

“Remember that there is nothing stable in human affairs; therefore avoid undue elation in prosperity or undue depression in adversity.” —Socrates, 399 B.C.

“In the economy, an act, a habit, an institution, a law, gives birth not only to an effect, but to a series of effects. Of these effects, the first only is immediate; it manifests itself simultaneously with its cause— it is seen. The others unfold in succession— they are not seen: it is well for us if they are foreseen.” —Frederic Bastiat, *That Which Is Seen, That Which Is Unseen*, 1850

“*Res nolunt diu male administrari.* Things refuse to be mismanaged long. Though no checks to a new evil appear, the checks exist, and will appear.” —Ralph Waldo Emerson, 1844

“Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one.”—Charles Mackay, *Extraordinary Popular Delusions and the Madness of Crowds*, 1912

# 2014

## ANNUAL REPORT

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## Why We Worry Top-Down and Invest Bottom-Up

“A rising tide lifts all ships” is bandied about in our profession like a shuttlecock at a garden party badminton game.

It seems that whenever an analogy is that simple and quaint, there must be a catch. And there is: the waves. In their endless repetition they mask the invisible but prodigious ebb and flood tides. The daily headlines are almost always about the waves, particularly, even if unnoticed, when the tide is rising.

Those of us who worry top-down are keenly aware of those signs that may give us an early indication of an impending change in phase (i.e., from when the flood tide peaks at high tide and begins to reverse its flow or vice versa). If we are patient and aware, a rising tide is today’s ally, and within an ebbing tide is tomorrow’s opportunity.

Because security markets are the outward expression of an endless stream of millions of individual decisions—all along the continuum from brilliant to banal—that is both cause and effect of the market’s ups and downs, they lack anything approaching the harmonic symmetry of the tides. As random as they seem from day-to-day—or even year-to-year—there is nonetheless a rhythm to them, as there is to all of nature.

This year’s letter seeks to identify the tidal ebbing and flooding of the markets since the turn of the 20<sup>th</sup> century.

The endeavor is simple in concept, yet anything but easy in implementation. Like the changing effect of the sun and the moon on the amplitude and duration of the tides’ rising and falling, the forces impacting the markets are forever changing as well. The crucial difference is that with the latter, these forces are unpredictable. We invariably find ourselves on the horns of a dilemma: We may have a general idea about the stage of the tide, but we know it’s a fool’s game to attempt to predict when or at what level high or low tide will occur.

The macro-worrier is not powerless in resolving this tension. When, in his or her reasoned judgment, the flood tide reaches a water level above which the prevailing risks begin to overshadow the prospective returns, capital can be reallocated so as to minimize the effect of, and sometimes profit from, the eventual shift in phase.

As for the not-so-easy part, unlike the regularity of the tides, the ebbing of markets is typically disorderly—sometimes utterly chaotic—making it difficult to distinguish the waves from the tides. Occasionally the ebb current is so strong that even the best are swept out to sea. Aware of this propensity, macro-worriers are invariably early to seek a safe mooring—sometimes so early as to look the very fool they so diligently sought not to become. (See asset allocation chart on Page 2.) Why do we put ourselves through this agony? Because it works!

Macro-agnostics minimize the psychological discomfort of cognitive dissonance by avoiding situations and information that might cause it. Using backward-looking models—a common coping tool—computing the probability of something disastrous that has never happened before usually produces a number close to zero. With a probability that slim, most become disaster myopic. They don’t even think about it. Equally troubling, studies have shown that new information conflicting with one’s worldview is most often rejected.

Such macro-agnosticism has become mainstream. This development is dangerous and hubristic in our view. This year, by taking you on a whirlwind tour of 114 years of market history, we want to arm you with better tools to judge where we stand. Benjamin Graham, deservedly the “Dean of Wall Street,” urged that an investor should “*have an adequate idea of stock market history, in terms, particularly, of the major fluctuations. With this background he may be in a position to form some worthwhile judgment of the attractiveness or dangers ... of the market.*” As pundits continue their refrain of “this time is different,” we hope you will share our conclusion. Despite the deceiving/distorting “waves” caused by unprecedented Fed policies which have currently stretched asset valuations to near-bubble levels, the tide is still ebbing, following the once-in-a-lifetime 20-year flood tide that set a new high watermark in 1999. Those who mistake the waves for the tide may be in for a cruel awakening.

One thing we know for sure is that, in time, once the ebb tide has run its course, the next flood tide will follow. With liquidity, patience, a contrarian streak, a steely temperament and a willingness to seize opportunity within our spheres of competence, we are ready. While thought to be crazy at the time, only Noah is part of history. Others may have talked about it, but he’s the only one who actually built an ark!

## A Data-Driven Story: The Ebb and Flood Tides from 1900

Unlike last year’s annual report, the principal essay in this the 2014 effort will concentrate on low degree-of-difficulty worrying—the kind that requires a rational mind, common sense, an awareness of historical proportion and that pays disproportionately large psychic and financial dividends. The condensed findings of an examination of a sea of data stretching over a century of market history follow. Going back to 1900, we have subdivided history thematically into consecutive eras of rising and ebbing tides, based on the returns investors earned, alternating between long-term secular peaks and troughs. Shorter-term cyclical bull and bear markets occurred within these grand secular trends—the waves within the tides—to which we will turn on another occasion. By seeking to identify the conditions that precede both types of eras, one might find oneself happily on the right side of history.

**Table I**

<b>S&amp;P 500 Real Annualized Total Return w/ Dividends Reinvested</b>		
<b>Time Span</b>	<b>Ebb</b>	<b>Flood</b>
1900-1921	2.6%	
1922-1929		26.9%
1930-1949	2.7%	
1950-1965		13.9%
1966-1981	(1.0%)	
1982-1999		14.4%
2000-2014*	2.0%	

*\*Not necessarily indicative of low tide, but simply the latest date for which data is available.*

The spoils of the seemingly relentless stream of innovations marking the 20<sup>th</sup> century as the most productive in the history of man did not fall upon investors like a steady rain of riches. Quite to the contrary, investors experienced four extended and anguishing periods of stagnation—spans of 21, 19, 16 and 14 years (thus far), respectively. Those who were invested during the ebb-tide years accepted—knowingly or otherwise—the risks of owning the equity tranche of a corporation’s capital structure without any defensible prospect of earning the “equity risk premium.”<sup>1</sup> In a flourishing country in which people are focused on making money, how can that be? In the simplest, mathematical terms, above-average returns in the flood-tide years were compensated for by below-average returns in the ebbing ones. The inflation-adjusted total return from the S&P 500 (including dividends)—*which averaged 6.5%*—cannot exceed (or fall behind) indefinitely the rate of intrinsic value growth in the businesses themselves.

It is also a well-understood identity that investors as a whole cannot do better than the market. It should be of no surprise to readers that an investment results-based frequency distribution of the total population of investors takes the shape of a bell curve with a narrow standard deviation. Clearly the vast majority of market participants experience average returns. This is not a criticism, only an observation.

Like our clients, we aspire to be other than average. Unlike the randomness of the toss of a coin, the great investor outliers tend, over time, to be on the “right” tail of the bell curve. Because of their rational, disciplined, process-driven approach to the game, their high batting averages overshadow the inevitable strikeouts and occasional slumps. On no lesser authority than Buddha, we justify our single-minded desire to emulate the masters: “The mind is everything. What you think you become.” Forearmed with knowledge not only of facts, figures and events, but of the nature of

<sup>1</sup> The excess return that an individual stock or the overall stock market provides over a risk-free rate. This excess return compensates investors for taking on the relatively higher risk of the equity market.

men and markets, giants like Ben Graham, Warren Buffett, and Seth Klarman<sup>2</sup> are among the hardy perennials whom we wish to flatter by our imitative thinking.

