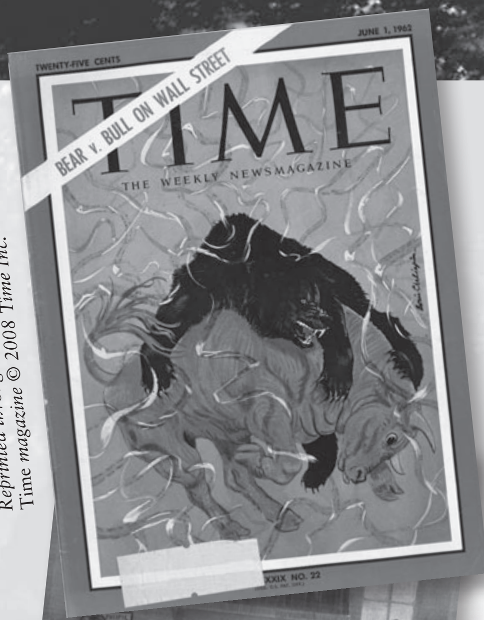
ANOTHER FINANCIAL HURRICANE:

Is It Different This Time?

By Kenneth G. Winans



Top: 1962 issue of Time *magazine with cover story "Bear v. Bull on Wall Street." Bottom: "War Rumors in Wall Street," February 24, 1898.*

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It's official. the stock market is having its worst year since 1931 with the Dow Jones Industrial Average (DJIA) humbling even the most seasoned investors with a drop of 41 percent at this year's lowest point.

The market's daily volatility is at record levels, and the "perma-bears" have been busy panicking an already-frantic investing public with predictions of a "one-of-a-kind" global economic depression or worse. Sadly, the media have added to this confusion by providing incomplete historical comparisons.

A classic example of this was *The San Francisco Chronicle's* recent article titled, "The Great Depression: How Close Are We?" Without hesitation, the article jumped into how today's financial crisis resembles 1929–32, but fails to mention the 10 other dramatic one-year declines in the financial markets over the last 108 years, or the fact that we have had comparable stock market declines as recently as 1974 and 2002.

In fact, every single past generation has experienced serious stock bear markets (1906–07, 1929–32, 1973–74, 2000–02) where loses exceeded 40 percent, and the financial devastation is well remembered with fear and anger.

While we have all heard the phrase "history repeats itself," very few people properly apply long-term history to investing. Worse yet, the default assumption of most investors is to think it's different this time and find themselves buying into financial bubbles or cashing out near a bear market low.

Clearly, investors need to spend more time studying investment history. A good place to start is by studying past market corrections and what happened during the years that followed.

FINANCIAL HURRICANES

Like major hurricanes that frequently strike our nation, these one-year cliff-dropping bear markets are unique but not uncommon. Since 1900, there have been 14 times when the DJIA declined more than 28 percent within a single year. And even worse, there was no "shelter" to escape to as real estate, bonds and commodities also suffered steep declines during most of these periods (see Table 1), and cracked the foundations of even the best-managed portfolios.

TABLE 1

No Shelter in Financial Hurricanes

	DJIA	U.S. Home Prices (WIREI)	DJ Corporate Bonds		CRB Index
			Price	Yield	
1903	(24%)	13%	(9%)	4.8%	(6%)
1907	(38%)	(15%)	(11%)	5.0%	(2%)
1914	(31%)	(5%)	(7%)	5.3%	(4%)
1917	(22%)	(10%)	(13%)	5.6%	35%
1920	(33%)	25%	(6%)	6.2%	(30%)
1929	(17%)	(3%)	(2%)	5.1%	(15%)
1930	(34%)	(11%)	2%	5.1%	(31%)
1931	(53%)	(10%)	(18%)	7.5%	(30%)
1932	(23%)	(43%)	(0.5%)	9.1%	(17%)
1937	(33%)	(4%)	(12%)	5.2%	(26%)
1962	(11%)	7%	5%	4.7%	0.2%
1974	(28%)	5%	(9%)	10.1%	17%
2002	(17%)	7%	4%	4.1%	23%
2008*	(41%)	(13%)	(15%)	8.8%	(21%)
Average	(29%)	(4%)	(7%)	6.2%	(8%)
w/o 29–32	(28%)	0.5%	(7%)	6.0%	(2%)

**up to 10/31/2008*
WIREI = Winans International Real Estate Index

as the Federal Reserve raised interest rates 47 percent and thus over tightened the money supply. A bomb exploded on Wall Street that injured 400 people, and GOP candidate Harding was elected President ending eight years of Democratic administrations.

