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## Making Money with the Market's Buffett

In 1999, Warren Buffett was interviewed by Fortune magazine and discussed his thoughts on the stock market and how it might do over the next 17 years. It was, to put it mildly, a dour assessment. His views were triggered by surveys showing an unusually high level of expectations and confidence among both new and experienced investors. As we look to the future, it's a good time to review Buffett's thoughts from the second half of 1999.

Based on his historical analysis of the U.S. stock market, Buffett concluded that stocks could return 4% per year on average including dividends (+2%) and adjusted for inflation (-2%) from November of 1999 to November of 2016. This compares to around an 8% real return earned from 1926 to today. Buffett said that if he were to be wrong, he'd guess the actual results might be lower than 4%. Here is how he arrived at his forecast.

First, the crowd psychology was all wrong. In July 1999, UBS Securities found by surveying experienced clients that they expected a 12.9% return over

the next five years and less experienced clients expected 22%. Buffett described this as "rearview mirror" investing. The prior five years had provided very high returns (abnormally high) and investors were extrapolating those results forward.

Second, Buffett acknowledged that the prevailing interest rates on relatively low risk investments like treasury bonds and notes have a great deal to do with pricing the future profits of common stocks. If the interest rates are high on low risk investments, investors feel there is no need to take risk. However, when the prevailing interest rates decline, payment

of future profits are worth more to investors. Between 1964 and 1981 the Gross Domestic Product (GDP) of the U.S. grew 370%, but investors preferred inflation protection and earning interest as rates went higher and higher.

Third, corporate profitability as a percentage of Gross Domestic Product (GDP) is an important variable. When profitability rises over long stretches of time, stocks can get more popular and when profitability falls, stocks can lose popularity. Profits as a percentage of GDP bottomed at 3.5% in 1982 and rose dramatically over the next 17 years during a period of great stock popularity.

Today the U.S. stock market is sitting about 5-10% below where it was when the original interview was printed in November of 1999. The first question for us is, "how will we do going forward if his 17-year prediction comes true?"

The second question is, "have those three important variables changed since then to affect his prediction?"

The good news isn't that we saved a bunch of money on our car insurance, but that Buffett's 1999 prediction was for the S&P 500 Index to hit 2900 by November of 2016. From where we are today, around 1300 on the S&P 500 Index, it would be a gain of 115% in the remaining 8-plus years or somewhere close to 9% per year appreciation. This could exceed the historical 8% norm.

The variables that he felt could change the outcome of his prediction also paint a positive picture. The crowd psychology of the stock market is about as favorable as it can get because the expectations

of investors are as low as at other major market bottoms. First, looking backwards in the rearview mirror for four, five and eight

years makes an investor wonder if there is any money to be made owning quality U.S. companies. Second, individual investors have panicked out of the market for the last 60 to 90 days and the American Association of Individual Investors weekly poll recently showed their members are the most

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negative they've been in 20 years (the direct opposite of 8 years ago). Third, a major investment firm survey showed that the big money institutional investors are as negative as they have been anytime in the last

7 years (including right after the 9/11 attacks).

Fourth, among the historically smart money crowd, the market-making specialists on the New York Stock Exchange

(NYSE) are selling short the least amount of stock as a percentage of overall short sales in 40 years, officers and directors of publicly-traded companies are buying at record levels and wealthy billionaires like Buffett, Wilbur Ross, Warburg Pincus and Sandy Weill are buying bargains like mad men.

Interest rates on Treasury Notes and Bonds are well lower than they were in November of 1999 (2-year notes around 1.8% versus 5% and 10-year bonds at 3.6% versus 6% in 1999). This indicates to Buffett that the future profits of the companies should be valued more highly because of a less competitive

risk-less rate and a lower discount rate for computing present value.

The profitability scorecard shows a

mixed picture. Companies have been much more profitable since 1999 than Buffett expected, but those profits are high in relation to GDP, which argues that profits growth will be harder to come by in the future. However, in 1999 Buffett pointed out that there was much more economic growth between 1964

and 1981 (370%) with lousy stock market results. We assume at this point that the cyclical industries (Oil, Basic Materials and Heavy Industrial) which are enjoying record profit margins will see profits and margins recede through this business cycle. Simultaneously, the financial service companies are reporting the fallout from the “sub-prime debacle” and the combination of the two sector profit margin declines (cyclical and financial) could quickly drive the ratio of profits to GDP back to a comfortable zone. As we have seen in the market-place, “what the Lord giveth, the Lord taketh away.”

Let me tie it all together. Warren Buffett correctly predicted a difficult 17-year stretch in the stock market back in November of 1999. Based on his prediction and the variables which he felt would most affect it, we feel the next 8.5 years could be an excellent period for the kind of large capitalization recession-resistant stocks we like to own; even if his dour prediction comes true. Buffett followed his teacher, Ben Graham, who taught him the concept of “margin of safety” and we believe our participation going forward has one. We look anxiously and positively to the remainder of 2008 expecting our scenario could play out in the marketplace. ■

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