Another right-tail anomaly, I recall Peter Bernstein speaking to but one of many tendencies that lead to the exaggeration of the sentiments among of the mass of investors that amplifies market movements and gives rise to ebb- and flood-tide eras:

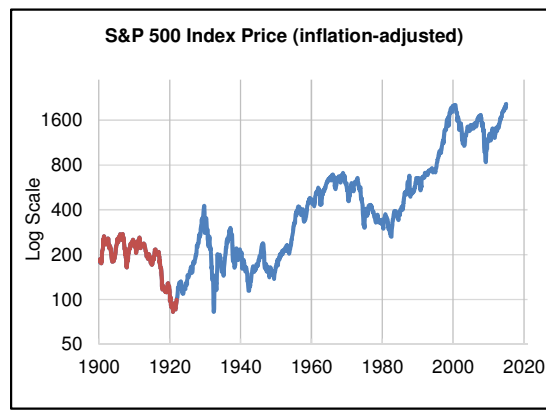
In their calmer moments, investors recognize their inability to know what the future holds. In moments of extreme panic or enthusiasm, however, they become remarkably bold in their predictions: they act as though uncertainty has vanished and the outcome is beyond doubt. Reality is abruptly transformed into that hypothetical future where the outcome is known. These are rare occasions, but they are unforgettable: *major tops and bottoms in markets are defined by this switch from doubt to certainty* [italics added].

**An essential guide to understanding the charts and tables that follow:** The data in this longitudinal study is adjusted to exclude the distorting effect of inflation, which increased 30-fold over the 114 years. Thus, GDP and debt, as well as S&P price, earnings, and dividends are presented as “real” (inflation-adjusted). Because the 20<sup>th</sup> century witnessed unprecedented gains in productivity (output per person) while, at the same time, the population increased 3.2 times over the entire 114 years, such data as GDP (as well as public and private indebtedness) is presented per capita.

The long-term charts at the beginning of each section appropriately use logarithmic scale so that market fluctuations over history are proportional. The tables rely on data provided by Nobel Prize winner Robert Shiller, about whose credibility more is said later in the report. The Shiller P/E is determined by dividing the real S&P index price by a ten-year moving average of S&P earnings. The price return is a function of the beginning-to-end change in both the P/E and the Shiller earnings. S&P dividends, the Dividend Return, are assumed to be automatically reinvested in the index in order to arrive at the Total Return. To avoid endless repetition, unless noted otherwise, these standards will apply throughout the document.

## 1900–1921

Chart 1



<sup>2</sup> Seth Klarman gets credit for the title of this report. We know of no prominent investor whose returns, if one properly adjusts for the risks he doesn't take, are greater and more likely to be repeatable.

**Table II**

<b>Time Span</b>	<b>Shiller P/E</b>		<b>Annualized Rate of Change in</b>		<b>S&amp;P 500 Real Annualized Return</b>		
	<b>Beginning</b>	<b>End</b>	<b>Shiller P/E</b>	<b>Shiller EPS</b>	<b>Capital Appreciation</b>	<b>Dividend Return</b>	<b>Total Return</b>
<b>1900-1921</b>	<b>18.5</b>	<b>6.1</b>	<b>(4.9%)</b>	<b>2.4%</b>	<b>(2.6%)</b>	<b>5.3%</b>	<b>2.6%</b>

Leaving the station like a steam-powered locomotive on this characteristic 21<sup>st</sup>-century, information-age, high-speed tour through history, the Industrial Revolution in the U.S. was well underway by 1900, with Henry Ford introducing yet another life-changing and labor-saving innovation—the Model T and the assembly-line process for manufacturing it—in 1903. The population was a comparatively smallish 76 million (one fourth of today’s 316 million). Long before the introduction of the myriad government-sponsored social and economic safety nets we know today, the national character could be summarized as hearty, resilient, hard-working and industrious. Personal accountability was not a choice. Labor-saving (and thus labor-displacing) innovations proliferated throughout the 20<sup>th</sup> century. As a powerful example of increased productivity, automation and genetic engineering displaced farmers. As a result, the task of feeding the nation, which a little over 100 years ago employed 18% of the U.S. population, today requires only 1%! What Keynes later described as “spontaneous optimism” and “animal spirits” gave rise to growth that created jobs for displaced workers and overall productivity boomed. Per capita GDP rose eightfold from \$6,400 in 1900 to \$54,000 in 2014. Still, by today’s standards the country was a fledgling, with many of its political, business, legal and social institutions underdeveloped.

This caricatured epoch began with a power struggle among railroad barons for control of the Northern Pacific Railroad, culminating in the Panic of 1901, the first since the Panic of 1893. The Panic of 1907 was a wild and woolly financial crisis triggered by a failed attempt to corner the market in the stock of the United Copper Company. A run on the banks that financed the scheme ensued, the most notable of which was the Knickerbocker Trust Company, from which the run then spread to its regional correspondents and, eventually, across the nation. Side bets by unregulated bucket shops exacerbated the panic. J.P. Morgan stemmed the crisis by pledging his own money and convincing other New York bankers to do the same, thus providing needed liquidity for the banking system. The Panic of 1907 became fodder for those advocating the first central bank since the time of Alexander Hamilton. Steeped in controversy, Federal Reserve Act was signed into law in 1913.

Militarily, the United States’ active involvement in the “war to end all wars” began in April 1917 and ended with armistices in late 1918. On the heels of World War I came an unprecedented pent-up-demand-induced inflationary boom followed by the (lowercase “d”) depression of 1921. Real GDP fell by 9%. As a point of reference, GDP contracted 4.3% during the Great Recession of 2007–09, with both downturns lasting about 18 months. Again, for comparison purposes, not only did output fall farther in 1921, but it recovered quicker and with more force than the U.S. has experienced thus far in the post-Great Recession recovery. From the depths of 1921, real per capita GDP surged 25% through 1926. In the five years since the current recession officially ended in 2009, real GDP has grown a paltry 6%.

The depression of 1921 was the last untreated depression. Under the laissez-faire presidencies of Harding and Coolidge, no attempt was made to stop the fall in prices and wages. Wholesale prices plunged 37%, consumer prices by 11% and farm prices by 41%. By today’s standards, such thinking was unenlightened—or was it? If hourly wages were allowed to bring costs in line with prices, it was reasoned that a business losing money had a chance to return to profitability. And by returning to profitability, it would have a reason to invest in assets and people and thereby grow. The process wasn’t heartless. Those in power understood that wage rates had to be properly realigned with other costs of production. If they were not allowed to fall, such a policy would have found favor among the dwindling remnant of fully employed workers. *But* society’s overall income would have been lower at that uneconomic level of compensation.

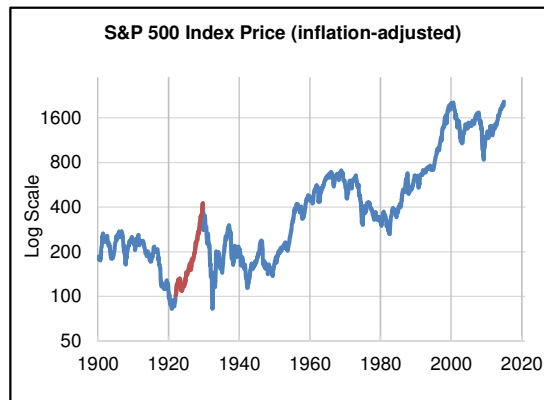
In spite of the economic ups and downs, including the destabilizing effect of the war, the impetus from the expanding use of electricity, autos, and the telephone was enough to keep the country moving, albeit slowly. Real per capita GDP, in fits and jerks, advanced at an annual rate of 0.3%. The average for the entire 114-year period? 3.3%.

The future looked promising as the 20<sup>th</sup> century dawned. Corporate profits had been rising and P/E ratios expanding. Having enjoyed a few flood-tide years—panics were more frequent in those days—investors were optimistic. Considering the state of the factors that express themselves in the price-to-earnings ratio—interest rates, the expected growth in corporate profits, the risk appetite of investors—the market was surely near high tide. Unless the best got a whole lot better, the tide would eventually shift. No one could’ve imagined in 1900 that there would be two panics in the first decade, World War I in the second, all capped by the depression of 1921.

By the 1921 depression, the future looked as miserable as the past. And yet, the valuation metrics at the time screamed a very low tide. In the depths of despair, however, no one was listening. No one could have dreamt what was in store for the 1920s—except that the tide would eventually change. Most times that’s enough.

