August 17, 2007

Notes

To: PMs

RE: *A 10% Correction – Oh My!*

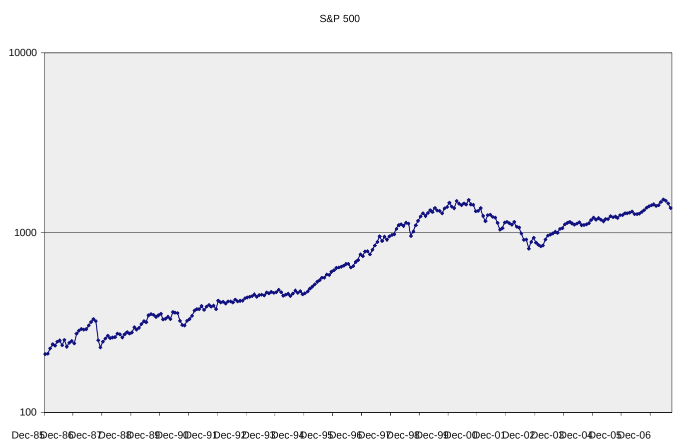
The present Credit Panic has given us our first taste of the market's dark side in quite some time. Defining a "Bad" market spell as a monthly S&P 500 decline of 5% or more or a three-month decline of 10% or more, it's been four-and-a-half years since our last "Bad" spell. This long, quiet period has created some misconceptions as to the true nature of the market, which can be dangerous if that leads to unrealistic expectations. Let's review some history together.

Major market events during my 22 years in this business include the Crash of '87, the first Gulf War major sell-off of '90 and the '00-'02 worst Bear market in almost half a century. Altogether, there have been 22 "Bad" months and 18 "Bad" three-month periods of the scale we face today and worse. In fact, nearly half (10) of these 22 years had at least one "Bad" month and/or three-month period. Equity investing would seem a hopeless proposition, save for:

1) The even more prevalent "Good" months (forty 5% or better);
2) And "Good" three-months (twenty-nine 10% or better);
3) And that even measuring to the present temporarily depressed point, the S&P 500 has delivered an 11.5% average annualized return despite all the setbacks during these 22 years.

The point of the above is that periodic market corrections are common occurrences and that the particular triggering event du jour doesn't really matter. At the end of the day, this is simply what the market does. Many investors succumb to the pressures of these episodes, thinking them unique, truly catastrophic events, thus capturing all the risk of the market and only a fraction of the return. Those who recognize these periodic storms for what they are, normal periods of market "excitement", patiently wait them out, which effectively turn them into nonevents. This is where experience pays off, as less seasoned investors find this patience much harder to come by.

To help put this into perspective, consider this chart of the S&P 500 from Dec85 to present and the significance of the present pullback as a function of time. Hard to imagine that something seemingly so meaningful practically disappears from this vantage point.



Lax lending practices will reform, sub-prime lenders and speculative borrowers will pay for their sins, and the U.S. economy will lose about one percentage point of GDP Growth. Not a great thing, but not the end of the world either.

Keep the faith!

Lowell