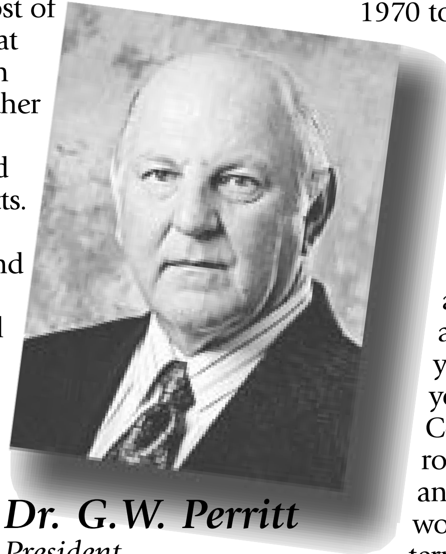
From the Desk of Doctor Gerald W. Perritt

Lessons from History

Although government statisticians have yet to call the current economic environment a recession, it sure feels like one. My neighbors complain about the high cost of gasoline and tell me that they are cutting back on their expenditures in other areas. Some are beginning to become worried about their job prospects. The price of a barrel of oil has topped $133, and farmers have diverted food production to fuel production. In addition, a rising standard of living in China has increased the worldwide demand for meat and poultry. The result has been a spike in prices at the grocery store.



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It now costs a lot more to fill my gas tank and my belly. Furthermore, both my house and my stock portfolio are worth far less than they were a year ago. Thus, rising food and energy prices have taken a bite out of my current income and falling asset prices have taken a bite out of my wealth. It's of little wonder that consumer confidence has plummeted in recent months. If it were not for the fact that I am a student of economic and stock market history, I too would be getting depressed.

With consumer prices on the rise and the economy weakening, I have begun to hear pundits bandying about the dreaded word "stagflation." I have not heard that word since the 1970's. Back then, inflation soared to a double-digit annual rate. Oil prices spiked, gold and silver prices headed into the stratosphere, and the unemployment rate in the Midwest rose to levels not seen since the Great Depression. Furthermore, from the beginning of 1970 to the end of 1979, the large-cap dominated Standard & Poor's 500 Index provided a paltry 5.9 percent average annual return consisting of 1.6 percent annual appreciation and a 4.3 percent average cash dividend yield. During that 10-year period, the Consumer Price Index rose by 7.4 percent annually. In other words, in after-inflation terms, stock market investors lost an average of 1.5 percent a year.

What novice investors fail to realize, the decade of the 1970's was an excellent time to be invested in small company stocks. According to *Ibbotson SBBI*, a highly regarded chronicle of historical investment returns, small company stocks provided an 11.5 percent compound annual return during the entire decade. Furthermore, during the five-year period following the 1973-1974 bear market, small company stocks returned an average of 39.8 percent per year. Thus, despite a prolonged economic slowdown and surging consumer prices, small company stocks provided some of their best returns in modern history.

According to statistics kept by the National Bureau of Economic Research, the U. S. economy experienced 20 economic recessions since 1900. (The

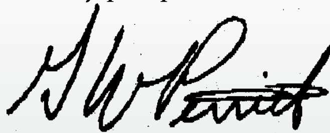
NBER defines an economic recession as two or more successive quarters of economic decline.) In other words, the U.S. economy experiences a period of economic decline, on average, once every eight years. During my working lifetime, I have experienced six economic recessions. From peak to trough, the longest period of decline persisted for 43 months (from August 1929 to March 1933), the shortest lasted only six months (from January through July 1980). The average length of the last 20 economic recessions was 14 months. The 11 economic recessions that have occurred since the end of World War II have been relatively mild. The two longest periods of decline lasted 16 months. Eight lasted less than one-year. The latest period of decline lasted eight months (from March through November 2001).

Most stock market investors fear economic recessions, and for good reason. During the typical recession, the unemployment rate rises, incomes decline, and consumers rein in their purchases of goods and services. As a result, corporate earnings and price-earnings multiples fall, and stock prices plummet.

Bear markets are indeed painful. When the pain becomes too much to bear, many investors dump their shares and head for the safety of money market instruments. History indicates that this usually occurs near the mid-point of an economic recession. What these investors fail to realize is the fact that every recession-induced bear market since the end of World War II began before the onset of the recession and ended at or near its mid-point.

In other words, when recession-induced bear market pain is greatest, the market is likely on the verge of a significant upturn. Furthermore, during the two years following the mid-point of economic recessions, stock prices have historically garnered average annual returns that are significantly greater than their long-term average. Although I too experience pain as I watch my wealth decline during an economic recession, I rely on my knowledge of history to ease my pain.

Of course, the future is not a mirror image of history. However, those who fail to heed history may be doomed to repeat it. History tells me that bear stock markets do not last forever. History also tells me that stock prices begin to decline before the onset of economic recessions and begin to head higher at the mid-point of an economic recession. It also tells me that the best time to add to ones portfolio may be during periods of stock market price declines. Finally, history also tells me that small company stocks can not only survive periods of stagflation, they can actually prosper.



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Past performance is not a guarantee of future results.

Opinions expressed are those of Dr. Perritt and are not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

Dr. Perritt received a doctorate in finance and economics from the University of Kentucky in 1974. He has taught courses in investments and finance at a number of colleges and universities and has authored several books on investing. Dr. Gerald W. Perritt shares the portfolio management duties of both the MicroCap and Emerging Opportunities Funds with Michael Corbett.

The Price to Earnings (P/E) Ratio reflects the multiple of earnings at which a stock sells.

The S&P 500 Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. You cannot invest directly in an index.