## 1922–1929<sup>3</sup>

**Chart 2**



**Table III**

<u>Time Span</u>	<u>Shiller P/E</u>		<u>Annualized Rate of Change in</u>		<u>S&amp;P 500 Real Annualized Return</u>		
	<u>Beginning</u>	<u>End</u>	<u>Shiller P/E</u>	<u>Shiller EPS</u>	<u>Capital Appreciation</u>	<u>Dividend Return</u>	<u>Total Return</u>
1900-1921	18.5	6.1	(4.9%)	2.4%	(2.6%)	5.3%	2.6%
<b>1922-1929</b>	<b>6.1</b>	<b>32.6</b>	<b>24.1%</b>	<b>(2.8%)</b>	<b>20.6%</b>	<b>6.2%</b>	<b>26.9%</b>

Just as Jane Austen’s novels capture the *zeitgeist* of the late 18<sup>th</sup>-century landed gentry in England, so do American author F. Scott Fitzgerald’s works define the 1920s. *The Great Gatsby*, published to little acclaim in 1925, and inspired by the parties Fitzgerald attended while visiting Long Island’s North Shore, explores themes of decadence, idealism, resistance to change, social upheaval and excess, creating a vivid portrait of the Jazz Age and the Roaring Twenties. Like Austen, eventual acclaim was momentous, although awarded posthumously.

More inclined toward the pragmatic, Warren Buffett credits Edgar Lawrence Smith’s 1924 book *Common Stocks as Long-Term Investments* with inadvertently providing the intellectual framework for the late 1920s stock market mania.

<sup>3</sup> Rather than year-end data, month-end figures from September were used. Stock prices fell 31% over the three months.

Smith found a hole in the reasoning that stocks should yield more than bonds because they were deemed more risky. He pointed out that stocks were more than their dividends because the unpaid portion of earnings was reinvested in the business on behalf of the shareholder. If successfully allocated, the retained and reinvested earnings would later reappear in the form of higher dividends or capital appreciation, or likely both. Decades later Warren Buffett pointed out both the folly and the genius in Smith's revelation. Quoting Ben Graham, "You can get in way more trouble with a good idea than a bad idea,' because you forget that the good idea has limits."

Yet another academic, Irving Fisher, perhaps the first U.S. celebrity economist and the man who won the approbation of some of the greatest economists of his time and in the years to follow, threw one of the largest and last logs on the bonfire of the vanities (and irreparably savaged his own considerable reputation) by publicly pronouncing that the stock market had reached "a permanently high plateau" just prior to the 1929 Wall Street Crash.

Acting more like gasoline than quenching water, the more the evidence of everything of which Fitzgerald wrote was poured on the fire of inflamed passions, the higher and more intensely it burned. "*Major tops and bottoms in markets are defined by this switch from doubt to certainty.*"

In terms of the fundamental underpinnings behind the great speculative epidemic, coming out of the 1921 depression, growth in real per capita GDP averaged an impressive 3.9%. The S&P P/E rocketed from 6.1 times to 32.6, a valuation record that stood for 70 years until the peak of an even greater bubble in 1999. The modest downward movement of longer-term interest rates was largely irrelevant during the speculative frenzy.

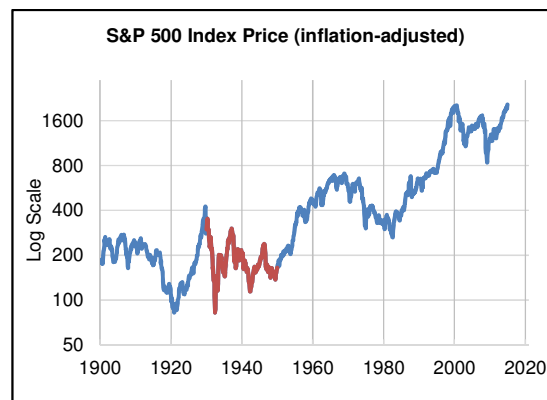
Profit margins rose to a still-standing record high of 8.8% in 1929. Real reported annual S&P earnings per share initially recovered haltingly, then soared 67% from \$12.66 in 1924 to \$21.13 in September 1929, although well below the prior peak of over \$31 during World War I. As noted in the table, ten-year moving average earnings actually declined.

As the great bull market sped toward the abyss, the rising cost and eventual shortage of short-term credit may have been the straw that broke the camel's back. In May 1928, the Federal Reserve System began tightening, raising the discount rate to 4.5%. It was raised again to 5% in July 1928 and to 6% in August 1929. The term "call loan" was apropos. Nervous brokers in the burgeoning and unregulated market began demanding their money back as the end drew near. Liquidity was in such short supply that call loan rates rose from between 10% and 25% in the summer, to 50% by October.

As the data in the table above indicate, the market had become a bubble. How could all but one in 100 have missed it? Yet, as so often is said, it's complicated. Please read on ...

## 1930–1949

**Chart 3**



**Table IV**

<u>Time Span</u>	Shiller P/E		Annualized Rate of Change in		S&P 500 Real Annualized Return		
	<u>Beginning</u>	<u>End</u>	<u>Shiller P/E</u>	<u>Shiller EPS</u>	= <u>Appreciation</u>	+ <u>Dividend</u>	= <u>Total</u>
1900-1921	18.5	6.1	(4.9%)	2.4%	(2.6%)	5.3%	<b>2.6%</b>
1922-1929	6.1	32.6	24.1%	(2.8%)	20.6%	6.2%	<b>26.9%</b>
<b>1930-1949</b>	<b>22.0</b>	<b>10.5</b>	<b>(3.6%)</b>	<b>0.8%</b>	<b>(2.8%)</b>	<b>5.6%</b>	<b>2.7%</b>

Unquestionably, the 1930s and 40s distinguished themselves as the two most tumultuous decades of the 20<sup>th</sup> century, with late 1929 into the early 30s being the tipping point. The series of events that marked this period—the stock market crash(es) of 1929–1932, the collapse of the economy into the Great Depression, and the attack on Pearl Harbor on December 7, 1941, that inextricably forced the U.S. into World War II for the next three and a half years—were unprecedented in modern times.

Since the nexus of this letter is the investment outcomes from beginning to end of grand secular cycles, we find ourselves straddling the 1929–1930 fence. Departing from historical precedent, we think it more than novel to view the “crash” as two discrete episodes.

The first began with the Dow’s peak at 381.17 on September 3, 1929, from which point daily price volatility and trading volume convulsed into spasms of fear and relief. The freefall, which began as “The Crash” on October 24 (“Black Thursday”), ended *three weeks* later on November 13, during which time the Dow plummeted 198.60 points, an overall decline of 47.9%.

During the seemingly eternal, somnolent *five months* between November 14, 1929, and April 17, 1930, the panic subsided and the Dow marched back to 294.07, recovering 48% of the ground lost during the crisis. President Herbert Hoover and Treasury Secretary Andrew Mellon, veterans of the 1920–21 depression, embarked on a whirlwind of intervention to “stop a depression before it could start.” At the President’s insistence, every faction in business, industry and labor convened in Washington on November 21, 1929, agreeing under varying degrees of duress to strike a bargain to forestall depression: neither would companies cut wages, nor would unions seek increases. Stabilization, an idea that gathered steam among economic luminaries including Keynes during the mid-20s—not disorderly 1921-style wage and price deflation—was to be the order of the day.

In May 1930, just as the relentless descent of the Dow resumed, the chastised Irving Fisher doubled down, declaring, “It seems manifest that thus far the difference between the present comparatively mild business recession and the severe depression of 1920–21 is like that between a thunder-shower and a tornado.” Thus the “Second Crash” originated (and thus the reason for so much of the narrative of the times appearing here in the 1930–1949 era), this time investors suffering a death-by-a-thousand-cuts, as the Dow slipped into the black hole of ignominy, shredding all hope as it faded from 209.4 to 41, losing 81% of its value over the next 26 relentlessly excruciating months.

Returning to probable causes, Hoover was determined to shift the burden of economic suffering from labor to capital. His humanitarian-motivated intervention unwittingly brought the whole house down. In 1920 and 1921, nominal wages fell as prices fell. There was no such adjustment in 1929, 1930 or 1931. “By late 1931,” as economic historian Lee Ohanian observes in a 2009 paper, “real manufacturing average hourly earnings had increased more than 10 percent as a consequence of the Hoover program and deflation. At the same time, manufacturing hours worked had declined more than 40 percent, and the average workweek in manufacturing had declined by about 20 percent.”<sup>4</sup> Unemployment reached 25% and stayed above 10% until 1940.

Although only ten years separated the depressions, the attitude toward the extent to which government should be involved in engineering solutions for economic problems was nothing short of revolutionary. Hands-on Franklin

<sup>4</sup> “What- or Who-Started the Great Depression?” Lee E. Ohanian (October 2009).



