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The Right Place to Be

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If history serves as our guide to the future, we're in for a rough road. This may not be the news you'd care to hear as we work our way through 2010, but it is likely. Fortunately too, it is likely temporary.

In 1912, Woodrow Wilson was elected President of the United States. In his first year in office, he was supportive of and instrumental in passing two largely irreversible and unquestionably controversial pieces of legislation. The first was the passage of the Federal Reserve Act in 1913 which created the central banking system we have today. The Act was a half step toward creating a banking system which was controlled at the Federal level, as opposed to a system which was monitored at a state level. It also laid the groundwork for the eventual delinking of the dollar from the gold standard, which turned the dollar into a fiat currency – money without real value – and allowed the Federal Reserve to become the "backer" of our bills.

The second, and equally impactful piece of legislation, was the passage of the 16th Amendment to the Constitution which established the progressive income-tax system we have in place today, and allowed the Federal government to tax individuals directly. Prior to this Amendment, the Federal government had to assess taxes to the states individually, based on census data, and it was then the responsibility of the states to assess and collect taxes from their individual constituents. Without the encumbrance of working through the states to collect tax revenue, the Federal government would find it much easier to raise taxes as needed to support Federal projects and initiatives.

Wilson, who viewed the Constitution and our government system as outdated, took pride in the passage of both instruments which drew power from the states, concentrated power at the Federal level, and which set the tone for Wilson's term in office. During his presidency, the stock market lost almost 40% of its value, and Wilson's term ended in 1920 with an economic depression which stretched into 1921, and which saw unemployment rise to over 12%.

The correlations between then and today are striking – we have markets, both stock and real-estate, which have lost a tremendous amount of value, we have high unemployment, and most recently, we have a White House and Congress which have again supported and passed legislation in the banking and healthcare areas which are considered by many to be irreversible and controversial, and which again concentrates more power at the Federal level. However, the most important correlation between these two periods relates to the American state of mind while these events were unfolding – it all has to do with perspective.

History has shown us that when the American people are concerned about their futures, more restrictive policies, more regulation and a greater push to concentrate power at the Federal level leads to a depressed economy and market. In 1912, our country went from a period of relative freedom to one of relative restriction, which was not received well economically or marketwise. The relative change was disappointing to Americans on the whole, and Americans reacted accordingly. The same can be said of today, with the change from relative freedom to relative restriction.

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On the contrary, a relative change in the other direction is generally well-received. Wilson's presidency was followed by the presidencies of Warren Harding and Calvin Coolidge, who cut taxes, reduced the size of government and cut the national debt by emphasizing low government spending. These changes, from relative restriction to relative freedom, were well-received by Americans, ushering in one of the greatest periods of American prosperity in history. The "Roaring 20's" were dominated by a stock market which grew by almost 200% in eight years, with Americans enjoying an unemployment rate under 3%.

Other periods can also be used to set this example, such as the difficult economic struggles of the 70's giving way to the prosperity and growth of the 80's, and they also have in common the same facts – that restrictive Federal government controls drive markets, economies and American dispositions down, and the release from those encumbrances, freer markets, less regulation and less political corruption and manipulation drives markets, economies and the American spirit up.

The goods news is that despite the troubled times we have had as a nation over the years, the spirit of American citizens has shown the resolve to persist, and eventually thrive, out of those challenges, bringing prosperity and opportunity to a new generation of people. Unfortunately, we are nowhere near that point yet, and until we get there, we can expect a very difficult economic and market environment.

This brings us to that question, if times are going to be tough, as investors, where is the right place for us to be? The answer is relatively straightforward… almost anywhere, if you have a very long investment horizon. The reality is that the only element of control an investor has is in managing the opportunities and risks they expose themselves to, which holds equally true for individual investors and professional money managers alike. Empirical studies have shown this to be the case, consistently and conclusively. As investors, we have the greatest opportunity for investment success when we invest for the long term – ten to twenty years or more – when we buy investments at a discount to what we think they are worth, and when we give ourselves exposure to good ideas and companies and disassociate ourselves from poor ones. Furthermore, money managers cannot manufacture superior returns for clients, despite what they may say, which is especially true in very tough market environments. About the best that can be accomplished is for an investor to expose themselves to risks which make sense, and to minimize exposure to risks which do not, and then let the markets give them what they will. If the markets in general aren't going to give much, investors cannot, and should not, expect much.

The most likely scenario from here is that this depressed environment will persist, and could persist for years, until there comes another point where the American people feel a relative, but important shift in their current condition toward the positive. This also means that investors shouldn't expect significant positive returns from their portfolios during this time, and should concentrate on buying relatively stable investments with solid income and predictable growth prospects. It also means, though, that for investors with longer time horizons, the long future is looking potentially very bright. Historically, investors who could stomach investing in more troubled times, and who emphasized buying good companies at good prices during those periods, were also the people who realized the most significant growth in asset values when the good times came back around.

For investors today, that means being selective, but consistent, in putting money to work today, knowing that the fruits of those labors may not pay off for some years to come. If, however, you believe that the U.S. will recover and thrive eventually, as it always has, that's the right place to be.