



## Recessions and Resilience

As advisors, we expect periodically falling markets, and we do our best to set the expectation for all our clients that they will have to live through them. To that end, we make extensive use of the FinaMetrica system, which puts historical risk and return data into charts that can help clients see: what have been the worst losses in a portfolio like mine in the past? how long has the portfolio taken to recover? what kind of rate of return has an investment mix like mine garnered over the long term?

Each client makes the decision: how much of their portfolio to place in low risk/low return assets like cash and bonds, and how much in high risk/high return assets like stocks. We use historical market data to help clients understand the risk/return tradeoff between these asset types. The historical data is clear: over the long term, despite numerous sharp and severe bear markets, and significant volatility along the way, stocks have significantly outperformed less risky assets, such as bonds, and the long term trend of the US economy, and hence the stock market, has been inexorably: up.

All well and good, until you ask yourself: could this time be different? is there something worse about this recession, this economic crisis, and this bear market? will we recover as fast or as strongly as we have in the past?

We have been struck by the number of Americans who appear to be losing faith that the answer to that last question is likely to be yes. There's probably a host of reasons for that, one of them being that this feels like the first economic crisis for many people.

Our last severe recession was in 1982, 27 years ago, and many people we're talking to had not yet accumulated much in the way of financial assets, or were working in a field unaffected by that recession (incidentally, I remember that recession fairly well, as I graduated from college in 1983, right into double-digit unemployment numbers, and grew up in West Virginia during the time that steel plants and factories were closing in large numbers, resulting in the "Rust Belt").

In a recent article, *The New York Times*' David Leonhardt posits additional reasons why public opinion surveys show Americans to be less optimistic about the economy now than they were back then:

*"First, the economic expansion that just ended wasn't as good as the 1970s expansions. The '70s get a bad rap, and deservedly so in many ways. But median family income still rose 2 percent during the decade, after adjusting for inflation. Over the past decade, it has fallen."*

*Second, people seem to understand that the worst is yet to come - that the economy has not yet worked off its excesses."*

Ground zero for those excesses is our financial institutions. We don't expect our banks to take on excessive risks. Hedge funds, sure, but Washington Mutual Bank? Surely that's part of reason this crisis is difficult to take. The banking system, our foundation, is requiring massive amounts of federal aid to remain viable, and on top of that, we've had a stream of dubious behavior which doesn't have an economic impact but does have a psychological impact: ranging from the stupid -- John Thain's \$1.2 million remodel of his Merrill Lynch office in the midst of that company's meltdown -- to the criminal -- Bernard Madoff's theft of billions of his investors' dollars.

The question is: assuming we can fix the current mess, are the housing bubble and subsequent financial crisis symbols of something weak or rotten in our system? Do they tell us something about the long term outlook for our economy? For a strong vote of confidence in this country's future, I recommend Fareed Zakaria's *The Post-American World*, published last year. Zakaria is the editor of *Newsweek International*, and a frequent contributor to the domestic version of the magazine. The title is provocative, but his thesis is that paradoxically, the US is well positioned to benefit from a world in which power is shifting away from US dominance. He reminds us of our strengths:

- a first-rank university system that teaches the best and the brightest to think, not just to take tests
- an individualistic culture that generates ideas and innovation, which will be the source of tremendous economic power in an increasingly global economy
- a demographically vibrant population
- a uniquely attractive set of ideals that people all around the world want to emulate

He provides a useful reminder:

*The United States has a history of worrying that it is losing its edge. This is at least the fourth wave of such concern since 1945. The first was in the late 1950s, a result of the Soviet Union's launch of the Sputnik satellite. The second was in the early 1970s, when high oil prices and slow growth in the United States convinced Americans that Western Europe and Saudi Arabia were the powers of the future, and President Nixon heralded the advent of a multipolar world. The most recent one arrived in the mid-1980s, when most experts believed that Japan would be the technologically and economically dominator superpower of the future. The concern in each of these cases was well founded, the projections intelligent. But none of these scenarios came to pass. The reason is that the American system was proved to be flexible, resourceful, and resilient, able to correct its mistakes and shift its attention. A focus on American economic decline ended up preventing it.*

Here's to working towards that result once again.

--Therese Govern. Posted 02/16/2009.