Roosevelt, inaugurated on March 12, 1933, wasted not a minute in enacting mountains of securities, banking, social and other legislation. From that point forward, governmental institutions have increasingly become the private sector's keeper, engendering a culture of dependency no doubt unimaginable at the time.

Benjamin Graham looks back on the episode in the first edition of *Security Analysis*, which he and David Dodd started at Columbia University in 1932 and published in 1934. Writing from his perspective as an educator, financial philosopher and investor—and *not as an economist*—he captures the essence of investment morphing into speculation.

At the quarter-century mark of 1925, the great bull market was under way, and Graham, then 31, had enjoyed impressive success as an investor in the challenging years since 1915. During an early-1929 conversation with business associate Bernard Baruch, both agreed that the market had advanced to “inordinate heights, that the speculators had gone crazy, that respected investment bankers were indulging in inexcusable high jinx, and that the whole thing would have to end up one day in a major crash.” Years later Graham lamented, “What seems really strange now is that I could make a prediction of that kind in all seriousness, yet not have the sense to realize the dangers to which I continued to subject the Account's capital [money he managed for clients, family and friends],” which, by 1932, had shrunk to 15% of its 1929 value. Graham's prodigious intellect was not defense enough against what he later described as a “bad case of hubris.”

Surely Graham was not alone in having at least a vague notion in the mid- to late-20s that things would end so badly in the summer of 1932. What he and others lacked was not so much the conviction, but the moral courage and the temerity to say “No” when everyone else was saying “Yes.” Graham's brilliance as an investor was demonstrated in his mastery of self. Though beaten and bloodied, his Account in shambles, he kept his wits and his sense of proportion. Instead of throwing in the towel as so many did, his illustrious career began at the lowest of all low tides. Based on what he wrote at the time, he saw that stocks had never been cheaper.

Owing to what is attributed to premature Fed tightening, the recovery hiccupped in 1937–38, only to be revived by demand for goods from our eventual allies before our official entry into combat during World War II. (Fast-forward to 2015 and apprehensions about repeating the 1937 “hiccup” is the Fed's greatest fear as it debates when to unwind its hyper-accommodative policy.)

It is often mentioned that the market did not get back to the levels reached in 1929 until the mid-1950s. In fact, adjusted for largely nonexistent inflation, the annualized return on the index alone was -2.1% through 1949. Adding back dividends totaling 5.7%, the return jumps to 3.5%. Dividends matter, although dramatically less so today.<sup>5</sup> As Chart 3 reveals, there were *two* cyclical bull markets of note: one beginning in the summer of 1932, in depths of the Depression, and lasting until 1937; and a second, beginning four months after Pearl Harbor was bombed, and ending in 1946. Both were conspicuous examples of the imperative of buying on bad news, selling on good.

GDP grew at a rate of 2.3% during the era. From the highs of the late 1920s to the lows in the early 1930s, profit margins averaged around 5% over the 20 years. Margins rose sharply after the wartime Excess Profits Tax was repealed. Not surprisingly, earnings inched ahead at the snail's pace of 1%, but the P/E ratio declined by half. Interest rates, which declined during the depression and were managed down during the war, did not boost the P/E ratio.

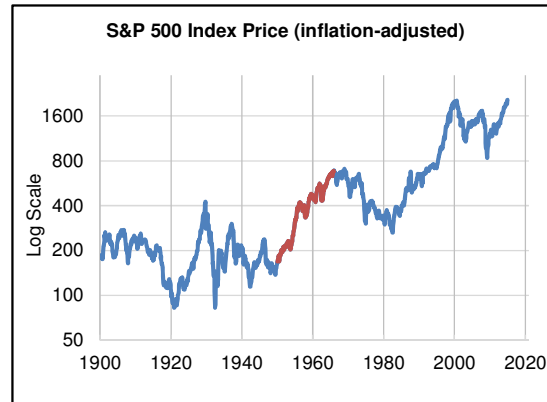
Looking back on these two chaotic decades, there was little to be optimistic about—except that stocks were selling for 10.5 times earnings and yielding 6.9%! As was the case in 1921, for a handful of forward-thinking investors, that was all they needed to know.

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<sup>5</sup> The trend line dividend payout ratio has gradually declined over the 114 years from 75% to 50%. For reasons explained in last year's report, since the mid-1990s the ratio has averaged roughly 35%.

## 1950–1965

**Chart 4**



**Table V**

<b>Time Span</b>	<b>Shiller P/E</b>		<b>Annualized Rate of Change in</b>		<b>S&amp;P 500 Real Annualized Return</b>		
	<b>Beginning</b>	<b>End</b>	<b>Shiller P/E</b>	<b>Shiller EPS</b>	<b>Capital Appreciation</b>	<b>Dividend Return</b>	<b>Total Return</b>
1900-1921	18.5	6.1	(4.9%)	2.4%	(2.6%)	5.3%	<b>2.6%</b>
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1930-1949	22.0	10.5	(3.6%)	0.8%	(2.8%)	5.6%	<b>2.7%</b>
<b>1950-1965</b>	<b>10.5</b>	<b>23.7</b>	<b>5.2%</b>	<b>3.8%</b>	<b>9.2%</b>	<b>4.7%</b>	<b>13.9%</b>

The post-World War II era morphed into the Cold War, gave birth to the baby boom, spawned greater participation by women in the workforce, and freed years of pent-up demand for cars and houses which coincided with a newfound willingness by banks and consumers to extend and to use credit. Americans were driven to build the interstate highway system, out of which came suburbia, television ... and the glorious story goes on! Public debt shrunk from \$14,400 to \$12,600 as wartime debts were extinguished. While the government reduced its liabilities, the private sector went on a spending spree with debt rising from \$9,500 to \$24,000 per person as consumerism took firm root.

By the 1950s, memories of the 1930s had faded and common stocks slowly returned to favor. At long last the rationale of Edgar Lawrence Smith's *Common Stocks as Long-Term Investments* was embraced by investors. For the first time the yield on the S&P 500 fell below Treasury bonds. Once the line was crossed, investors never looked back.

The tide rose during those 15 years. GDP grew at an annual rate of 3.2% and profit margins averaged 6%, reaching 7.1% in the mid-1960s, the highest level since 1929. Stock prices benefited from the double whammy of S&P earnings rising 83% and the P/E ratio's 126% surge. Although dividend payout ratios increased slightly during the era, averaging just over 55%, dividend yields declined to 3%. *The ascendancy of common stocks vis-à-vis bonds was apparent as the average premium in stock yields over Treasuries declined from 4% to -2%, crossing over in the second half of the 1950s.* CPI inflation was quiescent, rising at an annual rate of less than 1.8%. The demand for goods and services was in general harmony with the supply produced.

Every single data point on the last line of Table V confirms that stocks were expensive, and yet, looking back, investors only saw more of the same ahead. The adages, "If it seems too good to be true, it probably is," and, "Beware, the opportunity set of tomorrow may be different from today," fell on deaf ears.

## 1966–1981

Chart 5

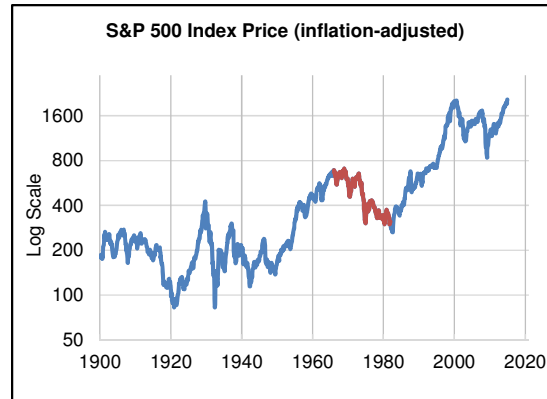


Table VI

Time Span	Shiller P/E		Annualized Rate of Change in		S&P 500 Real Annualized Return		
	Beginning	End	Shiller P/E	Shiller EPS	Capital Appreciation	Dividend Return	Total Return
1900-1921	18.5	6.1	(4.9%)	2.4%	(2.6%)	5.3%	2.6%
1922-1929	6.1	32.6	24.1%	(2.8%)	20.6%	6.2%	26.9%
1930-1949	22.0	10.5	(3.6%)	0.8%	(2.8%)	5.6%	2.7%
1950-1965	10.5	23.7	5.2%	3.8%	9.2%	4.7%	13.9%
1966-1981	23.7	7.8	(6.7%)	2.0%	(4.8%)	3.8%	(1.0%)

This era began with a low inflation rate. By 1966, President John F. Kennedy’s tax credit had reduced unemployment to 3.7% while inflation remained below 2%. With the economy booming, Kennedy’s successor, Lyndon Johnson, repudiated Eisenhower’s “guns versus butter” model of the 1950s. He wanted both: to continue New Deal programs *and* expand welfare with his own Great Society initiatives, as well as fully engage in the Cold War arms race and the fight against encroaching communism in Vietnam. Demand outstripped supply. By the end of the decade the combined inflation and unemployment rate—known as the misery index—had exploded to nearly 10%, with inflation at 6.2% and unemployment at 3.5%. By 1975, the misery index was almost 20%. Socially, the reaction against the conservatism and social conformity of the 1950s, along with the U.S. government’s extensive military intervention in Vietnam, reached a flashpoint. 1969’s Woodstock and the hippie movement were emblematic of this social upheaval.

