

WHY STOCKS WIN

December 2008

Since the credit crisis and ensuing panic struck markets around the world, we have repeatedly voiced the historic fact that stocks have always come back (usually unexpected at the time). Stocks have proven to be a reliable vehicle to stay ahead of inflation. This commentary explains why that has been the case. It also details our belief that staying the course is a wise move for any investor. We let the speculators worry about picking a bottom while we remain confident we will catch the bottom and recover if we stick to our long-term plans and give it enough time.



To illustrate, imagine starting a business. In order to do this, you will need capital to start and fund operations until earning profits. You have two choices for getting this money: borrow it or use your own assets. If you borrow, the lender will expect to receive a return for lending you the money, in the form of interest. As the owner, you keep the profits—the amount of which is affected by how much interest you paid, i.e. your cost of capital. If you did not anticipate your business would cover this, chances are high that you would not start the business on those terms. In other words, you have an expected return that must exceed your cost of capital.

If you have money of your own, you can forgo a lender to start your business. You would only do this if your expected return exceeded the expected return of other alternatives. You would compare your expected return to the cost of capital the lender offers you to the expected return from becoming a lender yourself (buying fixed income investments like CD's or bonds). You would also consider the expected return from buying an interest in other businesses, through purchasing stocks. In all cases, an expected return drives the decision-making, and the selection has an expected return that should be greater than the alternatives. This same decision-making process exists for all companies as they decide on new projects, products, advertising, expansions, and other expenses.

This sounds rational, yet market behavior is anything but rational at times. The key word is "expected". Expectations and perceptions change quickly with every piece of new information, thus causing stock prices to change quickly. Lately, stock prices have rapidly decreased.

Lenders only make money if paid back properly. They assess the risk involved in funding your operation: the higher the risk, the higher the cost of capital. Lenders will deny funding if the perceived risk is too great. If a business does fail, lenders are first in line to receive proceeds from the sale of the business' assets. The owner is last in that line.



By owning bonds, you become a lender. If the market perceives the entity you loaned to will have difficulty repaying debts, the market value of your bonds will drop. Consequently, that party will have to pay a higher price to borrow additional funds. Their cost of capital has increased and so has the expected return to stockholders. There is not any

un-owned stock; each share of stock is owned by someone. Stockholders with lower expectations can sell their stock, but the new owner has an expected return. The expected return exceeds that of bondholders to compensate for the risk of being last in line.



The current credit crisis exists because lending froze up in response to the perceived risk. Efforts to end the crisis have centered on lending institutions and improving confidence in lending for this reason. Lenders only make money if they loan to parties that pay them back. Not loaning money is as deadly as loaning to those who do not pay back properly. The owners (stockholders) of the lending institutions want the lenders to lend because it will lead to profits, which is the source of the owners' expected returns. The freeze will eventually thaw.

Markets come back because the expected return starts to look attractive. Actually, markets often go up simply in anticipation that profits will go up and realization of the higher expected returns will occur. This is hardly a smooth process where added risk comes into play.

The quest for profits is how stocks stay ahead of inflation. As the costs of raw materials, services, wages, and other factors rise, only stockholders have the ability to react to these inflationary pressures. The owners will look to do whatever they can to keep generating profits. They can cut costs, improve efficiency and raise prices, among other things. Bondholders, on the other hand, have no ability to affect their future return. They get a maximum of only the fixed interest payments and a maturity value promised from the bond. You can see just how striking this difference is in the table below. Government bonds are considered free from the risk of repayment failure.

Percent of periods since January 1926 where return beats inflation:

	1 Month US Treasury Bill	5-yr Gov't Bond	20-yr Gov't Bond	S&P 500 stocks
1yr	64	65	62	69
5yrs	62	70	57	77
10 yrs	63	71	55	87
15 yrs	68	72	51	94
20 yrs	68	72	46	100

Data derived from Center for Research in Securities Prices, University of Chicago.

Moreover, the average return, pre-tax, over inflation for ten year periods of time, were .32% for T bills, 1.82% for 5-yr bonds, 1.84% for 20-yr bonds and 7.24% for the S&P500.

Past results do not guarantee any particular result. We don't know what we will get going forward, but owning stocks for the purpose of generating spending in future years has been, and should be, the most prudent strategy. The longer the time frame, the better. Bonds are generally superior to stocks for current income and relative stability. They make a wonderful choice for short-term goals, like spending in the next few years.

Stocks, by their nature, are riskier than bonds and thus have a higher expected return. There is significant risk in being an owner. Many businesses fail every year. This is a highly imperfect, often maddening process, full of anecdotes that seem to contradict the underlying fundamentals. Many failed businesses were good businesses run by good people. In the aggregate, however, capital flows where it is rewarded. By owning broadly diversified stock holdings, it mitigates the risk of the market's perception of a particular business' struggles or possible failure, yet it allows us to participate in the higher expected returns over time. We tailor each client's portfolio with a mixture of stocks and bonds to manage a variety of risks and find a balance between shorter and longer term goals.

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