The *Investment* House LLC

The Investment House Quarterly: March, 2015

Index %	Q1 2015	2014	2013
S&P 500	+0.95	+ 13.69	+32.39
Barclays US 20+ Yr Treasury	+4.19	+27.48	-13.88

Source: Morningstar

Does the future of the economy matter to investment returns?

Many managers, in an attempt to quiet the understandable fears of their clients, reply, "In the long run, everything will work out," – or something akin to it. They cite the average positive returns to stocks over a long period of time, note that even the sharpest market drops have eventually been not only recovered, but exceeded, and counsel not to worry.

Our answer is somewhat different: *Of course the economy matters!*

The problem is *not* that the direction of the economy does not matter to investment results, but that 1) it is nearly impossible to predict the short term direction of the economy with any accuracy, and that 2) investment returns are often completely uncorrelated with the actual state of the current economy, as markets attempt to look into the future and discount future expected returns. So that, even if we could predict the trajectory of the economy, it would be very nearly impossible to predict the trajectory of stock market returns.

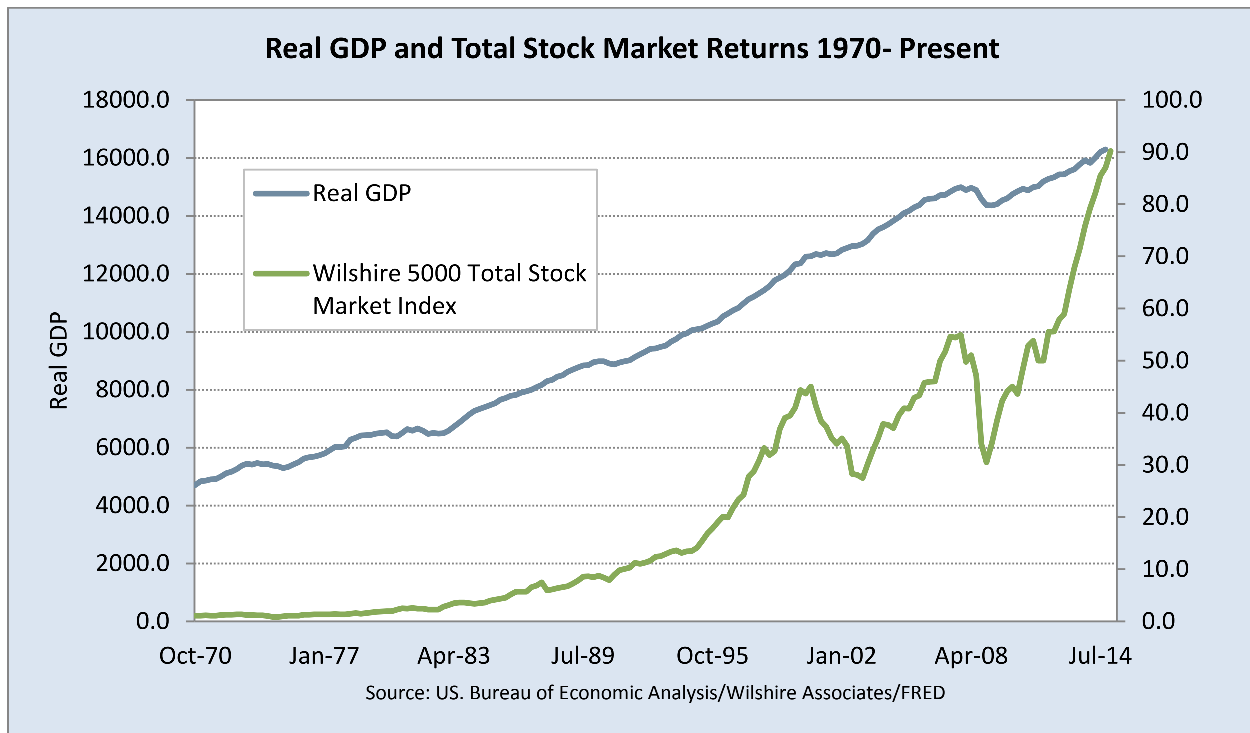
As CBS News.com pointed out:

- *The majority of economists didn't "predict" the three most recent recessions (1990, 2001 and 2007) even after they had begun.*
- *In November 2007, economists in the Philadelphia Federal Reserve's Survey of Professional Forecasters called for growth of 2.4 percent for 2008, with only a 3 percent chance of a recession, and only a 1 in 500 chance of the GDP falling by more than 2 percent. GDP actually fell 3.3 percent.*
- *Since 1990, economists have forecasted only two of the 60 recessions that occurred around the world a year in advance*

The article cites Jan Hatzius, Goldman Sachs' chief economist on the difficulty of economic forecasting: "Nobody has a clue. It's hugely difficult to forecast the business cycle. Understanding an organism as complex as the economy is very hard."

