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Seeking Shelter From the Storm

Overview: Investors seeking shelter from the current market storm may be tempted to try to bet on the next winning investment sector. The following discusses why such a strategy may not be in investors' best interests.

Many investors may be seeking safe havens from the current market storm. Others may be looking for those “diamond in the rough” stocks or investing sectors that will get their portfolios back on track after such a devastating period. Perhaps lessons from the Great Depression can provide such investing insights.

As luck would have it, there is one sector that produced significant returns in the three years following the market crash of 1929. Those looking for that safe haven may want to get ready to jump into ... logging.

In a February 14, 2009 article in *The Wall Street Journal*, columnist Jason Zweig teamed up with the Center for Research in Security Prices (CRSP) to see how various investing sectors performed 1930–1932 (after the stock market had lost one-third of its value in the crash). Logging was the only industry to post positive returns during that time period with a cumulative gain of 40 percent. It should be noted that the sector contained two stocks: one company that made trees into packing materials and one that turned timber into matchsticks.

It is doubtful that many investors would have pegged the logging industry as being the mostly likely to rebound from portfolio devastation of the Great Depression, which is why remaining diversified is likely to prove to be the right strategy for investors. History has continued to show that rebounding returns come from some unexpected places. Consider some more recent evidence.

In the year following the 1987–1989 bear market, the top performing market sector was financial stocks, returning 64.9 percent in the 12 months following the trough of the preceding bear market. Of course, investing in financial stocks in this market may seem more like holding a lightning rod to the sky than ducking out of the downpour.

Similarly, the year following the 2000–2002 bear market saw information technology stocks rise up as the top performing investing sector. At that point in time, investing in technology-related stocks would likely have been a difficult call for many investors, as technology stocks are typically blamed for that bear market in the first place.

History has shown that market rebounds typically come quickly, and the top performing sectors are often unidentifiable. Some investors may still scramble to find the perfect place to park money until the storm passes. Few (if any) can know when markets will recover and what sectors will lead the way. And history has also shown that those who do make such correct predictions are more likely to be lucky than good.

According to the historical evidence, trying to pick winning stocks and time the market is more likely to lead to investors lagging the returns of the market, rather than outperforming them. Consider the evidence by *Timer Digest*, which tracks buy and sell calls from financial newsletters. The publication showed that of the 112 market timers tracked from 1991 through 2000, only one managed returns that beat the S&P 500 Index.

If that is not enough, consider the story of Benjamin Graham, considered one of the finest stock pickers to walk the earth.

The Father of Security Analysis

Graham wrote two books — *Security Analysis* (first published in 1934) and *The Intelligent Investor* (first published in 1949) — that are still considered among the finest investing books ever written, even today. Warren Buffett summed up *The Intelligent Investor* by simply calling it, “By far the best book about investing ever written.”

Graham's basic investing philosophy was to thoroughly analyze stocks and to only buy stocks once they were considered dirt cheap. This underscores the premise that working hard enough at analyzing stocks will eventually produce superior returns.

However, Graham seemed to recant this stance shortly before his death in 1976. Here's what he told *The Journal of Finance*: “I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. This was a rewarding activity, say, 40 years ago, when *Security Analysis* was first published; but the situation has changed. I doubt whether such extensive efforts will generate sufficiently superior selections to justify their cost.”

In an article in *Slate* magazine, Henry Blodget said that Graham's words reflected a more diversified and high-level stock selection strategy, rather than attempting to pick individual winners or sectors. “Specifically, Graham recommended screening stocks using simple valuation and fundamental criteria and then buying large groups of them, the same way a modern ‘passive’ fund (such as a value-oriented index fund) does. What Graham did ‘recant’ was the idea that by studying companies in detail, one could identify a few super-promising opportunities that could safely deliver market-crushing returns.”

Summary

During difficult market conditions, many investors may be tempted to seek out the fast-recovering sectors in hopes of getting their portfolios “back on track.” As history has shown, the odds of choosing the right stocks or sectors are slim and largely based on luck. Even investing legends such as Graham recognize the fallacy of trying to pick the next winners. The preferred strategy for investors should be to remain diversified.

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