Are we in a bull, a bear, or a cowardly lion market? As we will see, the answer can make a huge difference in your investment portfolio. In his recent book, Active Value Investing: Making Money in Range-Bound Markets (Wiley, 2007), he exhorted investors to fasten their seat belts and lower expectations for the next decade or so. He also provided a strategy for improving returns in this environment, what he calls range-bound or cowardly lion markets. In his presentation Katsenelson goes through his analysis of what will happen and provides an overview of how investors can make money in what will otherwise be an ocean of stagnant returns.
We are used to thinking about secular (longer than 5 years) markets in binary terms:

or
There is another type of long-term market – **Cowardly Lion or Range-Bound Markets**

“bursts of occasional bravery lead to stock appreciation, but are ultimately overrun by fear that leads to a subsequent descent”

– Active Value Investing: Making Money in Range-Bound Markets
The “bear” markets were actually range-bound markets and happened $\frac{1}{2}$ the time.
Dow Jones Industrial Average 2000 - 2009

So far markets have gone sideways ... hell of a ride, but still sideways
Secular Bull and Range-Bound Market Cycles Were NOT Caused by:

- Economy
- Earnings growth
- Interest rates
- Inflation

They Were Caused by:

- Valuation
As Long As: Inflation Remained Reasonable, Deflation Was Absent, GDP And Earnings Growth Remained Positive – Market Was Either Bull Or Range-bound.

<table>
<thead>
<tr>
<th>Decade</th>
<th>Nominal Gross Domestic Product</th>
<th>Real Gross Domestic Product</th>
<th>S&amp;P 500 EPS</th>
<th>Inflation (Deflation)</th>
<th>S&amp;P 500 Total Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>1930 - 1940</td>
<td>-1.4%</td>
<td>0.5%</td>
<td>-5.0%</td>
<td>-1.9%</td>
<td>0.0%</td>
</tr>
<tr>
<td>1940 - 1950</td>
<td>11.2%</td>
<td>5.9%</td>
<td>7.7%</td>
<td>5.0%</td>
<td>8.9%</td>
</tr>
<tr>
<td>1950 - 1960</td>
<td>6.3%</td>
<td>3.8%</td>
<td>5.4%</td>
<td>2.1%</td>
<td>19.3%</td>
</tr>
<tr>
<td>1960 - 1970</td>
<td>6.6%</td>
<td>4.5%</td>
<td>5.6%</td>
<td>1.9%</td>
<td>7.8%</td>
</tr>
<tr>
<td>1970 - 1980</td>
<td>9.7%</td>
<td>3.2%</td>
<td>7.9%</td>
<td>6.3%</td>
<td>5.8%</td>
</tr>
<tr>
<td>1980 - 1990</td>
<td>8.3%</td>
<td>3.1%</td>
<td>5.5%</td>
<td>6.3%</td>
<td>17.3%</td>
</tr>
<tr>
<td>1990 - 2000</td>
<td>5.6%</td>
<td>3.0%</td>
<td>7.1%</td>
<td>3.4%</td>
<td>18.0%</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Secular Trend</th>
<th>Decade</th>
<th>Nominal Gross Domestic Product</th>
<th>Real Gross Domestic Product</th>
<th>S&amp;P 500 EPS</th>
<th>Inflation (Deflation)</th>
<th>S&amp;P 500 Total Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Range-Bound</td>
<td>1936 - 1950</td>
<td>9.4%</td>
<td>5.3%</td>
<td>7.9%</td>
<td>3.9%</td>
<td>6.9%</td>
</tr>
<tr>
<td>Bull</td>
<td>1950 - 1966</td>
<td>6.4%</td>
<td>4.1%</td>
<td>4.8%</td>
<td>1.9%</td>
<td>13.9%</td>
</tr>
<tr>
<td>Range-Bound</td>
<td>1966 - 1982</td>
<td>9.3%</td>
<td>2.7%</td>
<td>6.1%</td>
<td>7.0%</td>
<td>7.7%</td>
</tr>
<tr>
<td>Bull</td>
<td>1982 - 2000</td>
<td>6.3%</td>
<td>3.7%</td>
<td>7.5%</td>
<td>3.3%</td>
<td>16.7%</td>
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</table>

<table>
<thead>
<tr>
<th>Bull Market Average</th>
<th>Nominal Gross Domestic Product</th>
<th>Real Gross Domestic Product</th>
<th>S&amp;P 500 EPS</th>
<th>Inflation (Deflation)</th>
<th>S&amp;P 500 Total Return</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>6.4%</td>
<td>3.9%</td>
<td>6.2%</td>
<td>2.6%</td>
<td>15.2%</td>
</tr>
<tr>
<td>Range-Bound Market Average</td>
<td>9.4%</td>
<td>4.0%</td>
<td>7.0%</td>
<td>5.5%</td>
<td>7.3%</td>
</tr>
</tbody>
</table>

Note: Real GDP growth was extremely stable throughout all secular markets
There Is A Very Tight Relationship Between Interest Rates And P/Es During 1960-2006

P/E (S&P 500, 1 Year Trailing)

Implied P/E = 1 / 10 Year Treasury Yield
The Relationship Between Interest Rates and P/Es is Extremely Weak Between 1900 and 1960.