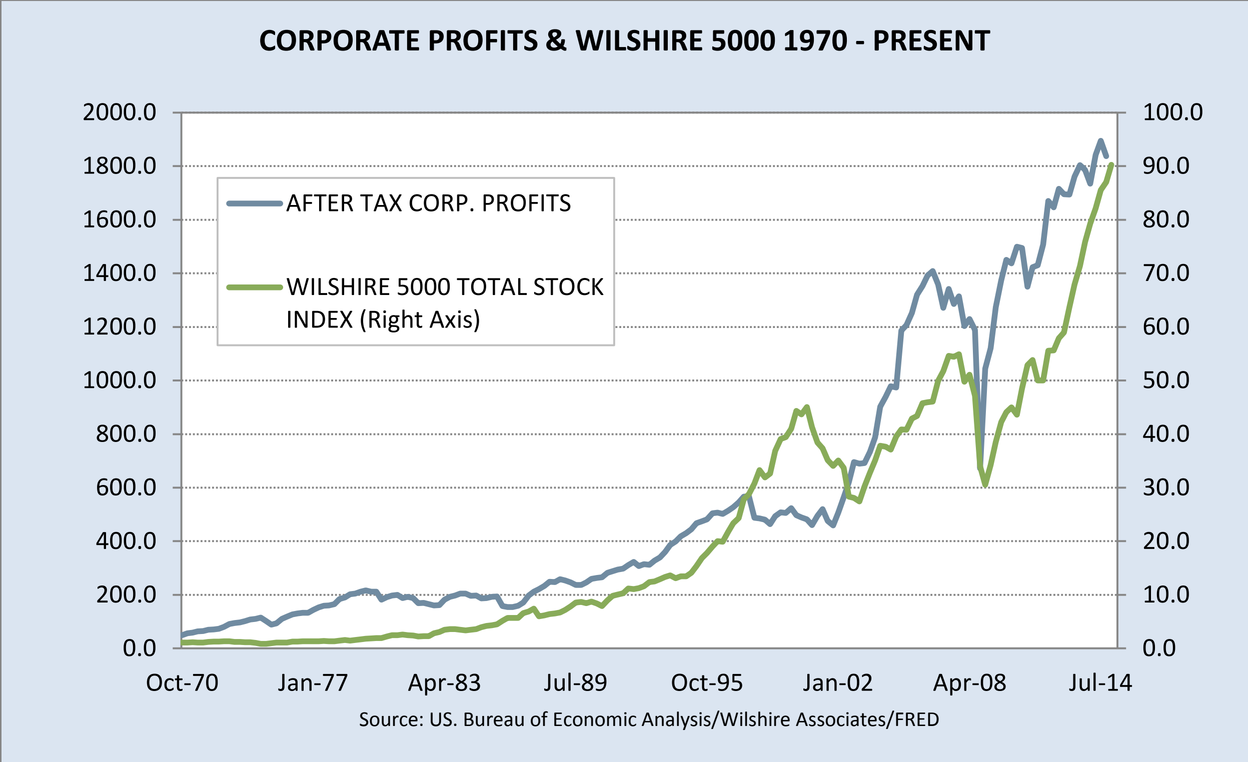
As if that weren't enough, the relation between the economy and the stock market is even more treacherous.

The two charts below point this out.



As the first chart shows, since 1970, the returns to stocks have been vastly more volatile than has been the growth of the economy.

Now, when we look at the chart on the next page, we see not only are corporate earnings more volatile than the overall economy, but that stock prices often move in the *opposite direction* to those earnings. While over a long period of time, they move in the same direction, there appears to be no hard and fast rule as to the relation between economic growth, corporate earnings, and the level of stock prices in the short run.



What is the solution?

Our answer, at The Investment House, is to focus on the things we can analyze with a greater degree of confidence – the strength, growth, and valuation of individual businesses which are likely, in our view, to drive economic growth more than average. To be sure, this is no easy task either. But for any given level of economic growth, we would rather focus on those companies which can demonstrate superior returns in their own, growing industries, than to attempt to estimate the direction and timing of the overall economy, partly because, even in down economies, there are always some industries and some companies which are growing, and we attempt to find those in all economic environments and to thereby grow our capital accordingly. We take the view, not that it is a stock market, or a market of stocks which matters, but that it is a market of real businesses, some small portion of which have the enduring profitability, managements, and valuation we really want to own.

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