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Comstock Partners, Inc.

What You Think You Know That Isn't So

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In the late 1990s we wrote a lengthy report with the above title at a time when investment advisors, strategists and economists were exclaiming that all one had to do was ignore the stock market fluctuations, invest in stocks at any time, and watch your nest egg return an average of 10% per year. We pointed out that although there was a kernel of truth in the argument, investors were actually running great risks in buying stocks at excessive valuations near the end of secular bull markets. Although valuations are somewhat lower than the ridiculous heights reached in early 2000, the cyclical bull market since October 2002 has once again put the market in a position where the risks of losing money--or at least not making any—are once again very high.

The kernel of truth in the long-run thesis is that U.S. stocks really have returned about 10% a year on average over the very long term. There are two factors, however, that proponents often overlook when promoting this view. First, of the 10% overall return, about 4% has historically been accounted for by dividends, leaving about 6% attributable to the gain in the stock index alone. Since we know that the current dividend yield is only about 1.8%, the historic 10% return is not applicable to the current situation. Second, and more importantly, there have been many long periods where the market not only did not return 10%, but actually declined. Here are some examples covering different periods of time using the Dow Jones Industrials, which goes back the 1880s in real time. In each instance we show the starting date the ending date, the decline in the Dow, and the number of years.

August 1886 to November 1903—minus 16% (17 years)

September 1899 to July 1932—minus 27% (33 years)

January 1906 to August 1921—minus 15% (15 years)

November 1919 to April 1942—minus 22% (23 years)

September 1929 to January 1950—minus 50% (21 Years)

August 1959 to December 1974—minus 17% (15 years)

February 1966 to August 1982—minus 23% (16 years)

Furthermore, since 1903 there have been 26 different years where at some point that year the Dow was lower than at another point 15 or more years before. This comprises a full 25% of the total number of years within that span. It is therefore extremely misleading to conclude that investors can enter the market at any point in time and be reasonably assured of a 10% return.

Peaks of secular bull markets have generally been characterized by high valuations and an optimistic view of stocks, while bottoms have occurred at a time of low valuations and a view of stocks as being too risky for most investors. We believe that the long and powerful secular bull market of 1982 to 2000 has given way to a potentially lengthy secular bear market such as the periods outlined above. Given the current excessive valuations and the major economic and financial structural imbalances we have discussed repeatedly in prior

comments, it is likely that positive returns from current levels will be exceedingly difficult to achieve for years to come.

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