1900-1960

Implied P/E = 1 / 10 Year Treasury Yield

P/E (S&P 500, 1 Year Trailing)
### Bull, Bear and Range-Bound Markets Happen When...

<table>
<thead>
<tr>
<th>Market</th>
<th>Economic Growth</th>
<th>Starting Valuation (P/E)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bull</td>
<td>Good (Average)</td>
<td>Low</td>
</tr>
<tr>
<td>Range-Bound</td>
<td>Good (Average)</td>
<td>High</td>
</tr>
<tr>
<td>Bear</td>
<td>Bad</td>
<td>High</td>
</tr>
</tbody>
</table>
Stock Market Math

Price + Dividends = Total Return from Stock(s)

Earnings Growth + $\Delta \text{P/E}$

or

Earnings Growth + $\Delta \text{P/E}$ + Dividends = Total Return from Stock(s)
Wal-Mart A Typical Range-Bound Market Stock...

2001 - 2009

[Graph showing stock price fluctuations from 2001 to 2009 with key points labeled: 47, 48, 57, 62, and 60.]
Sources of Return Example: Wal-Mart

Annual Price Appreciation

Total annual rate of return

2000 - 2009

P/E

45.4

13.7

-12.4% a Year

+ Earnings

1.25

3.42

11.8% a Year

= Price

57

47

-2.1% a Year

+ Dividends

1.0%
Sources of Return: Secular Bull Markets

**Bull Markets: P/E Expansion + Earnings Growth = Super Returns**
Sources of Return: Secular Range-Bound and Bear Markets

Range-Bound Markets: P/E Contraction + Earnings Growth = Low Returns
Bear Markets: P/E Contraction + Earnings Decline = Negative Returns
Japanese “by the book” Bear Market - Japan

- Initial peak: E = 584, P/E = 66
- 13 Years 4 months, 80% Decline
- Bottom: E = 832, P/E = 16
- Recovery: E = 271, P/E = 43
Bull Markets Start at Below Average and End At Above Average Valuations. Range-Bound Markets Start at Above Average and End at Below Average Valuations.

Reversion *Beyond* the Mean
1 Year Trailing P/Es for S&P 500

P/E - 2/20/2009
Price = 770
E (EPS): 2008

We are today
Takeaways: 1) Stocks are still not cheap 2) Earnings growth will be lower (consumer is deleveraging, government debt is growing – higher interest rates and higher taxes)
Bull Markets Start at Below Average and End At Above Average Valuations. Range-Bound Markets Start at Above Average and End at Below Average Valuations.

Reversion *Beyond the Mean*
10 Year Trailing P/Es for S&P 500

We are today
Market Psychology

End of Bull Market

“New” average expectations are NOT met – P/E stopped expanding

\[ \text{P/E} + \text{EPS} = 0\% + 6\% \approx 6\% \]

Range Bound Market

Returns are NOT “new” average, not average but below average:

\[ \text{P/E} + \text{EPS} = -6\% + 6\% \approx 0\% \]
Should I Be In Bonds Instead?

90% Of Return Comes From Asset Allocations,

True Or False?
Bull Markets: Stock Do Outperform Bonds Hands Down

Real Returns Stocks vs. Fixed Income Instruments
Bull Market of 1982-2000

S&P 500 Real Total Return
Real Long Term Government Bonds
Real Treasury Bills Total Return

Throw money at stocks, and you’ll do much better than bonds or cash. In general, the fewer decisions you make the better off you are (buy and forget).
Asset allocation is *not* as important as stock selection.
90% Of Return Comes From Asset Allocations, True Or False?

- Bull markets - True
- Range-bound markets – False

Additional point: Fed is printing money faster than you can read this. In the long run inflation will rise – bad for bonds.
Conclusion: Stock Selection Matters A Lot!

Investing as you did during secular bull market will not work. Your analysis and strategy needs to be modified.
Be buy and sell investor. Buy and hold is in the comma (see next chart). Time (price) stocks through a strict buy and sell process. Buy when undervalued sell when fairly valued.

Time Stocks Not The Market: Market timing is very difficult. In the short-run emotions are in the driver seat.

Don’t buy for the sake of being invested. Don’t lose money by making marginal decisions. In absence of good stocks to buy, be in cash. The opportunity cost of cash is not as high as in the secular bull market.

Increase margin of safety: Fewer (better) stocks will be in your portfolio.

Favor dividend paying stocks. Dividends were 95% of the return in previous range-bound markets. (warning: dividends are part of analytical equation, not the equation.)

Look overseas - increases return without increasing risk
Secular Range-bound Markets Is Comprised Of Many Cyclical Markets

Secular Range-Bound 1966-1982 Market
Dow Jones Industrial Average

5 Bull + 5 Bear + 1 Range-Bound
Thank you!

More information about the book and PDF of this presentation

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To receive my articles via email send me an email:

vitaliy@usa.net

More information about Investment Management Associates Inc.

www.imausa.com