THE MURCHISON GROUP

MANAGING WEALTH FOR ALL GENERATIONS

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# Was Last Year the First in a New Era?
# Reflections on a Lifetime of Investing

**Executive Summary**

- The first fifteen or sixteen years of my investment life coincided with the worst stretch of time for U.S. investors in 100 years when inflation is factored in—even worse than any fifteen years that encompassed the Great Depression.
- The subsequent forty years the major stock market indices were phenomenally good for U.S. investors—despite three or four devastatingly bad bear markets.
- Helping drive exceptional real, after-tax, after-inflation returns over the past forty years were five big factors, in my opinion: 1) a really cheap starting point; 2) favorable tax policies; 3) favorable monetary policy; 4) American ingenuity and innovation; and 5) declining inflation.
- The tide may have turned in the case of at least three of those factors: 1) the starting point at the start of 2022 was the opposite of cheap and is still not cheap despite the drops last year; 2) tax policy appears unlikely to be poised to become more favorable; and 3) monetary and fiscal policy appears to have ignited a higher rate of inflation – the highest in 40 years.
- If the tide has indeed shifted, it is not at all clear whether it will go out far or long enough to spell the end of an era—one that may have handsomely rewarded those who had the patience and the fortitude to maintain a disciplined, long-term investment posture.
- We think the early days of last January marked the end of a remarkable investment era. But the level of speculative froth has dissipated greatly over the past twelve months. For this reason, we think the future can be positive for investors even if less extraordinary than the last decade ending December 2021.
- We think it best to move into the future with eyes wide open to the challenges ahead, with cautious optimism, and with realistic expectations.

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## A Look Back Through the Eyes of My Own Experience

As I approached my twelfth birthday in the fall of 1966, my maternal grandfather thought it was time I learned about the stock market and the benefits of owning a piece of great American companies. He offered to give me some stock as a birthday present—provided that I could persuade him that the stock I chose would be a good long-term investment.

The 1950s and 1960s had been a boom time for the U.S. Most of the rest of the world was still recovering from the devastation of the Second World War. America was an unmatched economic force, and American companies faced only modest competition from abroad. Stocks, especially those of the largest and strongest companies, roared upward. In the dozen years following my birth, The Dow Jones Industrial Average (the Dow) more than tripled in value[1], almost reaching 1,000 in early February 1966--and that was before adding in dividends.

Then stocks slid over the next nine months, dropping nearly 20% to 807 around the time I turned twelve and became a young investor. Fifteen years later, when Linda and I were married in October 1981, the Dow had attempted without success to surpass its 1966 high, had experienced an excruciating bear market which many participants likened to slow water torture, and had inched up at best maybe 5%. By the next August, the Dow was right back to where it was when I turned twelve. In real, inflation-adjusted terms, the market as measured by the Dow lost roughly 65% of its value in a little under sixteen years.[2]

## What had happened to cause such a rout?

Economically, the late 1960s and 1970s represented a big change from the decade and a half before. Inflation and interest rates, rather than stocks, roared upward, seemingly with no end in sight. U.S. companies were no longer dominating the world. Weariness with the Arab oil embargo, the War in Vietnam, Watergate and rising capital gains taxes had dampened spirits.

By the end of the 1970s, investor optimism about the future had turned into deep pessimism—U.S. investors were unwilling to pay even half the multiple of a stock's earnings they had paid before. Japan had come to be viewed as the economic superstar to be imitated. *Business Week* early in the next decade featured a bold cover asking "Are Equities Dead?"

There's an old saying that "it's always darkest before the dawn." That sure seems to have been the case by late summer 1982, when the Dow stood exactly where it had been when I turned twelve nearly sixteen years earlier.

Then, stocks began a long march upward. And what a march it was. On January 4, 2022, the Dow was 36,799. At that level, the Dow had grown 42-fold. $100,000 invested in August 1982 would be worth over $4,500,000 - even if you spent all your dividends. The S&P 500, which has historically paid a lower level of dividends, has grown even more. $100,000 invested over that period in the S&P 500 would have grown roughly $15,000,000 - again, even if you spent all your dividends[3].

**What happened to propel such an amazing level of return?**

[1] Source: Macrotrends
[2] Macrotrends
[3] Macrotrends

Dividends are not guaranteed and are subject to change or elimination. The Dow Jones Industrial Average is a price-weighted index of 30 "blue-chip" industrial U.S. stocks. The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.

The mirror opposite of what had caused the rout that came before.
Stocks were really cheap by late summer 1982, regardless of the metric used to gauge valuations. P/E ratios were well under 10 back then, less than half of their long-term average. The S&P 500's dividend yield was above 5%, well above its long-term average[4].

