use fixed-income securities to accomplish two tasks: 1) provide stable, predictable income to spend or reinvest, and 2) provide stability to an overall portfolio, in each case assuming the safety of principal invested. When one “stretches for yield” they expose themselves to an income stream that may not be predicable and the risk of default on the underlying issuer.

Of particular concern for those “stretching for yield” are preferred stocks issued by corporations whose financials may be less than solid. While the yields on these securities are very high, one exposes themselves to default risk, the risk of suspension or elimination of the dividends, interest rate risk if rates rise, plus call risk which means that the issuer may redeem these high yielding investments if their circumstances improve.

Seeking high yields in bonds, preferred stocks, leveraged mutual funds, or unit investment trusts is not inherently bad. But one must be cognizant that such investments are equity surrogates due to the risks previously mentioned. In the fixed income component of your portfolio, only a small percentage should be committed to these instruments of moderately high yields.

In today’s environment, some common stocks pay very high dividends. While this can present interesting opportunities, inordinately large dividends are often times a precursor to the sudden elimination or reduction of the dividend. Investments in common stock, of course, present different issues as those investments are often not made with safety of principal as a primary objective.

Always remember, we own fixed income investments to provide predictability and stability. Remember that with the promise of higher yields comes great risk to predictability and stability.