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New high for the S&P 500: how meaningful will it be?

The S&P 500 index closed today slightly below its previous all-time closing high of 1527.46 on March 27, 2000, and it was above that level during the day. I would not be surprised to see it set a new high this week. One critical characteristic of a market trending up is that it makes higher highs. The more widely quoted Dow Jones Industrial Average has been making new highs for about six months, but the S&P is much more representative of the U.S. stock market and if often used as a benchmark for the performance of stocks. Would a new high mean that the “secular” bear market I have been writing about for several years is over and that we are now in a secular (one that can be expected to last on the whole for many years, typically 15-20) bull market as opposed the cyclical bull (one within a secular bear market that may last for a few years) that I have said we are currently in? In short, I don’t think so.

The main reason is that a dollar is not worth what it was seven years ago. Although inflation has been fairly modest by historical standards, over that length of time, its effects do add up. During the 85 months since the March 2000 through April of this year, the Consumer Price Index has risen by almost 21%, so the S&P would need to gain that amount plus the future increases in the CPI to set a new inflation adjusted high. For those who want an exact number, as of the end of April, that would be 1845.15.

However, there is more to the story. Some of the stocks in the index pay dividends, and those can offset to some extent the effects of inflation. A better comparison would take the dividends into account. If we assume the dividends will be used to buy more of the index, the easiest way to accomplish that is buying a traditional mutual fund that “owns” the index and having its distributions reinvested. The Vanguard Index 500 fund (ticker VFINX), which has been around for more than thirty years, was the first index fund and has a very low expense ratio. Because stocks recovered most of their initial drop after the March 2000 highs, when the dividends are factored in, the high for VFINX in 2000 was on September 1. Using the CPI to measure the effects of inflation, that fund would now need to gain about 7.5% plus future CPI increases to set a new inflation adjusted high.

When the S&P makes a new inflation adjusted high, will I then say the secular bear has gone into hibernation (regardless of what time of year that happens)? I can't answer that now since it depends on when and how the stock market is behaving at that point. However, my answer, one way or the other, is not important from an investment point of view.

Let's say the Vanguard fund makes a new inflation adjusted high in the next couple of months. That (and new nominal S&P highs) will likely generate a lot of shouting from the talking heads on CNBC, gurus who work for traditional brokerage houses and mutual funds, and especially from John Bogle, former head of Vanguard and the father of the index fund, saying that stocks should just be bought and held because "they always come back." As I have said many times before (perhaps too many for some of you), I strongly disagree with that point of view.

First, when VFINX matches it previous inflation adjusted high, that will mean a total return in purchasing power of the fund of a staggering 0%, total or compounded, over about seven years. Over the period since the end of August 2000, the Vanguard Federal Money Market fund has beaten inflation by about 2.3% (total, not compounded) despite the Fed cutting short-term rates to near zero a couple of years ago. That's not exciting, but it is virtually risk free.

That leads to the second and far more important reason behind my thinking. These "experts" who advocate buying and holding are almost certain not to make mention of or play down the fact that both the index and the index fund lost over 47% from their high points in 2000 to their low points in October 2002. When inflation is taken into account, that would mean a loss of over half of the purchasing power of the investment. If one needed to liquidate stock holdings during that time, it would have been quite a shock to the financial position. Moreover, holding on after that type of drop is quite difficult for most investors. Rip Van Winkle would not have a problem, but who wants to sleep for 20 years in order to avoid worrying about the stock market?

Instead of "buy and hope," I advocate using well researched, quantitative, unemotional models to identify those times when the risk of owning stocks is too high in comparison with the potential returns to justify being in the market. When the models so indicate (and they don't right now), I'll move assets out of stocks. My web site, in the context of investing for retirement, has an extensive discussion of the subject. (http://www.pankin.com/retire/).

Please get in touch with me if you want additional information or would like to discuss this or other financial matters.

Notes:

1) The above calculations do not take taxes into account. The comparisons are accurate for retirement accounts that do not pay taxes or have taxes deferred, but the comparisons for taxable accounts might be different
2) You should not consider the above to be a recommendation of the Vanguard funds discussed. While Vanguard has many well run, low cost mutual funds, similar funds are available from other mutual fund companies. Most client accounts are with Fidelity, and Vanguard funds are not available for those accounts. However, Fidelity offers funds comparable to the two mentioned.

Mark Pankin
703-524-0937
mdp2@pankin.com