Inflation has trended down significantly. Inflation was in double digits for three years in a row from 1979-1981, peaking in 1980 at 13.5%. Two years later, it was half that level. Over the past ten years, it has averaged only around 2%[5].

Interest rates have followed inflation down, dropping even more significantly. Historically, ten-year U.S. Treasury interest rates have been higher than inflation, providing bond holders with a real return. For many recent years, those interest rates have been below inflation, delivering a negative real return. Ten-year U.S. Treasury interest rates exceeded 15% in the latter half of 1981. By the beginning of 2000 they were under 6%. And today, they stand at less than 1.7%[6].

Investment-related tax rates trended down, with a few reversals along the way. President Jimmy Carter championed a 28% cut in the top capital gains tax from 39% to 28%. Capital gains rates dropped to 20-to-21% for much of the Reagan and Clinton years. Then President George W. Bush pushed both the top capital gains and dividends tax rate to 15%, which held there through 2012. Although the top rate was increased to 23.8% (including the 3.8% Obamacare tax) in 2013, top corporate income taxes were reduced from 35% to 21% (a 40% reduction) in 2017.

Ordinary personal income tax rates dropped markedly. The top marginal income tax rate was 77% in 1969. It dropped to 50% in in 1982, 38.5% in 1987, and 28% in 1988 before rising over time to somewhere between 39.6% and the current 37%[7].

Corporate income tax rates dropped more than half from 46% in 1981 and 1982 to 21% in 2017.

American companies regained their competitive edge[8].

### Where were we just one year ago? At least a partial mirror-image of where we were 1981/1982.

Stocks were no longer cheap. P/E ratios were near historically high levels. Dividend yields were near historically low levels.

Inflation was low, but beginning to show signs of rising. How much or how fast it would rise was unknown. What we did know was that the Federal Reserve had said repeatedly in recent months that it wanted higher inflation, that it would tolerate rising inflation more than in the past, and that it would put a greater priority on reducing unemployment than maintaining low inflation.

Interest rates were low, and unlikely to go a lot lower.

Investment-related taxes looked like they're going up further. President Biden's proposed top rate (43.4% including the 3.8% Obamacare tax) was nearly double today's top rate on qualified dividends and capital gains.[9]

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[4] Shiller, Robert:*Irrational Exuberance*
[5] Macrotrends
[6] Macrotrends
[7] Forbestadvice
[8] Brittanic Procon
[9] Wallstreet Journal

Income tax rates looked likely to rise at the top. President Biden's proposed top rate of 39.6% represented a 7% increase[10].

Corporate income taxes looked likely to rise. President Biden's proposed top rate of 28% represented a 33% increase.

America and American companies faced increasing competitive pressure from China, as well as from other corners of the globe.

### So, where are we today?

Stocks are cheaper than they were a year ago, but nowhere near as cheap as in the early 80s. P/E ratios are still above average. Dividend yields are still below average.

Inflation soared last year, but appears to have peaked. Whether it will return to the 2% area for an extended period of time remains unknown.

Interest rates have risen at the fastest rate in memory. However, they are still low by historical standards.

Taxes appear to remain as they are (other than a possible minimum corporate income tax) until the 2024 election cycle.

American companies continue facing competitive pressures from China and other corners of the globe, as well as other unknowns such as global economic slowdown, possible recession, challenging labor market dynamics and possible de-globalization.

### What does it mean for us investors?

We expect real, inflation adjusted, after-tax returns to be lower over the next decade than they averaged over the forty years only a year ago. This does not mean we expect doom and gloom. Nonetheless, we do think expectations should be tempered and realistic. In fact, we expect inflation-adjusted returns on fixed income and cash to be better over the next decade than they have been over the past decade.

We think we will have to be more mindful of inflation. In the short-to-intermediate term, inflation tends to put downward pressure on equity valuations. In the longer run, however, owning great companies has historically been a good inflation hedge because their sales and profits tend to rise with inflation.

We think we should pay even more attention to opportunities outside the U.S. than at present. International and emerging market equities have lagged behind the U.S. for most of the past twenty years, and their valuations are a good bit lower. Investing globally will be important, we think.

We think our best guesses about the future's course—and the timing of any twists and turns—will likely prove to be only partially correct at best. So, we continue to think that we should pursue a disciplined investment approach.

This means we will continue to avoid making big bets, and continue to avoid making investment decisions based on short term trends. We will continue to help manage client investment portfolios as we have always done, adhering to the asset allocation in place for each individual client and making adjustments (rebalancing) as market actions warrant.

[10] Wallstreet Journal