1929: A stock market bubble ended with the worst one-day crash in U.S. history and a two-month drop of 48 percent. Hundreds of professionally managed, highly leveraged pools and investment trusts had to be quickly liquidated at low prices.

1930: The Hawley-Smoot tariff bill was enacted and started one of the largest trade wars in modern history.

1931: The Great Depression's high unemployment rate threatened the world's social and political stability. Roughly 200 banks closed each month and public anger at Wall Street drove federal investigations on short selling. England abandoned the gold standard for its currency, and many foreign stock exchanges shut down for a month.

1932: Bank failures set record levels, and the government enacted housing price supports and a foreclosure moratorium for homeowners. Franklin Delano Roosevelt, a perceived anti-Wall Street President, was elected.

1937: The Japanese sank a U.S. gunboat as it invaded China and thus started a U.S. trade embargo with Japan. Reduced margin rates and SEC oversight failed to stem the stock market's volatility. The Federal Reserve over tightened, and *New Deal* programs were perceived to be ineffective.

1962: The Cuban Missile Crisis nearly started a new world war. The SEC investigated American Stock Exchange floor trading abuses and large-scale insider trading cases. The U.S. Justice Department investigated the steel industry for price fixing.

1974: The Arab Oil Embargo was a result of the Yom Kippur War. The

THE "HOWS & WHYS" SEEM TO RHYME

Mark Twain said, "history doesn't repeat itself; it just rhymes." This might explain why historical comparisons are often misunderstood or blatantly ignored. Let's briefly look at some of the common factors that caused these disastrous bear markets:

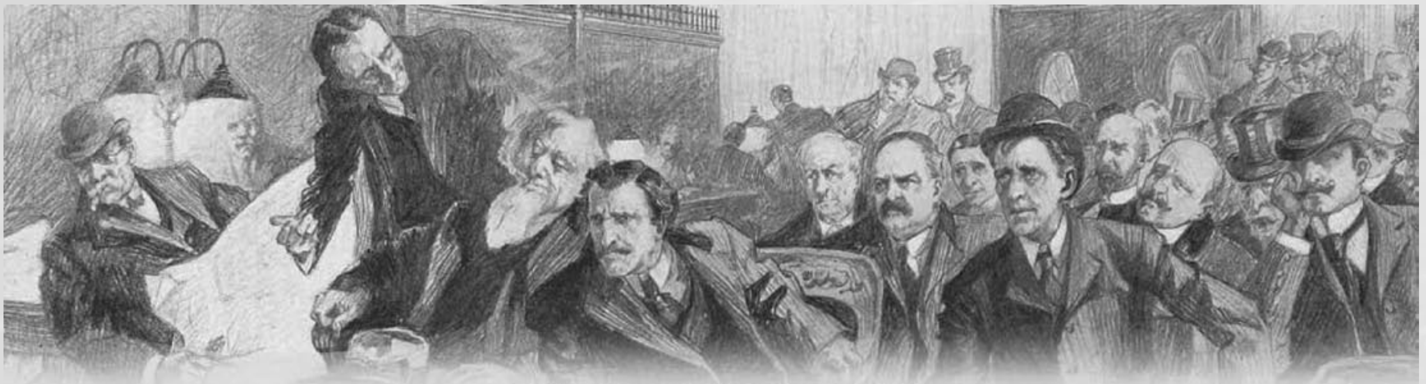
1903: The "Rich Man's Panic" was caused by the sudden illiquidity of overpriced publicly-traded trusts. Wall Street simply overestimated the demand and risks of these leveraged, illiquid inventions.

1907: A copper bubble burst, and a number of large financial trust companies failed. Global stock markets plunged due to over-leverage, and a J.P. Morgan banking consortium helped stabilize the situation.

