Holding Stocks Without Screaming

One opinion shared by many investors nowadays is that stocks are risky, and the near term outlook is especially unclear. Today's Wall Street Journal profiles a financial adviser in Chicago, Jeffrey Smith, who spends much of his time persuading clients that they should remain in equities in order to achieve their long term investment goals. One client apparently found his mind wandering to Edvard Munch's painting titled, "Scream" as he contemplated the many potential disasters waiting in the wings. Mr. Smith's cause can't be helped by daily headlines from Washington which largely serve to remind investors what a dysfunctional place it is. The very creation of a Fiscal Cliff was ill-considered, representing as it does a totally blunt instrument to control future deficits. While the original intent was to force tough decisions on a reluctant Congress so as to avoid automatic tax hikes and spending cuts, in fact the focus is really just on avoiding its consequences. News reports show that the most likely outcome is higher taxes on the 2%, some spending cuts and no doubt solemn commitments to do the heavy lifting of budgetary discipline next year.

It's not what was intended but is the best we can expect. Congress created the cliff and Congress can modify it. It's not really a tool to force action.

In fact, there's little reason to be long term optimistic on the U.S. fiscal outlook. Opinion polls regularly expose the incongruity of voters' desires for improved fiscal prudence combined with broadly unaltered tax policies and entitlements. On top of which, while there's much hand wringing about the future there's little visible cost to current policies. If Congress and the Administration did miraculously come together on a meaningful plan to achieve annual deficits of 2.5% of GDP (thought by many to be a long term sustainable target) bond yields could hardly fall very far in response. When Clinton raised taxes in the 90s to reduce the deficit interest rates fell and softened the blow somewhat. No such payback is likely today. So low expectations on this issue are appropriate.

Nonetheless the Math of equities remains compelling. $22 in the S&P 500 will deliver the same after tax return as ten year treasury notes held to maturity, assuming 4% dividend growth on the former. You can make your own synthetic bond with $78 in 0% yielding cash and $22 in 2% yielding equities. Even a disastrous 50% collapse in stocks would cause an $11 fall in your portfolio value or 11%. It would only take a 1.25% rise in bond yields to cause a similar 11% loss in ten year treasuries.

Choosing the stocks/cash combination with its range of possible outcomes instead of the fairly certain loss of purchasing power through bonds requires a long term perspective. However, that is the most reliable way to maintain the purchasing power of your savings.

Most recently we invested in Dollar General (DG). For some time we've followed this company as a comparison to Family Dollar (FDO) which we have owned in the past (although not at present). DG has better sales per square foot, operating margins and growth than FDO, but in recent months its valuation has slipped to where it's now comparable to FDO. These businesses tend to hold up fairly well during tough economic times and although DG is weaker today following its earnings release we think it represents an attractive investment.