Nominal GDP and corporate earnings grew impressively. But before we become too sanguine about the supposed good times, keep in mind that the cost to build a house, buy a loaf of bread, or send your child to college tripled! *All the calculations were thrown off by the first (and so far last) bout of virulent peacetime consumer price inflation.* It took the CPI 66 years to triple the first time; this time it did it in just 15 years. Interest rates followed the CPI, beginning at 4.8% and finishing at 13.7%. Even after adjustment for inflation, per capita GDP grew 1.9%, from \$23,000 to \$30,700, but profit margins, in part because of the high cost of labor and debt, fell from 7% to 3.5%. Counterintuitively, it was private sector per capita borrowing, not public sector Great Society debt, which grew sharply during the period: the former rising from \$25,300 to \$40,900, and the latter budging a miniscule \$500, from \$12,500 to \$13,000. To frame the debt data in the longer-term context, public sector debt, which at the end of World War II was \$20,900, fell by one third over the next 20 years. During the same period, private sector debt, by comparison, *quintupled* from \$7,700 in 1945. The age of consumer credit had shifted into second gear.

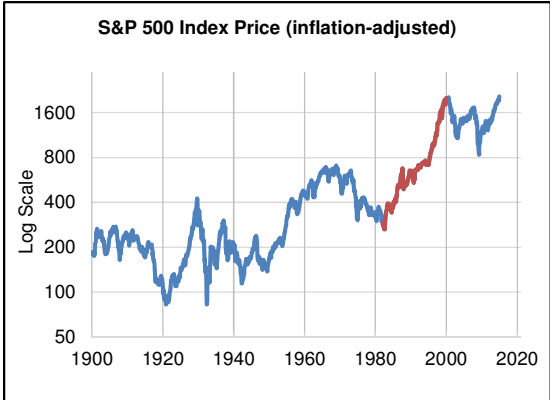
When the pricing mechanism got out of whack it had secondary effects. Nominal interest rates followed prices upward since few savers saw any sense in saving at a negative real interest rate. As interest rates rose, long-lived earning assets like stocks and bonds (or real estate, farms, etc.) became intrinsically less valuable. (Their worth is calculated by discounting estimated future cash flows. Since the cost of money is the largest factor in determining the discount rate, the tripling of that key variable overwhelmed the contribution to stock prices from rising nominal earnings.) Since bond coupons are fixed, by 1981 the investment of choice for so many generations finally hit an ignominious bottom. Figuratively spat upon, bonds were called “certificates of confiscation.” Like the 1979 *BusinessWeek* “Death of Equities” cover story, it was darkest before the dawning.

There is yet a third-order effect to be noted here. By saving, one is, by definition, deferring consumption. Investment in stocks and bonds is one of the ways savings are put to work. Eventually investments will be converted back to cash for the purpose initially deferred—consumption. If the dollar-for-dollar exchange rate declines over time, the loss of purchasing power is an effective tax on investment returns.

From the post-war euphoria that had become the standard by the mid-1960s, the ebbing investment years that followed were as unexpected as they were dispiriting. Although GDP grew at 2.2%, in the tripling of the gravitational pull of interest rates lies the major explanation of why tremendous growth in the economy was accompanied by a stock market going nowhere. P/E ratios declined by 67% to less than 8 times, profit margins collapsed and earnings, like stock returns, were anemic. Surveying the present and the immediate past, everything looked awful. Long-term interest rates were stuck in the mid-teens (a level to which they returned in 1983) and the country was enduring the unsettling consequences of the “Volcker recession.” The only bit of good news was hidden in the prices of earning assets. Whether in the bond market or, even better, in equities, the price to value ratio was incredibly compelling. But, as you are about to see, investors were not looking forward.

**1982–1999**

**Chart 6**



**Table VII**

<b>Time Span</b>	<b>Shiller P/E</b>		<b>Annualized Rate of Change in</b>		<b>S&amp;P 500 Real Annualized Return</b>		
	<b>Beginning</b>	<b>End</b>	<b>Shiller P/E</b>	<b>Shiller EPS</b>	<b>Capital Appreciation</b>	<b>Dividend Return</b>	<b>Total Return</b>
1900-1921	18.5	6.1	(4.9%)	2.4%	(2.6%)	5.3%	<b>2.6%</b>
1922-1929	6.1	32.6	24.1%	(2.8%)	20.6%	6.2%	<b>26.9%</b>
1930-1949	22.0	10.5	(3.6%)	0.8%	(2.8%)	5.6%	<b>2.7%</b>
1950-1965	10.5	23.7	5.2%	3.8%	9.2%	4.7%	<b>13.9%</b>
1966-1981	23.7	7.8	(6.7%)	2.0%	(4.8%)	3.8%	<b>(1.0%)</b>
<b>1982-1999</b>	<b>7.8</b>	<b>44.2</b>	<b>10.1%</b>	<b>0.7%</b>	<b>10.9%</b>	<b>3.5%</b>	<b>14.4%</b>

In 1982, as the reader must now be plainly aware, investors projected out into the future what they were currently seeing. Nothing was less threatening to the human need for order and symmetry than simple extrapolation of known trends into the vague and distant future. Anchored in the present, one of the great ironies is that investors imagine the future to be what they see in the rearview mirror. The windshield is simply too foggy. What they observed in 1982 was discouraging. And they interpreted what they saw to mean more of the same: high interest rates and low profits. They valued the market accordingly.

Out of that despair emerged the greatest bull market in modern history. Although one could argue that interest rates would've fallen on account of their own weight, Federal Reserve Chairman Paul Volcker's courageous actions have become well-deserved legend. Unlike his predecessors or successors, Volcker was willing to induce short-term pain for long-term gain. The recession of 1981–1982 broke the back of inflation. Like any number of remarkable leaders, at the very time he was doing his greatest work, he was vilified. Without a doubt, he was the last chairman not to be intimidated by the markets.

The antithesis of the preceding era, as interest rates fell, the price of earning assets rose. Remembering the shellacking bondholders experienced during the preceding 15 years, interest rates fell a long way before investors were induced to return. It slowly dawned on them that the fixed coupon bonds offered in a declining interest rate environment should be sought after rather than avoided. "Once burned, twice shy" investors were slow to embrace stocks as well. For the first 13 years, until January 1995, the index total returns rose at an annual rate of 8.1%. Reminding the reader of Ben Graham's earlier admonition, "'You can get in way more trouble with a good idea than a bad idea,' because you forget that the good idea has limits," the trajectory of the market for the final five years was exponential, ascending at an astonishing annual rate of 22.4%. It should be of no surprise, then, that the mutual fund investor, who went into hiding as the ebb-tide years progressed, ultimately came back with a vengeance. Five million families owned mutual funds in 1990. The number rose tenfold by 1999. Once a bull market gets legs, and once you reach the point where everybody has made money no matter what system he or she followed, a crowd is attracted into the game that is responding not to interest rates and profits but simply to the fact that it seems a mistake to be out of stocks. In effect, these people superimpose an I-can't-miss-the-party attitude on top of the fundamental factors that drive the market.

GDP grew at a rate of 2.4%, from \$30,200 to \$46,100. Profit margins hovered just below their long-term average of 5%. Though insidious, total public and private debt grew 5.2%, at more than twice the rate of GDP, from \$53,800 to \$133,700. The era was otherwise unequalled: the P/E ratio more than quintupled, while earnings grew by 75%.

It doesn't get any better than that—and it didn't. As the data above clearly reveals, the flood-tide years had come to an end.