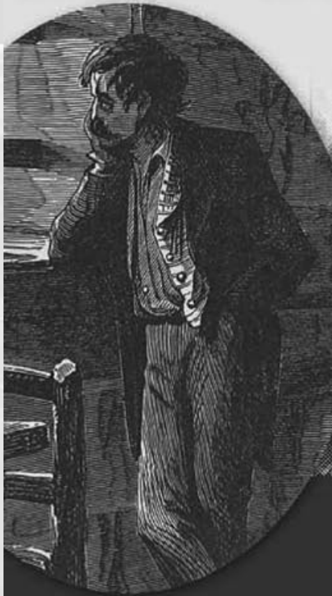
1914: World War I began and many European exchanges closed for years. The NYSE closed for four months, and stocks could only be sold with the approval of "Committee of Five" at an official price. Black markets for equities sprang up to provide liquidity in stocks at discounted prices.

1917: U.S. entered World War I and the Federal government took over the nation's railroads.

1920: A commodities bubble burst,

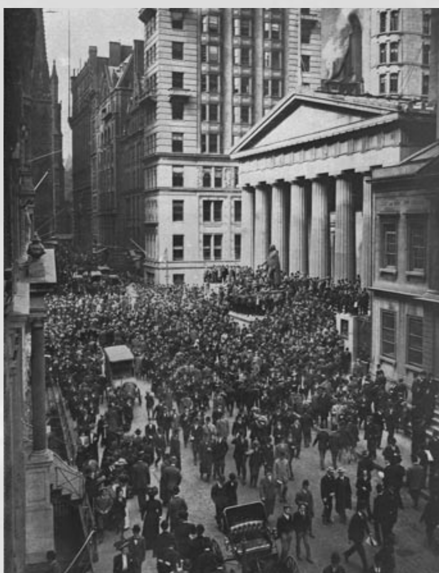


BEAR MARKETS
The Expressions Never Change!



1906

1857 1987 1962



Scene on Wall Street during the Panic of 1907.

Federal Reserve raised interest rates to record levels. Most real estate investment trusts (Reits) collapsed in value. The Watergate scandal brought about President Nixon's resignation.

2002: Thirty-three large publicly-traded corporations and the "Big Four" accounting firms were guilty of wide-scale accounting scandals. This led to several large bankruptcies and the criminal convictions of well-known CEOs. The Sarbanes-Oxley Law was enacted to significantly enforce corporate financial conduct. Congress authorized the President to use force against Iraq for noncompliance of U.N. sanctions.

2008: Commodity and real estate bubbles collapsed with housing having its worst decline since World War II. Highly-leveraged mortgage-backed investments collapsed in price, leading to a global credit freeze as several major international investment firms failed. The collapse of Lehman Brothers and Washington Mutual became the largest financial failures in U.S. history. The federal government authorized a $700 billion bailout package to purchase failing bank assets. Democrats took control of both the White House and Congress for the first time since the early 1990s.

There are common themes in these bear markets:

1. The combination of over-leverage and illiquidity burst bubbles in all financial instruments.
2. Many Wall Street innovations went awry.
3. Investments responded negatively to failed government actions and over-regulation.
4. The military conflicts, or the threat of conflicts, caused widespread investor panic.

Simply put, the names and dates might have changed, but the causes were similar.

THE GOOD NEWS

In most cases, these dire times were followed by powerful market rallies over the following 12 months, and long before the media's headlines became bullish.

As can be seen in Table 2, these tough years have been followed with strong performances 10 out of 13 times averaging 20 percent. Even more impressive is that these market rallies have typically extended for two years (85 percent of the time) with an average total return (including dividends) of 44 percent. If the Great Depression years of 1929–32 are removed from the calculations, the two-year cumulative total increases to an impressive 62 percent.

