Chapter One

Fasten Your Seat Belt

Sideways Markets Are Here to Stay

GET READY FOR A GREAT ROLLER-COASTER RIDE in the markets. For the next decade or so the Dow Jones Industrial Average and the S&P 500 index will likely do what they did over the preceding decade: go up and down, setting all-time highs and multiyear lows along the way. But at the end of the ride, index and buy-and-hold stock investors, having experienced ups and downs and swings akin to those on an amusement park ride, will find themselves pretty much back where they started. This is all well and fine for visitors to Six Flags, but not really what most of us want for our investments and savings.

The length, the velocity, and the twists of the ride are yet to be written by history, but the flat long-term trajectory has been ordained by the 18-year bull market that ended in 2000. Using history as a guide, until about 2020 (give or take a few years) the U.S. stock market will likely continue to stagnate. Welcome to the sideways market!

Take a Trip to the Zoo

When we think of market direction we think in binary terms: bull—going up, and bear—declining. But what about markets that go nowhere over time? They are known as sideways markets and they look quite different from bear markets, although the distinction is seldom made. *All* long-term markets of the last century, with one exception, were either bull or sideways.* Since investors are used to associating animals with the direction of the market, I suggest a moniker for the sideways market:

*A few weeks after my first book *Active Value Investing: Making Money in Range-Bound Markets* came out, I started to regret calling the market range-bound, as I constantly was asked, "What is the range?" In the book, I never suggested I knew the range of these markets, but the book's name suggested otherwise. "Sideways" is a more accurate and less technical description of these very real markets, and it is the term I adapted for use in the present book.

the cowardly lion, whose bursts of occasional bravery lead to stock appreciation but are ultimately overrun by fear that leads to a descent.

We also split trends by how long they last. A *secular* market describes a state that lasts more than five years, perhaps taking place only once in a generation. A *cyclical* state is a significantly shorter market cycle that lasts a few months to a few years. When I discuss *secular* bull, bear, or sideways markets, I'll refer to them just as bull, bear, and sideways markets. I'll use the word *cyclical* when referencing cyclical markets.

During the twentieth century, almost every protracted bull market lasted about a decade and a half or so and was followed by a cowardly lion market that lasted just as long. For evidence, see Exhibit 1.1. The only exception was the Great Depression, where the bull market was followed by a bear market. Sideways and bear markets are radically different in nature and your investment strategies need to be radically different, too.

Let's look at a really long-term picture of the market. In Exhibit 1.1, we see that our current sideways market started on the heels of the 1982–2000 secular bull market. Since then, as you see in Exhibit 1.2, we have had a two-and-a-half-year cyclical (short-term) bear market, followed by a four-year cyclical bull market and then an all too familiar 50 percent decline that has been followed by

Exhibit 1.1 Bull or Sideways, Dow Jones Industrial Average, 100 Years and Counting

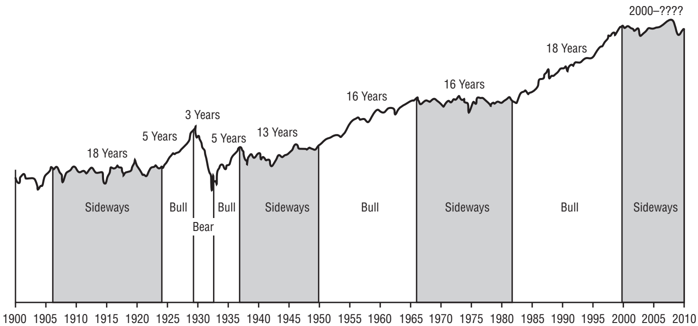
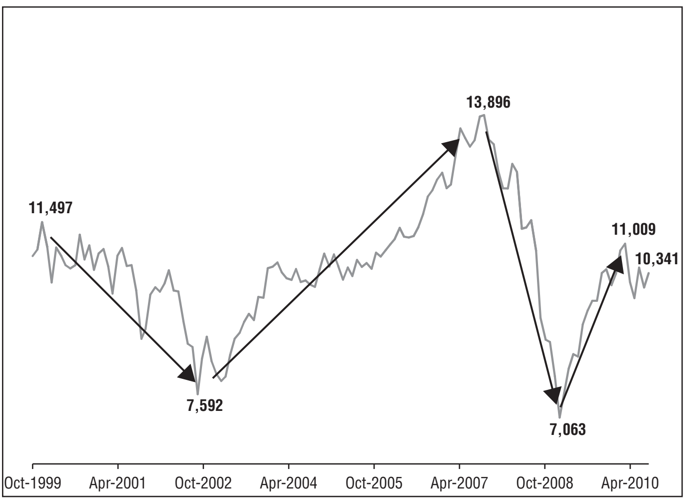


Exhibit 1.2 2000–2010 Dow Jones Industrial Average Sideways Foxtrot



a nice bounce since March 2009. Altogether, the market hasn't gone anywhere in more than 10 years. If you are a long-term investor in an index fund or buying and holding, you are pretty much where you started 10 years ago.

It Takes (At Least) Two

Ask an investor what the stock market will do over the next decade and he'll tell you his expectations for the economy and earnings growth and then turn them into a projection for the market. This kind of thinking only looks at half of the equation that explains stock market (and individual stock) returns, while ignoring a very important variable that is responsible for a significant part of stock returns: the price-to-earnings (P/E) ratio. The P/E tells us what investors are paying for a dollar of earnings: A $15 stock of a company that earned $1 last year is trading at a P/E of 15.

Stock prices in the long run (not minutes or days, but years) are driven by two factors: earnings growth and changes in valuation (P/E ratio). Add a return from dividends, and you've captured all the variables responsible for the *total* return from stocks. The following equation*

*This equation is imprecise because it ignores the power of compounding. For clarity I am using simple addition and subtraction, as opposed to doing the precise thing by multiplying and dividing. In future chapters, to simplify the illustration of concepts, I'll continue to be imprecise with my formulas for the sake of clarity, by ignoring compounding.

(don't worry, this is the only one in the entire book) illustrates this:

$$\text{Stock's total return} = \text{Earnings growth/decline} \\ + \text{change in P/E} \\ + \text{dividend yield}$$

I hate the use of formulas in investing, as they usually do more harm than good (especially the ones with fancy Greek symbols), but this one is actually helpful and not dangerous.

I dug up economic and stock market data for the last 100 years, sliced it and diced it in different ways, and came to only one possible conclusion: Performance of the economy and earnings growth did not vary much between cowardly lion and bull markets. Although in the short run the rates of economic and earnings growth were responsible for (cyclical) swings in the market, in the longer run, as long as we had an average economy (not super-good or super-bad), the animal in charge of the market was either the bull or the cowardly lion.

Feeling Skeptical? It's Okay

If someone else was making a prediction that markets will be sideways for another decade and he was relying on past data to make this disturbing claim, I'd be skeptical.

After all, the past has passed and the future may be different. If you are feeling a bit wary about what I've said so far, you have a right to be, but hang on as I present the case. As you'll see, this prediction is less wacky than it appears at first.

I am an investor. I live and breathe stocks and have little patience for theoretical discussions. Thus, this is not a theoretical little tome. It is a practical guide to value investing in sideways markets. In Chapters 2 and 3 I explain what sideways markets are and how they will impact us. Then I put you in the shoes of a value investor through the story of Tevye—the milkman, farmer, and value investor. Finally, I introduce you to the framework for guiding your stock analysis that takes into account the lingering effects of the Great Recession, the financial crisis of 2008–2009, and the coming impact of the economic conditions in Japan and China so that you will be able to steer your portfolio safely and steadily in the face of continued uncertainties.