## 2000–2014

Chart 7

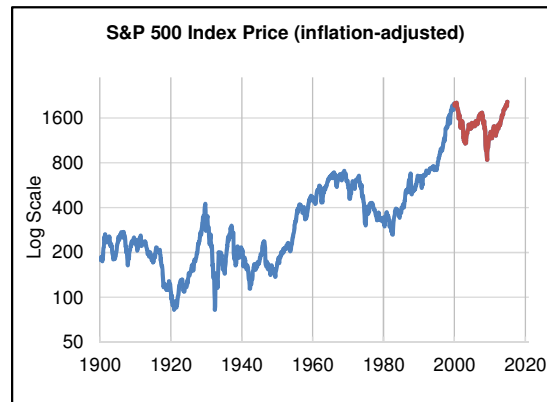


Table VIII

Time Span	Shiller P/E		Annualized Rate of Change in		S&P 500 Real Annualized Return		
	Beginning	End	Shiller P/E	Shiller EPS	Capital Appreciation	Dividend Return	Total Return
1900-1921	18.5	6.1	(4.9%)	2.4%	(2.6%)	5.3%	2.6%
1922-1929	6.1	32.6	24.1%	(2.8%)	20.6%	6.2%	26.9%
1930-1949	22.0	10.5	(3.6%)	0.8%	(2.8%)	5.6%	2.7%
1950-1965	10.5	23.7	5.2%	3.8%	9.2%	4.7%	13.9%
1966-1981	23.7	7.8	(6.7%)	2.0%	(4.8%)	3.8%	(1.0%)
1982-1999	7.8	44.2	10.1%	0.7%	10.9%	3.5%	14.4%
2000-2014	44.2	27.1	(3.2%)	3.5%	0.2%	1.9%	2.0%

In 1999 Warren Buffett warned investors that their rearview mirror view of the future would likely leave them sadly disappointed. Acknowledging that “markets behave in ways, sometimes for a very long stretch, that are not linked to value,” he was unequivocal when he stated that, sooner or later, value counts. Prices do not exist in a vacuum, but are tethered to something, even if by a bungee cord. Paine-Webber/Gallup poll results released in July 1999 reveal just how myopic investors’ expectations can become. The survey shows that the least experienced investors—those who had invested for less than five years—expected annual returns of 22.6% over the next ten years. Even those who had invested for more than 20 years were expecting 12.9%. It was simple extrapolation at its worst!

Common sense’s, and therefore Buffett’s, nemesis at the time was investors’ fascination with the possibilities unleashed by the revolution in information technology under way as the Internet became commercially accessible in the mid-1990s. Although Buffett was openly enamored with the proliferation of innovations, he went to great lengths to explain that it was the consumer and not the investor who benefited from the life-changing inventions of the past, using the automobile and the airplane as examples. He felt the Internet would be no different. The most respected investor extant nonetheless was ridiculed for being out of touch with the potential of this latest groundbreaking innovation.

Knowledge about how people behave, Buffett knew as an investor, was more important than intimate familiarity with the innovation and its potential. Speculators in the highflying social media companies today, take note!

Looking forward from 2000 to 2017 (a terminal date not meant to be precise, but merely to keep the symmetry of the 17-year biblical lean and fat cycles of the locusts which Buffett popularized), he examined what he argued were the key value-determining variables:

- Interest rates

- Growth in GDP
- Corporate profitability as a percent of GDP
- The price one must pay relative to earnings to participate

Buffett concluded the best one should expect is an average real total return of 4%. If returns were to be greater than that over the ensuing 17 years, give or take a year or two, the following would have to happen—which he thought unlikely: First, interest rates would have to decline further—which they did, from 6.3% in 1999 to 1.7% at year-end 2014. Second, after-tax profit margins would have to rise, which also happened. From an above average 6% in 1999, they are presently at 7.3%. Offsetting these factors, through 2014 real per capita GDP has grown at a sub normal 1.03% and the P/E ratio has fallen from 44.2 to 27.3. The net effect of all of the above is that the real total return for the S&P 500 14 years into this ebb-tide era is 2.0%, below Buffett’s estimate. The returns from 2000–2014 are certainly indicative of an ebbing tide ... to date.

In examining the grand secular flood and ebb tides of the market from 1900 to the present, we have thus far limited our attention to what we have observed to be the three most important variables: beginning and ending price-to-earnings ratios based on the smoothed trend in earnings, the slope of the trend in those earnings, and the dividends investors received.

While the past is essential prologue, it is in the future where we will spend the rest of our investment lives. From this point forward we will broaden and deepen the scope of our inquiry into the causes for which the data in the tables are the effect.

What of the speculative waves of the past several years? For reasons of his own, Buffett has not so conspicuously opined on the market since 1999, not even prior to the financial crisis. Aspiring to think like Buffett, and fully aware that what we write or say will not budge markets in the slightest, we felt compelled to speak out against the excesses that culminated in the financial crisis and we became increasingly vocal about our concerns since QE2 was launched late in 2010. The nemesis for rational investing today, in our judgment, is the scale of an experimental Federal Reserve policy that has both badly distorted the mechanism by which earning assets are priced and, in the simplicity of the “put” of Greenspan and his successors, the Fed, acting like Pavlov, has conditioned investors and speculators to salivate at the very hint of monetary stimulus—long before its intended effects are known. Unlike Pavlov and his dogs, however, the Fed may find it harder weaning humans, who may ultimately bite the hand that fed it for so long.

As made clear in the table above, markets are currently priced at or near bubble levels. In the surreal world of zero-bound interest rates, misaligned incentives are the new norm. Behavior once regarded as conservative now is penalized and speculation is rewarded. For the first time since the Federal Reserve Act became law in 1913, Fed policy effectively has closed access to all safe harbors.

Perhaps, by returning to the earlier discussion of the depression of 1921 and the Great Depression, we can learn something. The former was the last “hands-off” depression, while the latter set the precedent for a “hands-on” public response to a private-sector malaise. Under Chairman Bernanke, with the Great Depression as his model, the Fed’s policy was to fight the last war, to engage the enemy of depression and instability this time around with every weapon in its arsenal, including those never tried before. Paradoxically, the acute instability during the 1921 depression likely gave rise to the stability that immediately followed. Its polar opposite, the attempt to maintain stability of wages (thus distorting the cost of a key factor of production during the first two years of the Great Depression) in no small measure contributed to the chronic instability throughout the rest of the decade. Could fixing the price of money, in an attempt to promote near-term stability, lead inevitably to acute instability in this latest round of market-price tampering?

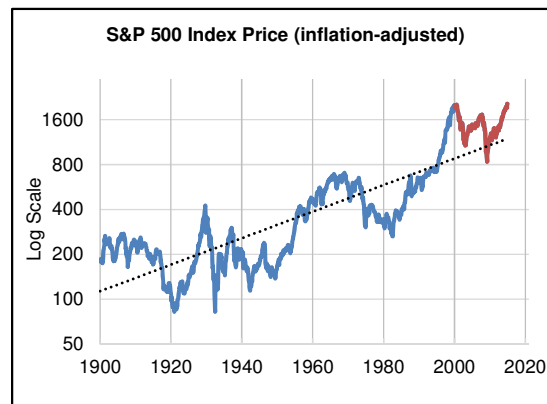
## 2015~2017

As we leave the certainty of the past and venture into the unknown of the future, we are forearmed with profound insights, if not eternal truths, from two preeminent non-economists: an English Renaissance playwright and a 19<sup>th</sup>-

century essayist. The following four words, “What’s past is prologue,” the central theme from Shakespeare’s *The Tempest*, contend that history influences and sets the context for the present. Ralph Waldo Emerson adds the element of proportionality to the dynamic interplay between the present and the future: “Cause and effect, means and ends, seed and fruit, cannot be severed; for the effect already blooms in the cause, the end preexists in the means, the fruit in the seed.”