A DEAD CAT BOUNCE OR NEW BULL — JANUARY IS A GUIDE

As investors try to decide if the glass is half full (i.e., a great buying opportunity) or half empty (i.e., a bull trap), history has once again given us a time-tested guide to follow, "The January

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TABLE 2

The Rebound

Dow Jones Industrial Average:

Year	Low Point	Year-end	Following Year-end	Following Year 2	Cumulative % Total Return
1903	(34%)	(24%)	42%	38%	104%
1907	(44%)	(38%)	47%	15%	79%
1914	(33%)	(31%)	82%	(4%)	86%
1917	(31%)	(22%)	11%	31%	59%
1920	(38%)	(33%)	13%	22%	51%
1929	(34%)	(17%)	(34%)	(53%)	(59%)
1930	(37%)	(34%)	(53%)	(23%)	(52%)
1931	(55%)	(53%)	(23%)	67%	40%
1932	(47%)	(23%)	67%	4%	84%
1937	(37%)	(33%)	28%	(3%)	34%
1962	(28%)	(11%)	17%	15%	41%
1974	(33%)	(28%)	38%	18%	72%
2002	(28%)	(17%)	25%	3%	33%
2008	(41%)	na	na	na	na
Average	(37%)	(28%)	20%	10%	44%
% of Time Positive Return			77%	69%	85%
w/o 29–32	(35%)	(26%)	34%	15%	62%
% of Time Positive Return			100%	78%	100%

TABLE 3

The January Barometer — Old Reliable

Year	Percentage Change: January	Percentage Change: Year-end	Accurate
1904	(0.4%)	42%	
1908	6.7%	47%	yes
1915	4.7%	82%	yes
1918	7.3%	11%	yes
1921	5.8%	13%	yes
1930	7.5%	(53%)	
1931	1.8%	(23%)	
1932	(2.2%)	(23%)	yes
1933	1.6%	67%	yes
1938	0.8%	28%	yes
1963	4.7%	17%	yes
1975	25.8%	38%	yes
2003	(3.5%)	25%	

Visit the Resources section of **www.MoAF.org** to watch Ken Winans speak on this subject at the Museum of American Finance.

Abigail Adams, Bond Speculator

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At the age of 75, John Adams compiled a financial autobiography and sent it to a friend and fellow signer of the Declaration of Independence, Philadelphia doctor Benjamin Rush. In it he asserted that he was the one who had decided to buy that first Loan Office certificate back in 1777—even though the files in his library contained his wife's June 1, 1777 letter explaining the whole idea to him. In the document he sent Rush, Adams did not mention *any* of the government securities his wife had purchased for him. John had benefited immensely from Abigail's shrewd venture into bond speculation, but he had no desire to see her trades broadcast to the wider world. FH

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Barometer." The old Wall Street saying, "As January goes, so goes the year," is mostly true. The rule is simple: if the DJIA's January close is above the prior December close, then the market should finish the year higher. However, if the DJIA's January close is below the prior December close, another bad year can be expected.

During the previous 13 periods studied, this technical indicator has been effective 69 percent of the time in determining the direction of the DJIA after an oversold year (see Table 3).

FINAL THOUGHTS

In reviewing the last decade of investing to find answers to what went wrong on Wall Street, a simple question needs to be asked: Why did the majority of modern investors, the most knowledgeable and technologically advanced in history, mishandle the "dot com" stock bubble, the recent "nothing down" real estate frenzy and the asset freefall of 2008? The answer: A lack of knowledge about U.S. financial history.

Clearly, the constant barrage of news, earnings projections, economic reports and advice from respected professionals streaming over media outlets 24 hours a day has not helped investors tackle the age old problems of successful, time-tested investing.

Ultimately, people's emotions (greed and fear) about money and investing have not changed much over time, and their actions typically resemble those of their ancestors. It is also helpful to remember that there is very little that is truly new in the world of investing. Stocks, bonds, real estate and commodities are continuously repackaged and renamed by Wall Street, but the basics in the money game have remained the same for generations.

If an investor wants to break the vicious "buy high, sell low" cycle that still plagues most investors, s/he should be more of a historian and less a financial analyst. Now is a good time to put history to work. FH

Kenneth G. Winans is the award-winning author of Preferreds *and* Investment Atlas, *a renowned collector, and President and Founder of the respected investment management and research firm Winans International. For over 26 years, he has conducted landmark investment analyses and designed leading market indices in stocks and real estate. He is a regular guest on numerous TV and radio shows and has had much of his investment research published by leading websites, magazines and newspapers.*

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Data provided by Global Financial Data.