Most of us are simply too busy, having neither the time nor the inclination to ponder such abstractions. Our awareness of the future of necessity tends to be limited to what is immediately visible—metaphorically speaking, the breaking waves, but not the slow-moving tides or the once-in-a-lifetime tsunamis. Going from the sublime to the ridiculous, we encourage those preoccupied with the present to bear with us, the diligent lifeguards overseeing a beach noted for its skinny dippers. For those swimming sans suit, it is only when the tide goes out that the harsh reality of cause and effect is laid bare. Mindful of our duty to keep our clients out of harm’s or indignity’s way, we’ve brought the tide table above up-to-date. The data provided are the practical flesh on the philosophical bones of the penetrating observations about human nature of Shakespeare and Emerson. For those wanting something more tangible, feel free to substitute Sir Isaac Newton’s laws of motion or, for the mathematically inclined, mean reversion. Chart 8 has one additional feature, a best-fit trend line (ramrod straight when the scale is logarithmic). Even at the most visceral level, the message is persuasively the same. Why so many people do not see or hear the lightning and thunder of these arguments is the very essence of why markets fluctuate to extremes and why outsized opportunities exist for those willing to go against the grain.

**Chart 8**



In the preceding pages you may have been able to envisage a vague but still potentially useful symmetry in the patterns of markets past. After all, you already knew how each chapter in the ongoing story ended. But what we can’t capture in historical accounts is how it actually felt to be on the front lines, in the thick of the battles prior to 1966. Do you wonder, as I often do, whether, forewarned with what we know today about bipolar markets and the madness of crowds, you could have remained emotionally detached? Would you have been looking opportunistically upward in the depths of the 1921 depression or downward with trepidation when you heard Irving Fisher’s authoritative assurance that the stock market had reached a “permanently high plateau” in 1929? Of course, that’s all hypothetical. It’s time to get real—to see what we’re made of—in early 2015.

Lest we yield to the inclination to write off the whole exercise as futile, we may have reason to take heart in searching for and identifying common threads woven through each of the prior secular episodes. Simply put, one of the seemingly obvious threads is that the market was expensive on the eve of the ebb-tide years, and cheap preceding the flooding ones. Exactly how expensive or cheap seems largely irrelevant. For if an expensive market becomes richer still, does not the case for its opposite become that much more compelling? Cannot the same be said for falling prices in bear markets?



Predictably, certain people stand out in history as congenitally wrongheaded and thus become reliable indicators of what not to do. At its publication in 1924, Edgar Lawrence Smith's *Common Stocks for Long-Term Investors* was as insightful as it was ill-timed. Ironically, exactly 70 years after Smith, Wharton professor Jeremy Siegel provides the reincarnated academic seal of approval to the once again prevailing wisdom that everyone should be invested in the stock market ... for the long run.

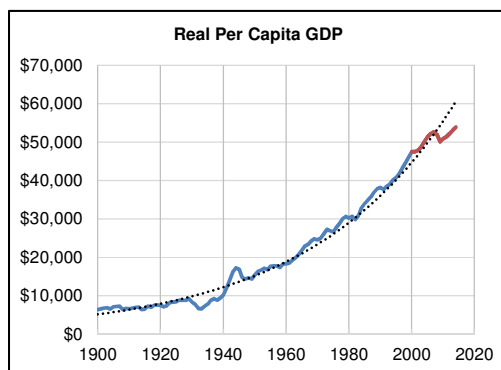
Unlike stone-age Smith, Siegel crunched massive amounts of historical data. His thesis was mathematically pure: Given a sufficiently long period of time, stocks are less risky than bonds, where risk is defined as the standard deviation of annual return. The first edition of Siegel's somewhat unoriginal *Stocks for the Long Run* was published in 1994, 14 years into the greatest bull market of the century, just as it became firmly detached from reality. But Siegel didn't stop there. Subsequent editions were published in March 1998, June 2002 and November 2007. Most recently, a fifth edition was released on January 7, 2014 (noted without comment so the reader may infer whatever he or she wishes).

On the flip side of the predictability coin, Robert Shiller is the one academic whose right-headed written record, in my judgment, has earned him a place in the pantheon of investment giants. To say the timing of the first two editions of *Irrational Exuberance* was prescient grossly undervalues Shiller's contribution to understanding the forces behind the rising and falling of the tides. One need only read the prefaces to the first two editions to glean the significance of his work, an undertaking made both easy and simple in this information age. The third edition became available on Amazon on January 25. In addition to reprinting the earlier prefaces from the 2000 and 2005 editions, the preface to the third is no less compelling. Like its predecessors, it is no surprise that this one is not flying off the shelves. In this age of information overload, allocating precious time to the most productive pursuits is critical. As much as I enjoy writing to you each year, I made time to read Shiller's latest offering within days of its release. Among the many reasons we use Shiller data is its nearly unequaled authenticity and originality of source.

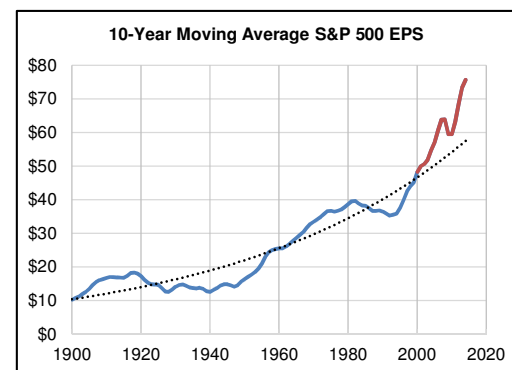
Anecdotes aside, market history is not entirely random, nor are price and value forever inseparable. Like tether and ball, price is tied to value, not by a rope but by the aforementioned bungee cord, and through that stretchy mechanism the past is connected to the present and the present to the future.

First, we turn to the creation of value. In the first of the two related charts (9 and 10), you will notice that real per capita GDP—a simple measure of productivity growth—has fallen below its trend line growth rate since 2000, averaging 1%, only half of the long-term rate of 2%, the worst showing since the depression years. We think it reasonable to muse about what happened to the productivity gains presumed to be the byproduct of the technology revolution. Intuitively, beginning in 2000, Chart 10 seems to contradict Chart 9. The ten-year moving average of S&P earnings rises sharply above its trend line growth rate at the same time GDP is flagging. Productivity going down, but profits going up?

**Chart 9**



**Chart 10**

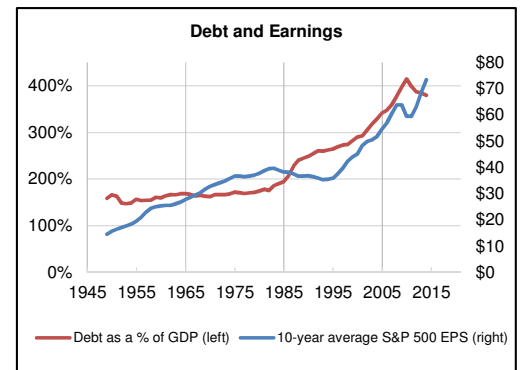


We believe there are two causal factors, with the sustainability of each in question. First, there is the much ballyhooed improvement in after-tax non-financial corporation profit margins as implied in Chart 10. Although exhibiting extreme volatility since 2000, at 7.3% they are currently at the high-end of a range that has averaged 5%. On countless occasions in the past—most noticeably when investors embraced the latest, greatest innovation—the expectation of a new era of high profit margins arose. Thus far, there have been no new eras, and for good reason. Warren Buffett spoke eloquently to this point earlier.

Chairman of the Council of Economic Advisers under Pres. Nixon, Herb Stein famously observed: “If something cannot go on forever, it will stop.” Mimicking Buffett’s partner, Charlie Munger, “We at MCM have nothing to add!”

**Chart 11**

Second, Chart 11 addresses a financial reality that most economists don’t talk about—the rapid growth in real total per capita debt since the mid-1980s, and the first such occurrence since the 1920s (which was paid down as goods were rationed during World War II and the personal savings rate ballooned to 25%). We’re writing about money borrowed by governments, consumers and corporations relative to the size of the economy. The beginnings of deleveraging since 2010—if that, in fact, is what is underway—is primarily attributable to increasingly nervous debt-encumbered consumers. In recent months most pundits have argued that savings at the gas pump because of falling oil prices would be spent. There are times when the consumers’ crystal ball is much clearer than the one used by economists!



In case you haven’t noticed, the second line (blue in color), is the post-1950 carbon copy of the same ten-year moving average of S&P earnings brought to your attention in Chart 10 above. Given the relentless decline in interest rates from the mid-1980s, and the concurrent increasing willingness of consumers, businesses and governments to incur debt rather than save to fund consumption spending, it may not be unreasonable to suggest under such accommodating conditions that earnings may have grown faster than if the debt ratio had remained around 150% of GDP. Intuitively, we believe that rising profit margins and growing levels of debt are, at least in part, connected in what has become a positive earnings growth feedback loop with corporate profits (as a share of GDP) being the mirror image of deficits in the household and government sectors. Reversing the process, which the Fed proposes to do sometime this year, could have unwanted consequences in a disinflationary environment, not the least of which would be the negative affect on S&P earnings. In a phrase, the rise in S&P earnings appears anomalous and ephemeral.

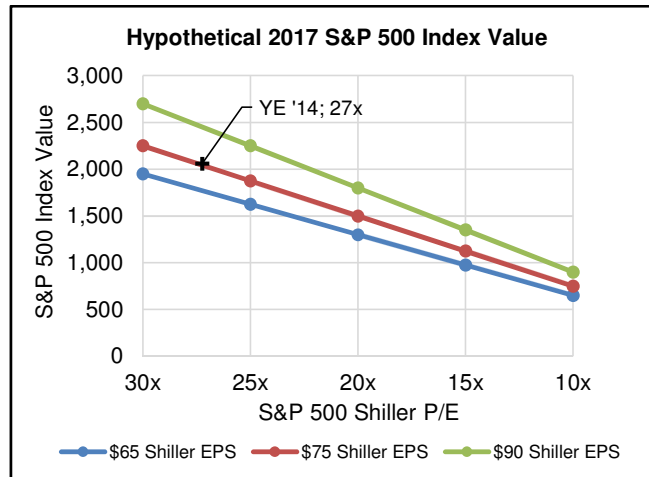
The final and critical variable is determining the P/E multiple that should be applied to one’s estimate of terminal earnings. In terms of proportion, the change in the Shiller P/E is the make or break variable. Take one last look at Table VIII on page 15. *The rate of change in the Shiller P/E matters the most in almost every era, the rate of change in Shiller earnings, the least. As a rarely mentioned aside, since the 1920s the steady and reliable dividend return has insidiously withered, no longer the total return anchor it once was during ebbing tides.*

Regarding this variable, the best we can do is generalize. First, philosophically, one might reflect on the words of Shakespeare and Emerson at the outset of this section. Since the rising-tide years from 1982–1999 were historically and figuratively obese and the most exuberant ever, one would expect some vague balancing of the scales of proportionality as the subsequent ebb-tide years come to an end. Second, mathematically, there is the apparent inevitability of mean reversion (and beyond) manifestly evident in all such tables above.

“All roads lead to Rome,” and, for the purposes of this communiqué to you, to the simple decision graphic (Chart 12) below. Metaphorically, the huge man-made market wave since 2009 has obscured what we believe, based on the arguments above, to be a continuing ebb tide. The fact that not one in 100 share our view, or that when it does we won’t be able to predict when and at what level low tide will happen, doesn’t detract from our conviction that it will. Chart 12 gives you what we think are a reasonable range of possible outcomes. That’s the best we can—or should—do.

The graphic provides a range of hypothetical levels for the S&P index three years hence. As for the two variables, the range of possible 2017 earnings for the S&P 500 mathematically represents the average of the preceding ten years. On the high side, we have assumed that S&P earnings will grow at 10% a year for the next three years, reaching \$90. On the low, consistent with our generally downbeat assessment of the prospect for rising earnings, and at the clear risk of being generally right but precisely wrong, we felt we had to plug in something. Thus, we have earnings falling cumulatively at the rate of 50% for two years and then rebounding by 75% in the third year, or \$65. If ten-year average earnings remain unchanged from 2014, they will be \$75. As for the assumed terminal P/E ratio, the entirety of the report is to prepare you for making that decision.

**Chart 12**



We are not predicting prices, but simple cause and effect. If prices are unsustainable, then they will eventually revert to their mean and likely beyond—at least temporarily. The exact timing of when this might occur is unknowable, but focusing on what is knowable, that prices will mean-revert, is critical to understanding and avoiding risk of permanent capital loss.

Worrying top-down has been arduous. The rewards have always been long in coming and only after considerable pain. Despite the high cost to ourselves and our business, worrying top-down has served us well thus far. We have avoided every bear market since 1966. Here we are again in early 2015, having slipped away from the party early, while still sober enough to make it home. We are keenly aware of the secondary effects that no one talks about, and about risks that are infrequent, opaque and complex. With the water near high-tide level and with a paucity of compelling investment ideas, we are long in liquidity, made all the more painful because, for the first time in the last 114 years, it pays nothing. At the outset we posed and answered this question: “Why do we put ourselves through this agony?” This time I will be a little more circumspect. We do it because, if our roles were reversed, that’s the sacrifice we would expect from you if our money were under your care.

We find solace in our extended and solitary sobriety from the Oracle of Omaha: “You’re neither right nor wrong because other people agree with you. You’re right because your facts are right and your reasoning is right—that’s the only thing that makes you right. And if your facts and reasoning are right, you don’t have to worry about anybody else.”

### Final Thoughts ...

Last year’s report acknowledged the challenges encountered in the search for my eventual successor. When a friend and client expressed his concern about the time I was spending in that pursuit, my answer took the form of

two questions: Should there be a time limit imposed when one is searching for someone of integrity, commitment and competence to assume stewardship responsibility for one's (and one's clients') estate or portfolio? *Is it not true that in times like the present one's personal wealth is but one self-serving, incompetent or dishonest manager away from extinction?*

Those willing to talk the talk were as plentiful as those who would walk the talk were scarce. As this and all earlier reports have hopefully left no doubts, MCM has never changed its priorities: The client comes first. Period. Embedded deeply in that simple four-word statement is a degree of commitment very few people are willing to make. There's lots of gray area in the continuum from job to career to total unconditional commitment. One must look very far these days to find someone who will actually live the adage, "I'd rather lose half my clients, than half my client's assets." The opposite is endemic: clients sadly are the means, not the end—a discovery usually made only after the damage is irreversible.

Moving from a focus on affiliation with another advisor, we turned to individuals in order to strengthen the firm's investment management and research process organically. Early in 2014 we implemented the first phase of a meritocracy-based investment management model patterned after Berkshire Hathaway's. Clint Leman, who began his career with MCM, and Jeff Robbins, who was a highly prized intern with MCM 20 years earlier and joined us early last year, have wholeheartedly embraced the high-accountability, high-reward model. Recently, Chris Ridenour, a recent University of Chicago MBA graduate, came aboard on the same terms. From the timestamps on their emails, they are likely to become charter members of the total commitment club! Their impressive bios are on our website.

In late October 2012, I received an unusually well-written letter from a Peter Wong, which piqued my curiosity but was put aside to attend to more pressing matters. Peter graduated from Yale as a Rhodes scholarship finalist, and has spent his career at Goldman Sachs in Hong Kong and a hedge fund in San Francisco. Several months later I reread the letter in which Peter quoted his father: "It may be difficult to build a fortune, but it is far more difficult not to lose it." Since Peter joined us last spring, he has demonstrated that he walks the talk. While there are bridges yet to cross, "the search for a younger person who will succeed me as MCM's chief investment officer when the need arises" has very likely come to an end. Peter has won the admiration and respect of all of us in MCM and we're confident he'll earn yours as well.

Peter, unlike anyone with whom I've worked closely, is a young man of both brilliant thought and measured action. On-site less than a year, Peter has been a tireless take-charge agent for constructive change, no matter the size or scope of the undertaking. Hummingbird Partners, LLC, an SEC-registered alternative asset fund, is to be launched this quarter after almost a year of preparation. Its initial mandate is to capitalize on the long and short opportunities to be found in the market which this report seeks to describe. The idea was originally conceived in early 2008, but the tide turned before the idea left the drawing board. Almost single-handedly, Peter made it happen.

My successor as CIO will also be my likely successor as majority owner of MCM. It is a high calling to maintain the culture of honesty and integrity that includes unconditionally subordinating the needs of the firm's owners and employees to those of our clients. We are in a service profession and serving ourselves must be a byproduct of first selflessly serving our clients. These priorities cannot be reversed.

This annual report is an MCM first: a truly collaborative effort by an inspirationally collegial team. It is in the character, commitment and rigorous intellectualism of those who made it happen—Peter, Clint, Jeff, Chris, Dallis and Kristen—that my confidence about your (and our) future resides.

Lastly, and most importantly, I relish the opportunity to express my gratitude to you, our clients. Without your potent combination of patience spiced with encouragement, constructive criticism leavened with love, I often wonder whether I would be able to bear up under the relentless pressure to conform.

Very truly yours,

Frank K Martin, CFA